Uniform
Commercial Code
Law Journal

Vol. 42, No. 2 **February 2010**

Published in coordination with the Penn State Dickinson School of Law

Foreclosing on Collateral That Includes Intangible Rights

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This article first appeared in the UCC Law Journal, Volume 42, No. 2 (February 2010), published by West.

Mat #40698091

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*John Karesh is a shareholder at Vedder Price P.C. The views expressed in this article are those of the author and do not necessarily reflect the views of Vedder Price P.C. on any of the matters addressed herein. The author gratefully acknowledges the assistance of Erin Zavalkoff-Babej, a former associate at Vedder Price P.C., in the preparation of this article.

I. INTRODUCTION

Issues faced by a secured party in foreclosing on its collateral are particularly troublesome in leveraged lease[1] or other secured transactions in which the collateral includes intangibles such as the rights of a lessor under a lease of personal property and the right to file a proof of claim against a lessee that may be appropriate if the lessee files a petition for relief under the bankruptcy code, 11 U.S.C.A. § 101 et seq. (the "Bankruptcy Code"). This article will discuss two recent cases in which such issues were adjudicated and certain of the implications of the holdings in those cases. Although both these cases involved the leveraged lease financing of commercial aircraft, many of the issues discussed in this article are relevant to other equipment finance transactions in which an equipment lease and intangible rights arising under such a lease are part of the collateral.

II. IN RE NORTHWEST AIRLINES CORPORATION

1. COURT HELD THAT SECURED PARTY COULD NOT FILE A PROOF OF CLAIM AGAINST BANKRUPT LESSEE BECAUSE SECURED PARTY HAD NOT FORECLOSED ON LEASE RIGHTS

The decision in *In re Northwest Airlines Corporation*[2] involved a dispute between the owner trustee and the indenture trustee in a leveraged lease financing transaction[3] concerning which of them was the proper party to assert a

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[1] In a typical leveraged lease transaction, a lessor acquires equipment for lease to a lessee. The lessor borrows the majority of the acquisition cost of the equipment from a lender. The lessor secures repayment of the loan by granting a security interest in the leased equipment and all its right, title and interest in the lease including the right to receive rent and enforce the lessor's rights against the lessee in case the lessee defaults under the lease. Rent payable under the lease is generally assigned to the lender and is dedicated to pay the amounts due in connection with the loan. Because the continued payment of rent by the lessee is central to the success of the loan transaction, a default under the lease by the lessee usually constitutes a default under the loan documents.

[2] In re Northwest Airlines Corp., 383 B.R. 575 (Bankr. S.D. N.Y. 2008).

[3] In the leveraged lease transaction in *Northwest*, Wilmington Trust Company as owner trustee owned the aircraft in trust for the benefit of an equity participant, and leased the aircraft to Northwest Airlines. In its capacity as owner trustee, Wilmington borrowed money from a group of lenders whose interests were administered by Wells Fargo Bank North-

claim against Northwest Airlines, the lessee, in its Chapter 11 case for damages arising out of Northwest's breach of the lease.

The claim crystallized when the Bankruptcy Court approved Northwest's motion to reject the lease and entered a "rejection and abandonment order" dated October 18, 2005, which made the rejection of the lease by Northwest and its abandonment of the aircraft effective as of October 7, 2005.[4] In the wake of this order, on January 31, 2006, the indenture trustee served the owner trustee with an acceleration notice, stating in substance that (a) as a result of Northwest Airlines' chapter 11 case, the lease is deemed to be in default and, as a result of continuing defaults, the indenture trustee terminated the lease, reserving all of its rights and remedies under the operative documents and applicable law, and (b) the outstanding loan certificates were immediately due and payable.[5] According to the decision, the acceleration notice defined the collateral to include "the Aircraft, the Lease and the *other contents of the Indenture Estate*."[6] The acceleration notice stated, however, that the indenture trustee intended to sell only the aircraft by public sale.[7] Notice of public sale for the aircraft was subsequently published in several aviation periodicals. Those published notices described the property being sold as "all of the . . . *Owner Trustee's estate, right, title and interest* in and to the following assets and properties pledged by the . . . Owner Trustee to the Secured Party under the Trust Indenture, *including without limita-*

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west, N.A. as successor indenture trustee. To secure repayment of the loans, Wilmington, as owner trustee, granted to Wells Fargo, as indenture trustee, a security interest in the aircraft and the lease and "certain other collateral." *See* Northwest, 383 B.R. at 577. A review of the record in the proceedings before the Bankruptcy Court reveals that, more specifically, the collateral included the aircraft, the lease and all rent payable thereunder, all rights of the owner trustee to execute any election or option or to give any notice, consent, waiver or approval under or in respect of the lease or to accept any surrender of the aircraft "as well as any rights, powers or remedies on the part of the Owner Trustee, whether arising under the Lease . . . or by statute or at law or in equity or otherwise arising out of any Lease Event of Default . . ." and all proceeds of the foregoing.

[4]Northwest, 383 B.R. at 577–78.

[5]Northwest, 383 B.R. at 578.

[6]Northwest, 383 B.R. at 578. (Emphasis added.) Any rights, powers or remedies on the part of the lessor arising under the lease or at law or in equity were included in the Indenture Estate. *See* n.3, *supra*.

[7]Northwest, 383 B.R. at 578.

tion, all of the . . . Owner Trustee's *right, title and interest* in and to the following: One McDonnell Douglas DC-10-30 airplane [there follows a description of the aircraft]."[8]

Thereafter, both the owner trustee and indenture trustee filed proofs of claim for damages arising out of Northwest's breach of the lease.[9] Northwest sought to expunge the owner trustee's claim on the grounds that it was duplicative of the indenture trustee's claim, and this litigation resulted.[10]

The owner trustee took the position that the indenture trustee failed to foreclose on any asset other than the aircraft, and to the extent that the amount of the owner trustee's proof of claim exceeded the balance due on the debt, the owner trustee is entitled to the excess.[11] The indenture trustee argued that the owner trustee was not entitled to any claim arising out of the lease either because the indenture trustee had foreclosed on the lease[12] or because its acceleration notice gave the owner trustee notice of its intention to foreclose on all of the collateral and reserved the indenture trustee's right to do so, and that a subsequent foreclosure notice stated that the aircraft was sold at auction and that all claims against Northwest under the Lease (other than "Excepted Payments" which are typically defined to mean certain amounts such as indemnity and liability insurance payments not assigned as collateral) "have been

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[8]Northwest, 383 B.R. at 581. (Emphasis added.) The public auction sale of the aircraft was held on March 3, 2006. 383 B.R. at 579. The indenture trustee credit bid a portion of the debt and was the winning bidder. 383 B.R. at 579. The owner trustee executed an FAA [Federal Aviation Administration of the United States] form bill of sale with respect to the aircraft that stated that the owner trustee transferred all right, title and interest in the aircraft to the indenture trustee (383 B.R. at 579), and in order to clear title to the aircraft at the FAA, also an FAA lease termination agreement that certified the termination of the lease with respect to the aircraft and that confirmed that the aircraft is no longer subject to the terms of the lease. 383 B.R. at 579. The lease termination agreement further provided that it was intended only to remove the lease from the aircraft registry of the FAA so that the aircraft could be disposed of free from any encumbrance of the lease. The lease termination agreement reserved the owner trustee's rights against Northwest Airlines including specifically "all claims of . . . [the Indenture Trustee] under [the Indenture] . . .." 383 B.R. at 579.

[9]383 B.R. at 580.

[10]383 B.R. at 580.

[11]383 B.R. at 580.

[12]*See infra* note 20.

foreclosed on and belong absolutely to the indenture trustee for the benefit of the Lenders . . . ."[13]

The Court ruled in favor of the owner trustee and found that it was "absolutely clear"[14] that the indenture trustee had not foreclosed on its security interest in the lease or its proceeds[15] and, therefore, the indenture trustee did not "own" the claim.[16] Accordingly, the owner trustee, not the indenture trustee, was entitled to "assert" the claim against Northwest.[17]

We do not comment on the Court's finding of fact that the indenture trustee did not foreclose on the lease or claim rights except to note that the Court was not persuaded that reference in the notices of public sale to "all right, title and interest" in the aircraft included the lease and claim rights, or by the words "including without limitation" as implying a sale of more than the aircraft.[18] The Court said that "it is not difficult to write a foreclosure notice that includes claims under a Lease,"[19] and quoted from a foreclosure notice containing such information that appeared in the *New York Times* on November 15, 2007, with respect to an aircraft leased by Delta Air Lines.[20] That foreclosure notice included specific mention of the lease agreement and damage claims

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[13]383 B.R. at 580–81.

[14]383 B.R. at 581.

[15]Since the lease had already been terminated or at least rejected and the aircraft had been abandoned by the lessee, only lease proceeds (such as the claim rights (*see* U.C.C. § 9-102(a)(64)(C)) remained available for foreclosure on the collateral consisting of the lease. "The Lease was no longer an encumbrance or attribute to the property. At most, it represented a claim for damages against the lessee [Northwest Airlines] for breach, a claim that had to be filed in the lessee's bankruptcy if it was to have any value." 383 B.R. at 583.

[16]383 B.R. at 584.

[17]383 B.R. at 581. The Court also held that the indenture trustee's security interest attached to the proof of claim filed by the owner trustee (383 B.R. at 581, 584), but it is hard to see under the Court's reasoning how the indenture trustee could have exercised control over the owner trustee's proof of claim (for example, by exercising voting rights relating to the claim or selling the claim or even settling the amount and priority of the claim) without foreclosing on that proof of claim.

[18]S*ee* 383 B.R. at 582.

[19]383 B.R. at 582, note 6.

[20]383 B.R. at 582 at n.6. The indenture trustee also argued that the sale of the aircraft included a sale of the lease because the lease consti-

and the lease and claim rights were presumably disposed of together with the aircraft.

2. COMMENTS ON THE NORTHWEST AIRLINES CORPORATION DECISION:

(a) UCC Article 9 Actually Does Not Require Foreclosure for Secured Party to Enforce Assigned Lease Rights and Remedies.

The decision in *Northwest* is noteworthy because it held that the indenture trustee did not have the right to file its proof of claim[21] because the trustee had not foreclosed on the lease or the claim rights and, therefore, the indenture trustee did not "own" the claim.[22] U.C.C. § 9-607(a)(3) suggests a contrary result. That section provides that, if so agreed, and in any event after default, the secured party may notify an

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tuted proceeds of the aircraft under U.C.C. § 9-102(a)(64) and that property subject to an outstanding lease or other encumbrance is ordinarily conveyed subject to that encumbrance, and the buyer is entitled to the benefits and burdens of the lease unless the parties agree otherwise. But the Court distinguished this precedent from the facts of the *Northwest* case because, in *Northwest*, the Court said that the lease had terminated and the lessee had abandoned the aircraft prior to the foreclosure sale (383 B.R. at 583), whereas the precedent is based on the continued existence of the underlying lease at the time of foreclosure. 383 B.R. at 583. Regardless of whether the lease had terminated or had only been rejected in the bankruptcy proceeding, the right to enforce claims against Northwest Airlines arising under the lease continued to exist and had value.

[21] 383 B.R. at 581.

[22] 383 B.R. at 584. There is nothing in the decision to indicate whether the underlying transaction documents authorized the indenture trustee, to the exclusion of the owner trustee or the owner participants, as a matter of contract, to file a proof of claim for lease rejection and other damages if Northwest defaulted under the lease. Clauses to this effect, generally called a shared rights clause, are often included in the documentation of leveraged lease financing transactions. The record before the Bankruptcy Court indicated that § 7.02 of the trust indenture and security agreement provided that if a default under the indenture is attributable to a default by the lessee under the lease, then the indenture trustee may exercise any and all of the remedies provided under the lease "and may take possession of all or any part of the properties covered or intended to be covered by the Lien and security interest created hereby or pursuant hereto and may exclude the Owner Trustee and the Lessee and all persons claiming under any of them wholly or partly therefrom." Although taking possession of collateral does not seem relevant to intangible collateral such as claim rights, this language could support the idea that the indenture trustee had the right to file a proof of claim. A more specific version of a shared rights clause to address this issue is proposed in the appendix.

account debtor[23] to make payment or render performance to or for the benefit of the secured party and:

> may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor . . .. UCC § 9-607(a)(3).

Official Comment 6 to § 9-607 states that "[it] is not necessary for a secured party first to become the owner of the collateral pursuant to a disposition [pursuant to U.C.C. § 9-610] or acceptance [pursuant to U.C.C. § 9-620]."[24] Official Comment 3 to § 9-607 states that this section applies to enforcement generally against all persons obligated on collateral and specifically states that the rights of the secured party under § 9-607(a) include the right to enforce claims that the debtor may enjoy against others. However, a "secured party's rights, as between it and the debtor, to collect from and enforce collateral against account debtors and others obligated on collateral under subsection [9-607](a) are subject to [U.C.C.] Section 9-341 [pertaining to a bank's rights and duties with respect to deposit accounts], Part 4 [of Article 9 pertaining to the rights of third parties to the collateral] and other applicable law."[25]

U.C.C. § 9-607(c) requires that a secured party must proceed in a commercially reasonable manner if it under-

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[23]The lessee was a person obligated on the collateral of the lease and also an account debtor under the lease. "Account Debtor" includes a person obligated on chattel paper or a general intangible. U.C.C. § 9-102(3). A lease is chattel paper under U.C.C. § 9-102(11).

[24]The predecessor to U.C.C. § 9-607 [revised] is U.C.C. § 9-502. Although § 9-607(a)(3) is broader in scope than § 9-502(1), the law surrounding § 9-502 is still useful in understanding § 9-607(a)(3). "UCC § 9-502 provides a procedure for liquidation of intangible collateral separate and apart from UCC § 9-504 [now § 9-610 providing that after default, a secured party may dispose of collateral]." 10 Anderson, *Uniform Commercial Code*, 3d Edition, § 9-502:4 at 300–301. "When intangible collateral is involved, the disposition is governed by U.C.C. § 9-502 and not U.C.C. § 9-504." *Id*. at § 9-502:7 at 302. Clearly, the actions by the indenture trustees in *Northwest* and Bremer Bank v. John Hancock Life Insurance Company, 2009 WL 702009 (March 13, 2009, D.Minn.) (discussed *infra* at pp. 169-174) constituted the enforcement of the obligations of the lessees or the exercise of the rights of the owner trustees as lessors with respect to such obligations and were covered by U.C.C. § 9-607.

[25]Official comment 6 to U.C.C. § 9-607.

takes to collect from or enforce an obligation of an account debtor or other person obligated on collateral *and* the secured party is entitled to charge back uncollected collateral or otherwise has full or limited recourse against the debtor or a secondary obligor. Conversely, if the secured party has no such recourse and is not entitled to charge back to the debtor any uncollected collateral, under U.C.C. § 9-607(c), the secured party is not obligated to enforce its rights against the lessee or other person obligated on collateral in a commercially reasonable manner. Thus, U.C.C. § 9-607(c) appears to shelter a secured lender in a non-recourse financing from liability arising out of claims based on an alleged unreasonable exercise of such rights. This is not to suggest that a secured party is not well advised to act reasonably in enforcing inchoate rights pledged as collateral or at least to act in good faith in the enforcement of a relevant contract.[26]

The obligations (if applicable) of a secured party under § 9-607(c) are among the duties imposed on the secured party that cannot be waived under U.C.C. § 9-602(c). However, U.C.C. § 9-603(a) permits parties to a security agreement to determine, *inter alia*, the standard by which commercially reasonable conduct of the secured party will be measured, so long as the standard is not manifestly unreasonable.

In addition, U.C.C. § 9-608(a)(3) provides that a secured party need not apply or pay over to the debtor non-cash proceeds of collection or the enforcement of rights under § 9-607 ". . . unless the failure to do so would be commercially unreasonable.[27] A secured party that applies or pays over for

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[26]*See* U.C.C. § 1-203.

[27]Section 5.03, clause *three* of the indenture required that any surplus monies in excess of the amount due and payable under the indenture would be payable to the owner trustee. The indenture was submitted as Exhibit A to the Response dated April 17, 2007 of Wilmington Trust Company, as Owner Trustee, and Penta Aviation LLC to Debtors' Twenty-Fifth Omnibus (Tier II) Objection Pursuant to Section 502(b) of the Bankruptcy Code, Federal Rule of Bankruptcy Procedure 3007 and the Order Approving Procedures for the Filing of Omnibus Objections to Proofs of Claim, In re Northwest Airlines, Case No. 05-17930 (ALG), Docket entry 7492. The owner trustee specifically claimed that to the extent the value of its claim against Northwest exceeded the balance due the lenders, such excess should be distributed to the owner trustee. 383 B.R. at 580. The Court may have viewed the argument of the indenture trustee as an attempt to circumvent these provisions regarding surplus recovery. *See* n.33, *infra*.

application non-cash proceeds shall do so in a commercially reasonable manner."[28] U.C.C. § 9-608(a)(3).[29]

"Proceeds" are included in the definition of collateral under U.C.C. § 1-102(12)(A) and include "[w]hatever is acquired upon the sale, lease, license, exchange or other disposition of collateral",[30] "whatever is collected on . . . collateral"[31] and also "rights arising out of collateral."[32] The indenture trustee in *Northwest* argued that the lease was proceeds of the aircraft presumably so that its foreclosure on the aircraft would include foreclosure on the lease and its proceeds. But the indenture trustee in *Northwest* should have had the right to file its proof of claim pursuant to U.C.C. § 9-607(a)(3) without the need for a foreclosure regardless of whether the right was collateral or proceeds of collateral, because U.C.C. § 9-607 does not distinguish between rights that are proceeds from those that constitute the collateral itself.

The indenture trustee's proof of claim had substantial value,[33] and it appears that the indenture trustee sought a ruling from the Bankruptcy Court that it had foreclosed on the

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[28] § 9-608(a)(4) provides that the secured party shall account to and pay a debtor for any surplus. To the extent they give rights to a debtor or impose duties on a secured party, under U.C.C. § 9-602(d) the provisions of U.C.C. § 9-608(a) cannot be waived to the extent they deal with application or payment of noncash proceeds of collection, enforcement or disposition of collateral, and under U.C.C. § 9-602(e) the provisions of U.C.C. § 9-608(a) cannot be waived to the extent they require accounting for or payment of surplus proceeds of collateral.

[29] *See* U.C.C. § 9-603(a).

[30] U.C.C. § 9-102(64)(A).

[31] U.C.C. § 9-102(64)(B).

[32] U.C.C. § 9-102(64)(C).

[33] The decision stated that the claim of the indenture trustee was in the amount of $16,234,238.84 and that the lenders made a credit bid of $1.8 million for the aircraft and a few days later sold it for $2,125,000, and that the parties had stipulated that the projected recovery on the owner trustee's proof of claim would be at least $4.2 million. The decision makes reference (583 B.R. at 582) to Exhibit Y to stipulated facts that sets forth the lenders' calculation of the outstanding debt, but Exhibit Y was filed under seal. The Court said that if the lenders' argument were valid, they would have obtained an Aircraft at auction for $1.8 million that they immediately resold for $2.125 million and also retained a claim worth at least $4.2 million, all for a credit bid of $1.8 million, and that "[t]he law does not countenance such chicanery." *Northwest*, *Id*. at 582. The Court's apparent outrage that the lenders tried to control the claim rights for nothing seems misplaced. If the indenture trustee could have filed its proof of claim, it would have had to account to the debtor upon the

lease and the claim rights so that those claim rights would belong to the indenture trustee and, therefore, the indenture trustee could retain all amounts it would ultimately receive on account of the proof of claim, even if those amounts exceeded the balance due on the loan certificates. The decision that the indenture trustee did not foreclose on the claim rights should only have meant that those rights and the proof of claim continued to be collateral and that the indenture trustee had the right to file the proof of claim under U.C.C. § 9-607(a)(3), but with the obligation to account to the debtor pursuant to U.C.C. § 9-608(a)(1) and (4) for any cash proceeds received by the indenture trustee on account of the proof of claim that exceeded the balance due under the loan certificates.[34] As a practical matter, this is the result that the Court reached in its ruling that the indenture trustee retained its security interest in the proof of claim filed by the owner trustee. Viewed in this light, the *Northwest* decision did not really concern the proof of claim; it was rather about the right of the indenture trustee to keep the surplus proceeds. The Court's holding that the indenture trustee had no right to file its proof of claim because it had not foreclosed on and, therefore, did not own the lease or the claim rights was unnecessary to reach the result the court sought to achieve (i.e., that the indenture trustee was not entitled to surplus money at the time of the decision) and should thus be viewed as *dictum*.

(b) Practical Difficulties in Requiring Foreclosure as a Condition to Enforcement by Secured Party of Assigned Lease Rights and Remedies.

The decision has the potential to cause great difficulty for secured lenders because it is generally not feasible to dispose of the lease without simultaneously disposing of the leased asset due to the difficulty of separating title to the asset from the rights and obligations of the lessor under a continuing lease. This is especially true in the case of a titled asset such as an aircraft. If the decision in *Northwest* is interpreted

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recovery of cash proceeds (or non-cash proceeds if required under U.C.C. § 9-608(a)(3)).

[34] The indenture trustee might have had an obligation to apply or pay over for application the non-cash proceeds of the proof of claim if the Court were to find that it would be commercially unreasonable not to do so. U.C.C. § 9-608(a)(3). In such a case, the indenture trustee would be obligated to do so in a commercially reasonable manner. *Id*.

to mean that a secured creditor must foreclose on the lease (if the lease is in effect) in order to have the right to file a proof of claim for damages arising out of a breach of the lease, the secured creditor would have to foreclose on and dispose of the aircraft and the lease simply to have the right to file a proof of claim.[35] Presumably, a secured creditor could foreclose only on the claim rights if it wanted to file a proof of claim but did not want to dispose of the lease. Under *Northwest*, the secured creditor would have to foreclose on the claim rights if it wanted to file a proof of claim but the lease had been terminated and only the claim rights remained.[36] However, requiring foreclosure on the claim rights is not likely to advance the goal of maximizing the recovery from a disposition of such collateral.[37] It is likely to be more difficult to ascertain the value of the inchoate right to file a proof of claim[38] and to dispose of that right than to dispose of the proof of claim itself. In many bankruptcy cases, proofs of claim (unlike the right to file a proof of claim) are disposed of separately from the aircraft or the lease or other assets that give rise to them, and a market price is often readily ascertainable.

If a secured party sells the claim rights at a public sale, and the sale price is insubstantial, both the indenture trustee and owner trustee are burdened with a low realization value on the collateral and the benefit of any increase in such value would pass to the buyer at such foreclosure sale or to the secured creditor if its bid is the winning bid. A secured party could postpone the foreclosure sale in the hope that the value of the collateral will increase, but under the reasoning of *Northwest*, it might not be able to file its proof of claim until a foreclosure or acceptance of that collateral occurred.

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[35]Investors interested in buying a proof of claim in bankruptcy or the right to file a proof of claim are often different from the type of investor who is interested in acquiring a commercial aircraft. If offering both types of collateral for sale as a package discourages bidders from bidding on the aircraft, a debtor could argue that the disposition of the aircraft was not commercially reasonable in violation of U.C.C. § 9-610(b). For a discussion of whether a lease is an asset or an encumbrance on the aircraft, see Karesh, "Repossession of Collateral and Foreclosure of Security Interests in Leveraged Lease Aircraft Finance Transactions," Air and Space Lawyer, volume 10, number 2, Fall 1995 at pp. 9–13.

[36]*See supra* note 14.

[37]*See supra* note 34.

[38]The Court itself noted that the proof of claim had to be filed in order for the inchoate claim to have "any value." *Id*. at 583.

A high credit bid by the secured creditor, perhaps equal to the debt, might help to mitigate against the risk of an allegation that the bid was too low, but will potentially provide a windfall to the debtor and limit the secured party's recourse against other collateral or other obligated parties if the value of the claim turns out to be worth less than the debt. Too low a credit bid could expose the secured party to a claim of a commercially unreasonable disposition[39] and raise an issue under U.C.C. § 9-615(f) if the value of claim turns out to have significantly greater value than the amount of the secured party's credit bid.[40]

The requirement in *Northwest* appears even more troublesome if the decision in *Northwest* could be applicable to the enforcement of inchoate rights other than just the right to file a proof of claim. *See Bremer Bank*,[41] where the inchoate rights sought to be enforced by the secured party included the right early in the lessee's chapter 11 case to settle the amount of the proof of claim, extend the 60-day period under Section 1110 of the Bankruptcy Code[42] and renegotiate the terms of the lease with Northwest Airlines to induce Northwest to continue to lease the aircraft on restructured terms.

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[39]For a discussion of why a low price at a public sale is not *per se* evidence of a commercially unreasonable disposition, *see* Bremer Bank v. John Hancock Life Insurance Company, 2009 WL 702009, at *10 (March 13, 2009, D.Minn.). To avoid such issues, the secured party could offer the aircraft and lease (if it is still in effect), and the claim rights together as one parcel and if the price that the secured party is able to receive is not satisfactory, then offer the aircraft and lease (if it is still in effect) as a separate parcel from the claim rights. Proceeding in this fashion might improve the chances of maximizing realization on the collateral and also help to create a record that would tend to support a finding that the disposition of all the collateral was done in a commercially reasonable manner. But even a claim of a commercially unreasonable sale lacking in merit, especially one that involves issues of fact regarding the value of collateral that cannot be resolved summarily, can expose a secured creditor to significant legal expense.

[40]*See supra* note 33.

[41]Bremer, 2009 WL 702009 (March 13, 2009, D. Minn.), discussed at pp. 169-174, *infra.*

[42]Section 1110 provides in relevant part as follows:

> (a)(1) . . . the right of a . . . lessor . . . of [aircraft] to take possession of such equipment in compliance with a . . . lease . . ., and to enforce any of its other rights or remedies, under such . . . lease . . . is not limited or otherwise affected by any other provision of this title or by any power of the court.
>
> (2) The right to take possession and to enforce the other rights and remedies described in paragraph (1) shall be subject to [the automatic stay in] section 362 if—

These rights are not easily susceptible either to a public or private foreclosure sale and as a practical matter, often need to be exercised by the secured party early in a lessee's chapter 11 case, before the lease can effectively be disposed of.

III. BREMER BANK, NATIONAL ASSOCIATION V. JOHN HANCOCK LIFE INSURANCE COMPANY ET AL.

1. COURT HELD THAT EARLY STEPS TAKEN BY SECURED PARTY TO PROTECT ITS INTERESTS IN ASSIGNED LEASE CONSTITUTE ENFORCEMENT OF REMEDIES

Bremer Bank, National Association v. John Hancock Life Insurance Company et al.,[43] also involved enforcement by the secured creditor of intangible collateral rights in a leveraged lease financing of an aircraft leased to Northwest Airlines. The transaction documents were governed by New York law[44] and contained protection against an equity squeeze[45] by

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(A) before the date that is 60 days after the date of the order for relief under this chapter, the trustee, subject to the approval of the court, agrees to perform all obligations of the debtor under such . . . lease . . .; and

(B) any default, other than a default of a kind specified in section 365(b)(2), under such . . . lease . . .—

(i) that occurs before the date of the order is cured before the expiration of such 60-day period;

(ii) that occurs after the date of the order and before the expiration of such 60-day period is cured before the later of—

(I) the date that is 30 days after the date of the default; or

(II) the expiration of such 60-day period; and

(iii) that occurs on or after the expiration of such 60-day period is cured in compliance with the terms of such . . . lease . . . if a cure is permitted under that . . . lease . . . .

The first 60 days of a lessee's bankruptcy case are also important under § 365(d)(5) of the Bankruptcy Code as regards leases of any personal property.

[43]2009 WL 702009 (March 13, 2009, D. Minn.).

[44]2009 WL 702009, at *4.

[45]The term "equity squeeze" is generally understood in the context of a leveraged lease financing to mean the foreclosure by the lenders of the equity interest in the leased asset while maintaining the lease relationship with the lessee. Such an "equity squeeze" has the effect of eliminating the equity investors from the deal while the lender parties retain the benefit of the lease. *See* Ronald Scheinberg, A Modest Proposal: Standardization of Debt/Equity Points, Journal of Equipment Lease Financing, Spring 1997, at 23.

requiring that if an indenture default occurs by reason of a lease event of default, the indenture trustee must exercise its remedies against the lessee under the lease concurrently with its exercise of remedies under the indenture. Northwest Airlines and the lenders wanted to renegotiate the lease but, apparently, Bremer Business Finance Corporation (herein, "Bremer Bank"), as the equity participant, "indicated no intention to become involved in the renegotiation of the terms of the Lease."[46]

The sequence of events in *Bremer* was as follows: On October 18, 2005, the Bankruptcy Court granted Northwest Airlines' motion to reject various leases and abandon certain aircraft, including the subject aircraft and lease, but gave the airline 45 days to negotiate more attractive lease terms with its lessors.[47] Shortly before November 14, 2005,[48] in an effort to preserve the lease, albeit on revised terms, the indenture trustee entered into the first of several stipulations with Northwest that extended the 60-day period prescribed by § 1110 of the Bankruptcy Code through May, 2006, reduced Northwest's obligation to pay rent, and provided that if Northwest failed to perform any of its obligations under the stipulations, the indenture trustee could exercise any rights, claims or remedies under the lease.[49] On March 2, 2006, the indenture trustee and Northwest reached an agreement concerning a restructured lease and pursuant to which Northwest agreed to reject the existing lease, allow an unsecured claim of $15 million for rejection damages and enter into a new lease.[50] Northwest Airlines moved the Bankruptcy Court for approval of the term sheet memorializing this agreement. This motion was heard by the Bankruptcy Court on March 28, 2006.[51] Bremer Bank objected to Northwest's motion to approve this transaction.[52] The Bankruptcy Court did not grant Northwest's motion, but it did approve the "Summary of Terms and Conditions" relating to the agreement between the indenture trustee and Northwest

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[46]2009 WL 702009, at *2.

[47]2009 WL 702009, at *2.

[48]This date is the 60th day following the entry of the order for relief in the Northwest Airlines Chapter 11 case. *See* 11 U.S.C.A. § 1110(a)(2).

[49]2009 WL 702009, at *2.

[50]2009 WL 702009, at *3.

[51]2009 WL 702009, at *3.

[52]2009 WL 702009, at *3.

and adjourned the hearing until May, 2006 to give the indenture trustee time to foreclose the equity interest, and thereby render Bremer Bank's objections to the approval motion moot.[53]

Absent consent from the owner trustee acting on behalf of Bremer Bank, which consent was apparently not forthcoming, the indenture trustee had no right to restructure (i.e., to amend) the lease under Section 9.01(a) of the indenture.[54] Therefore, the indenture trustee had to foreclose the borrower's interest in the lease in order to be able to enter into the new lease. On May 2, 2006, the indenture trustee conducted a foreclosure sale to a third party "of the owner trustee's and Bremer Bank's beneficial equity interest in the trust indenture estate."[55] The third party's bid of $12,550,093.26 exceeded the indenture trustee's credit bid by $100,000. The owner trustee signed a deed and lease assignment and assumption agreement to transfer the trust indenture estate to the buyer.[56] This sale contrasts with the credit bid that the *Northwest* Court found had excluded the lease. The decision does not state whether the third party's bid exceeded the debt due and thus created a surplus. On May 18, 2006, at the continued hearing, the Bankruptcy Court approved the restructured lease transaction between the indenture trustee and Northwest Airlines.[57]

Bremer Bank brought an action against the indenture trustee and lender in the United States District Court for the District of Minnesota, claiming, among other things, that the foreclosure of Bremer Bank's equity interest violated

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[53]2009 WL 702009, at *3.

[54]Section 9.01(a) of the indenture, submitted as Exhibit C to the Amended Complaint in Bremer Bank, National Association v. John Hancock Life Insurance Company (D. Minnesota, 06 CV 01534-ADM-JSM, Docket entry 29) (see 2009 WL 702009, Motions, Pleadings and Filings), provided, with exceptions not relevant, that "The Owner Trustee and the Indenture Trustee each agrees it shall not enter into any written amendment of or supplement to the Lease . . . unless such supplement [or] amendment . . . is consented to in writing by the Indenture Trustee and the Owner Trustee."

[55]2009 WL 702009, at *3.

[56]2009 WL 702009, at *3.

[57]2009 WL 702009, at *3.

the equity squeeze provisions in the transaction documents.[58] On cross-motions for summary judgment, Bremer Bank contended that, at most, when the indenture trustee entered into the stipulations extending the 60-day § 1110 period, negotiated the restructuring term sheet, agreed to the amount of the rejection damage claim and served its acceleration notice, it merely had begun the exercise of remedies under the lease—it did not exercise the remedies.[59] Therefore, if no such remedy had been "exercised" against Northwest Airlines under the lease, pursuant to the equity squeeze protection clause in the loan documents, no remedies could be enforced against Bremer Bank or the owner trustee. The lenders, on the other hand, argued that these actions did constitute an exercise of remedies under the lease, relying on *Lone Star Air Partners, LLC v. Delta Air Lines, Inc.*[60] The District Court in *Bremer* agreed with the District Court in *Lone Star* and held that steps leading to

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[58]2009 WL 702009, at *4. Bremer Bank also alleged that the actions of the indenture trustee violated the implied covenant of good faith and fair dealing, but the District Court held that such claims were duplicative of the breach of contract claims and, therefore, did not constitute a separate claim for relief. Bremer, 2009 WL 702009, at *8–9.

[59]2009 WL 702009, at *5–6.

[60]Lone Star Air Partners, LLC v. Delta Air Lines, Inc., 387 B.R. 426 (S.D. N.Y. 2008), vacated and remanded, 313 Fed. Appx. 430 (2d Cir. 2009). The central issue in *Lone Star* was whether certain actions taken by the indenture trustee constituted the exercise of remedies sufficient to trigger a tax indemnity by the airline-lessee, Delta Air Lines, in favor of the equity participant. The tax indemnity would not cover a voluntary sale of the aircraft or the beneficial interest in the aircraft unless the sale was "attributable to the exercise of a remedy" available to the lessor under the lease. Threatened with a foreclosure sale, the equity participant arranged for a private sale of its equity interest in the owner trust. The equity participant argued that the sale was "attributable to" the exercise of lender remedies among other things because the sale was consummated after the indenture trustee negotiated a term sheet with Delta to restructure the lease that contemplated the exercise of such remedies and because the sale occurred under the threat of foreclosure after the indenture trustee had conducted a foreclosure sale even though the foreclosure sale was not consummated. The Bankruptcy Court held that Lone Star's "voluntary" sale was not attributable to the exercise of remedies because the foreclosure sale of the aircraft was not consummated and the term sheet for the restructured lease at most constituted the expectation of a future exercise of a remedy under the lease and that negotiating to restructure the lease did not derive from the remedies section of the lease but rather from the inherent power of the parties to a contract to renegotiate its terms. 2007 WL 2932774. The District Court reversed (387 BR 426) on the basis that regardless of the source of the indenture trustee's author-

the ultimate exercise of a remedy are themselves part of the act of exercising that remedy, and that to distinguish between steps leading to the exercise, on the one hand, and the actual exercise of the remedy, on the other, would render it "virtually impossible to make a principled distinction" between the two.[61] More significantly, at least for purposes of this article, the *Bremer* Court held that the actions of the indenture trustee *inter alia* in renegotiating the lease following Northwest's default that resulted in a term sheet for a new lease, and agreeing with the airline on the amount of its proof of claim fell within the ambit of exercising remedies under the remedies section in the lease, regardless of whether the authority to do so arose from the terms of the lease itself or from the inherent power of a party to a contract to renegotiate the terms of its contract.[62]

2. COMMENTS ON THE BREMER DECISION: WHY FORECLOSURE WAS NECESSARY

The District Court decision in *Bremer* does not address whether, and no party in *Bremer* appears to have argued to the District Court or the Bankruptcy Court that, the indenture trustee had to foreclose on the lease or the lessor's

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ity to negotiate the restructuring of the lease, that action qualified as an exercise of a remedy under the lease because the remedies clause in the lease included any right or remedy that may be available under applicable law. The District Court also held that the Indenture Trustee's actions in giving notice of, and holding, an auction sale constituted the exercise of remedies because the remedies clause of the lease permitted the lessor to elect to sell the aircraft and noticing and then conducting the unconsummated auction sale was an incremental movement toward the sale remedy. Further, the District Court held that Lone Star's sale of its equity interest was "in response to" the exercise of remedies because the term sheet that the indenture trustee entered into required foreclosure. In a decision dated just eight days before District Judge Montgomery's decision in *Bremer*, the Second Circuit reversed the District Court in *Lone Star* and remanded to the District Court with instructions to return the case to the Bankruptcy Court. The Circuit Court found an ambiguity in whether the sale by the equity participant of its equity interest in the owner trust was "attributable to the exercise of a remedy" under the lease. Lone Star Air Partners, LLC v. Delta Air Lines, Inc., 313 Fed. Appx. 430 (2nd Cir. 2009). The docket in the District Court indicates that the parties settled the case. The *Lone Star* decisions do not indicate that any party raised the issue whether the indenture trustee was obligated to foreclose on and dispose of the lease in order to control and exercise its rights under the lease.

[61] 2009 WL 702009, at *7.

[62] 2009 WL 702009, at *8.

rights under the lease in order for the indenture trustee to be able to enforce or exercise control over the lease rights. The Bankruptcy Court order in *Bremer* that approved the new lease entered into May, 2006, however, was signed by Bankruptcy Judge Alan Gropper, who also wrote the *Northwest* decision dated March 21, 2008. Judge Gropper appears to have recognized in *Bremer* a need for the indenture trustee to foreclose on the lease or lease rights in order for the indenture trustee to be able to enter into a new lease when he adjourned the hearing on Northwest's motion for approval of the lease restructuring term sheet to afford the indenture trustee sufficient time to foreclose the equity interests in the lease and the aircraft.[63] But the need to foreclose in *Bremer* resulted from the facts that in *Bremer*, unlike in *Northwest*, the lessee and indenture trustee intended to continue leasing the aircraft under a new (restructured) lease, but the indenture prohibited the indenture trustee from modifying the lease,[64] not from a rule of law that would prohibit generally the secured party from exercising remedies or enforcing rights against the lessee without first foreclosing on the lease or those rights. It is difficult to see a difference in this context between the right to file a proof of claim and the pre-foreclosure rights exercised by the indenture trustee in *Bremer*.

IV. CONCLUSION

Even though the *Northwest* decision may not be binding precedent, it is a carefully reasoned decision that could influence future decisions. Therefore, it should be narrowly limited to its facts, *viz*. a case in which the secured party sought to retain a surplus from cash proceeds of non-cash collateral as if it had foreclosed on that collateral. The broad holding of *Northwest* that a secured party must foreclose on a lease (or claim rights under a lease if the lease has been terminated) in order to file a proof of claim against the lessee arising under the lease is incorrect and not necessary to prevent the secured party from inappropriately retaining surplus money. The broad holding should, therefore, be regarded as *dictum*.

As a means of protecting against the issues raised by *Northwest*, secured parties might consider including in their

[63] 2009 WL 702009, at *3.

[64] *See supra* note 54.

security agreements language such as that proposed in the following Appendix.

V. APPENDIX:* Suggested Provisions to Avoid Issues Raised by the Northwest Case

1. Notwithstanding anything contained elsewhere in this Security Agreement to the contrary, upon the occurrence of an Event of Default and for so long as such Event of Default shall be continuing, the Secured Party shall have the right, to the exclusion of the Borrower and any other Person obligated with respect to any Obligation, without any requirement to foreclose on any Collateral, to exercise any or all rights or remedies of the Borrower, as lessor, under the Lease, including, but not limited to, the right (a) to declare the Lease to be in default under Article __ thereof, (b) to enforce the obligations of the Lessee under the Lease and any other Operative Document or arising under Applicable Law, and (c) to exercise any or all of the rights and remedies of the Borrower set forth in the Lease or in any other Operative Document or arising under Applicable Law, including, but not limited to, the right (i) to terminate the Lease, (ii) to file one or more proofs of claim in any insolvency proceeding in which the Lessee is the debtor or debtor in possession and to exercise any voting or other right related to any such proof of claim, (iii) to engage in any litigation against the Lessee or any other Person to enforce any of the Borrower's rights or remedies under the Lease or any other Operative Document or under Applicable Law, and (iv) to negotiate and conclude any agreement directly with the Lessee or any other Person concerning: (A) any matter affecting or relating to any such proof of claim, including the nature, amount and priority thereof or the settlement of any such litigation, (B) any provision of any statute affecting the Aircraft or Lease or the Borrower's rights in relation to the Aircraft or the Lease including Section 1110, 365(d)(5) or any other provision of the Bankruptcy Code and (C) the modification, amendment or supplement to any provision of the Lease or any other Operative Document including the expiration of the Term of the Lease or the amount or time for the payment of

*It is assumed that capitalized terms are defined elsewhere in the security agreement.

Rent or any other amount that is or may become payable thereunder.

2. Borrower hereby irrevocably waives, to the fullest extent permitted by Applicable Law, any obligation of the Secured Party to foreclose on any of the Collateral or the proceeds of any Collateral that at any time secures the Obligations as a condition to, or in connection with, the exercise or enforcement of any of the rights and remedies set out in paragraph 1.
3. The Borrower acknowledges and agrees that to the extent the exercise or enforcement by the Secured Party of any of the rights or remedies set out in paragraph 1 gives rise to non-cash proceeds of the collection or enforcement of such rights or remedies including, but not limited to, a proof of claim of the kind referenced in clause (c)(ii) of paragraph 1 and any agreement between the Secured Party and the Lessee or any other Person whether or not specifically referenced in clause (c)(iv) of paragraph 1, it shall not be commercially unreasonable for the Secured Party (i) to file such proof of claim or to enter into any such agreement to the exclusion of the Borrower as provided in Section 1 as Secured Party determines in its sole discretion to be in its best economic interest, and (ii) notwithstanding anything to the contrary set out in [the waterfall or proceeds allocation section], not to apply or pay over to or for the account of the Borrower any such non-cash proceeds[65] as long as such non-cash proceeds continue to be Collateral, provided, however, that cash proceeds shall be distributed in accordance with the provisions of [the waterfall section] of this Security Agreement.

[65]If the financing is with recourse to the Borrower, a clause should be added pursuant to U.C.C. § 9-607(c) to provide for standards by which to measure the commercial reasonableness of the Secured Party's undertaking to collect from or enforce an obligation of the Lessee and expressly to permit the secured party to restructure the lease with the lessee notwithstanding any prohibition against amending the lease without the borrower's consent contained elsewhere in the transaction documents.