



Bankruptcy
and Aircraft Finance

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BANKRUPTCY
AND AIRCRAFT FINANCE

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A Selection of Recent Airline Bankruptcies

Braniff International	May 13, 1982
Continental Airlines	September 23, 1983
Eastern Airlines	March 9, 1989
Pan American Airlines	January 8, 1991
America West Airlines	June 28, 1991
Trans World Airlines	January 10, 2001
US Airways	August 11, 2002; September 12, 2004
United Airlines	December 9, 2002
Aloha Airlines	December 30, 2004; March 31, 2008
Northwest Airlines	September 14, 2005
Delta Airlines	September 14, 2005
Frontier Airlines	April 10, 2008
American Airlines	November 29, 2011

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Introduction

Hundreds of billions of dollars are invested in aircraft equipment in the United States. These investments in aircraft are structured as secured loans, sale/leasebacks, operating leases, pass-through certificates, leveraged leases and public debt, such as equipment trust certificates or enhanced equipment trust certificates. In each case, the investment is secured by the aircraft equipment being financed or otherwise is subject to a lease. Because they are secured, these investments generally provide a stable, safe return to investors. As a result, pension funds and insurance companies include these types of investments in their investment portfolios. No investment, of course, is free from risk, and many airlines have had financial difficulties in the recent past. However, there are unique protections for investors in aircraft in the Bankruptcy Code.¹ We highlight some of these considerations in this paper.

The airline industry was deregulated in 1978, providing challenges to “legacy” carriers. Since deregulation, there have been over 100 bankruptcy filings by airlines. While a number of these bankruptcies have resulted in the liquidation of the airlines, airlines have been able to successfully reorganize under the Bankruptcy Code in many recent cases, such as United Airlines, US Airways (two times), Northwest Airlines and Delta Airlines. Most recently, American Airlines was able to emerge from a relatively quick chapter 11 reorganization that, due in part to American Airlines’ merger with US Airways, resulted in almost all creditors being paid in full and significant value being distributed to the airline’s shareholders.

Some of the causes giving rise to past bankruptcy proceedings include high fuel and capital costs, intense competition caused in part by deregulation, and “legacy” employee costs related to health care and pensions. One or all of these factors caused most of the major airline carriers to reorganize under chapter 11. Economic conditions have recently improved for airlines, given the current availability of relatively cheap capital and fuel, as well as a reduction in the number of carriers limiting competition. Many “legacy” issues were addressed in prior bankruptcy proceedings. Furthermore, the last round of airline bankruptcies allowed many carriers to tap credit markets to invest in modern fleets (including more fuel-efficient aircraft with optimized seat configurations) on favorable terms. The result is that, prior to the onset of the COVID-19 virus and its financial repercussions, many airlines experienced periods of high profitability.

Despite the recent overall health of the airline industry, like the airplanes they fly, what goes up may come down. It is extremely expensive to maintain an aircraft and as aircraft age, the cost of maintenance and other costs of operation increase. Further, while the industry has been better at managing fuel supply and pricing, any significant change in energy costs might rattle the industry. Increases in interest rates could likewise increase the cost of capital. Currently the industry is experiencing an extreme disruption in demand for travel caused by the COVID-19 virus including the

1 The United States Bankruptcy Code (hereinafter the “Bankruptcy Code”) can be found at 11 U.S.C. § 101 *et seq.* The term “chapter 11” used herein shall refer to chapter 11 of the Bankruptcy Code.

unwillingness of people to travel, the prohibition on unnecessary travel by businesses, and the border restrictions placed on travelers by governments. The effects of COVID-19 are causing significant distress for one or more airlines and, absent a significant bailout of the industry, may cause a further round of bankruptcy filings.

Aircraft are expensive — the costs of some models run into hundreds of millions of dollars. Due to the importance of air travel to the economy, Congress granted aircraft creditors special privileges in bankruptcy to provide incentives to invest in aircraft. These special privileges are unavailable to other types of creditors and are contained in § 1110 of the Bankruptcy Code. In enacting § 1110, Congress sought to encourage aircraft investment by granting aircraft creditors special protections in an effort to lessen the risks involved in financing aircraft. These protections include enabling aircraft creditors to repossess aircraft from a defaulting debtor notwithstanding the automatic stay² included in the Bankruptcy Code under certain circumstances, as well as limiting other protections afforded to debtors by the Bankruptcy Code.³ Section 1110 of the Bankruptcy Code provides aircraft creditors with the exceptional ability to either: (i) repossess the aircraft collateral sixty (60) days following such filing (despite the provisions of the automatic stay), or (ii) require that the airline provide the aircraft creditors with the benefit of their bargain during the pendency of the bankruptcy case through adherence to the terms of the underlying lease or financing agreements. Through amendment and court interpretation, a unique jurisprudence has developed around § 1110 of the Bankruptcy Code.

In the following materials, we seek to provide aircraft investors with an understanding of § 1110 and its related jurisprudence, as well as outline the state law remedies available to aircraft investors upon lifting the automatic stay that exist when a carrier or other aircraft operators file for bankruptcy protection or otherwise default on an aircraft obligation. We also provide a checklist of considerations in connection with dealing with aircraft before and during a bankruptcy proceeding. We hope to provide clients and other investors with an understanding of the legal protections available in the event an aircraft investment heads south, by explaining the various protections and legal mechanisms and sharing lessons learned from prior airline bankruptcies.

2 The automatic stay is set forth in § 362 of the Bankruptcy Code and stops virtually all actions that might be taken against the debtors. Section § 362 of the Bankruptcy Code is long and contains many exceptions. Prior to taking actions against a debtor, creditors would be wise to carefully review § 362.

3 *In re Air Vermont, Inc.*, 761 F.2d 130, 130–31 (2^d Cir. 1985).

Understanding § 1110 of the Bankruptcy Code⁴

1. § 1110 GENERALLY

Airlines, and more importantly the aircraft they operate, have a special provision of the Bankruptcy Code entirely devoted to them — § 1110 of the Bankruptcy Code. This section provides unique protections for lessors, conditional vendors or secured parties with security interests⁵ in aircraft, aircraft engines, propellers, appliances or spare parts, as each is defined in 49 U.S.C. § 40102 (collectively “*Aircraft Equipment*”) following a bankruptcy filing. At its core, § 1110(a) provides that, notwithstanding the automatic stay, aircraft creditors may exercise remedies provided for in the applicable financing agreements or lease, including taking possession of Aircraft Equipment, sixty (60) days following a bankruptcy filing *unless* the debtor agrees to perform under such financing agreements or lease and cures any outstanding defaults during such 60-day period (an “*1110(a) Election*”). The debtor’s election to perform under the applicable agreements or lease is subject to the approval of the Bankruptcy Court. Following a § 1110(a) Election, the protections of the automatic stay, which are in effect for the initial sixty (60) day period, remain in place until: (i) the parties agree otherwise, (ii) there is a default under the § 1110(a) Election, or (iii) the debtors’ case is completed. Importantly, obligations that become due under the governing agreement, including rent, maintenance costs and other related amounts, as well as all amounts necessary to cure any outstanding defaults, are deemed to be administrative expenses and must be paid by the debtor prior to its payment of most other types of claims. In addition, the debtor must perform non-monetary obligations thereunder.

Section 1110(b) permits the parties to mutually agree to extend the initial sixty (60) day period, subject to the approval of the court (a “*§ 1110(b) Stipulation*”). Often (but not always, as discussed below), such an extension is used by the parties to negotiate the terms of a § 1110(a) Election.

If a debtor fails to make the election and meet the requirements of § 1110(a) within the initial sixty (60) day period and the parties fail to consensually agree to extend the initial sixty (60) day period pursuant to § 1110(b), then, in accordance with § 1110(c), upon the receipt of a written demand for surrender of the Aircraft Equipment, the automatic stay is no longer applicable and the creditor may proceed to exercise its contractual and state law rights and remedies against the airline debtor, which may include repossessing the Aircraft Equipment.⁶

⁴ A copy of the text of § 1110 is appended to the end of this material as Appendix A.

⁵ For aircraft first placed into service before October 22, 1994, the term security interest is limited to purchase-money equipment security interests.

⁶ As noted earlier, in the absence of § 1110, the automatic stay would serve to block state-law foreclosure efforts as well as other collection efforts included in the parties’ credit documents. Section 1110(a), therefore, provides an important exception to the automatic stay which is unique to this specific type of equipment. However, it is important to note that the mere lifting of the stay simply returns the parties to their position before the bankruptcy—it does not necessarily compel the debtor to turn over the Aircraft Equipment.

Section 1110 is limited to certain types of users of aircraft as provided in § 1110(a)(3)(A). For the provisions of § 1110 to apply, a debtor must hold “an air carrier operating certificate issued pursuant to chapter 447 of title 49 for aircraft capable of carrying 10 or more individuals or 6000 pounds or more of cargo.”

2. REQUIREMENTS TO EXTEND THE STAY PURSUANT TO § 1110(A)

In the absence of an agreement under § 1110(b), to extend the effectiveness of the automatic stay beyond the initial sixty (60) day period, § 1110(a) requires a debtor to perform the following:

a. Performance of All Obligations That Become Due

In order to continue operating the Aircraft Equipment following a bankruptcy filing, a debtor must agree (subject to court approval) to perform all obligations under the lease, security agreement or conditional sale contract.⁷ Thus, following a § 1110(a) Election, the debtor must make all payments under the lease or financing agreement as they become due. This provision also requires that, unless otherwise agreed to by the parties, the debtor must continue to operate the aircraft in the same manner and meet the same terms and other obligations set forth in the lease or security agreement, including complying with maintenance provisions; the bankruptcy filing does not alter the underlying terms of the original agreement.⁸ In explaining this provision, courts have stated that:

§ 1110 protects the interest of a financier by entitling him to payments *according to the financing agreement terms or to his equipment*; [it] protects the estate and the reorganization process by leaving the choice of which the financier will get to the trustee. Thus, equipment that the trustee needs to keep operating the business is beyond reach by the financier *if the trustee is willing to continue to pay for it according to pre-bankruptcy terms*. If the trustee does not need the equipment, he may simply surrender it to the financier.⁹

b. Obligation to Cure Defaults

Section 1110(a) also provides that if there are defaults under the relevant lease or financing documents existing prior to the date of the § 1110(a) Election, the debtor is obligated to cure those defaults.¹⁰ Defaults of the type set forth in § 365(b)(2) need not be cured (*i.e.*, a default by virtue of the financial condition or a bankruptcy filing of the air carrier). In addition, the debtor is required to cure any

⁷ 11 U.S.C.A. § 1110(a)(2)(A).

⁸ *See In re Airlift Int'l, Inc.*, 761 F.2d 1503, 1508 (11th Cir. 1985) (“*Airlift*”) (finding that under § 1110 the debtor agrees to perform all obligations as they become due); *see also In re Trans World Airlines, Inc.*, 145 F.3d 124 (3rd Cir. 1998) (“*In re TWA*”); *In re Western Pacific Airlines, Inc.*, 221 B.R. 1 (D. Colo. 1998), *appeal dismissed*, 181 F.3d 1191 (10th Cir. 1999).

⁹ *In re TWA*, 145 F.3d at 138 (citations omitted).

¹⁰ 11 U.S.C.A. § 1110(a)(2)(B)(i). While payment defaults are easy to cure, some past defaults — such as a failure to carry insurance for a period — may be impossible to cure. Parties should both be mindful and agree to remedies related to past defaults that may not be cured.

postpetition defaults within thirty (30) days or the end of the sixty (60) day period, whichever is later.¹¹ Such amounts are also administrative expenses.

3. § 1110(B) EXTENSION

As an alternative to an election under § 1110(a), § 1110(b) allows the parties to agree to extend the initial sixty (60) day period and thereby extend the protections afforded to a debtor by the automatic stay. There are no limitations on the length of the extension; an extension may be for a short period or can run indefinitely. Extending the initial sixty (60) day period by mutual agreement allows the parties to work out details of the continued use of the aircraft in cases where the debtor is unwilling to make an election under § 1110(a) but is interested in continuing to use the aircraft on reduced terms, and where the creditor would prefer to accept modified terms over repossessing the aircraft. Unlike § 1110(a), § 1110(b) does not expressly require the resumption of payments or the curing of outstanding defaults. Rather, the debtor and aircraft creditor establish the terms of the extension. The debtor may agree to pay the creditor under a § 1110(b) extension—in the form of cash payments, extending liens to other collateral or other types of compensation—or the parties may agree to an extension without any monetary compensation. Whether and the amount a debtor will pay for such an extension of the automatic stay will chiefly depend on the aircraft market at such time. Regardless of the terms, any § 1110(b) extension must be approved by the court. Most parties proceed in front of the court on this basis by stipulation.¹²

4. LIFE UNDER § 1110(C)

If the debtor does not make a § 1110(a) Election within the first sixty (60) days, or fails to agree to a § 1110(b) extension, the creditor has whatever rights it has to repossess the aircraft under § 1110(c).

5. WHICH IS BETTER — A § 1110(A) ELECTION, A § 1110(B) EXTENSION OR NOTHING?

A number of factors weigh into which option is preferable for one or both parties. The current state of the market for aircraft is an important factor—can the debtor replace the aircraft relatively easily on better terms, or is the aircraft market strong enough that an investor is willing to bear the expense of taking back the aircraft and selling or re-leasing the aircraft to a third party? The availability of alternatives to the investor is an important factor. Parties might consider other costs incident to possessing an aircraft, including the cost of insuring, repossessing and maintaining the aircraft.

Prior to or as part of the bankruptcy process, an airline is likely to develop a fleet plan and make decisions on the makeup of its current fleet—*i.e.*, which aircraft meet the goals of the plan, which do not, and what types of aircraft might be needed—and the cost thereof. A § 1110(a) Election by the debtor to pay the contract rate is preferable to a debtor when it needs the aircraft and is making payments at or below rates that might otherwise be achievable in the open market. An airline debtor may take into consideration things such as the age of the aircraft, the amount of maintenance required

11 11 U.S.C.A. § 1110(a)(2)(B)(ii).

12 *See, e.g., In re AMR Corp.*, 2012 Bankr. LEXIS 4170 (Bankr. S.D.N.Y. Sept. 5, 2012).

on the aircraft in the near term, its costs of returning an aircraft and, if it needs the model type in its fleet, the cost of integrating different aircraft into its fleet.

The § 1110(a) Election is better for an aircraft creditor unless the amounts it will receive under the current agreement are substantially below market rates for the subject aircraft and the aircraft creditor can get more net value from a third party factoring in the costs of repossession, maintenance (to the extent paid by a creditor), reconfiguration of the aircraft and other considerations in connection with placing the aircraft into a new fleet. Another consideration is the creditor's belief about the likelihood that the debtor may ultimately need to convert its case to a liquidation, particularly if it is unlikely to be able to pay its administrative claims.

The interest of the debtor and creditor in entering into a § 1110(b) Stipulation is subject to similar considerations. An airline might be willing to retain an aircraft if the amount it had to pay were reduced to an amount closer to market rate. The airline likewise may want to continue to use the aircraft as it reconfigures its fleet but only for a shorter duration than the lease contemplated.

An investor may be willing to accept modified compensation if the aircraft market is depressed, and may wish to avoid the burden of insuring, maintaining and remarketing the aircraft. One additional benefit to an investor of a § 1110(b) Stipulation is the ability to attempt to reach an agreement on how the aircraft will be returned to the investor upon the expiration of the § 1110(b) Stipulation and the maintenance status of the aircraft upon return. An orderly return of the aircraft can be a valuable concession.

Aircraft Equipment that is subject to neither a § 1110(a) Election nor a § 1110(b) Stipulation give rights to the creditor under § 1110(c) and are sometimes referred to as "naked aircraft." Typically, in such an instance, the debtor continues to use the aircraft subject to the ability of the aircraft creditor to demand the immediate return of the aircraft at any time under § 1110(c) or to negotiate an appropriate stipulation with the debtor governing the use of the Aircraft Equipment. Even if the Aircraft Equipment is "naked" and there is no § 1110(a) Election or § 1110(b) Stipulation, the airline is still ultimately liable for the value of using the aircraft during bankruptcy, and creditors may seek payment pursuant to § 365(d)(5) (if there is a lease) or adequate protection on account of the debtor's use and any diminution in value that occurs.

6. OTHER IMPORTANT ASPECTS OF § 1110

a. § 1110 Only Applies to Secured Creditors, Lessors or Conditional Vendors

It is important to point out that § 1110 only applies to the interests of secured creditors, a trustee acting on behalf of secured creditors, lessors or conditional vendors. Whether an agreement is a lease or subject to a conditional sale is a fact inquiry, and such agreements are not necessarily required to be recorded.¹³ Further, typically, to be treated as a secured party, a creditor must have a properly

¹³ *Air Vermont*, 761 F.2d at 130–31 (finding that a conditional sale agreement was not filed with the FAA but § 1110 allowed for repossession).

perfected security interest. However, courts have held that a creditor without a properly perfected interest may still enjoy the privileges of § 1110 in certain circumstances.¹⁴ Therefore, even if a party's interest were not properly perfected, creditors that have made an attempt to perfect their interest may still be entitled to protection under § 1110.

b. § 1110 Applies Only to Certain Types of Equipment and Air Carriers

§ 1110 does not apply to all leased or financed aircraft and related parts held by a debtor. Rather, only specified types of equipment are covered,¹⁵ and the section only applies to certain types of debtors — those holding an “air carrier” operating certificate issued under title 49 of the United States Code “for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo.” Where a debtor does not qualify as an “air carrier,” § 1110 will not apply.¹⁶ In addition, where types or pieces of equipment do not meet the applicable definitions, such equipment will not be protected under § 1110.¹⁷ Thus, § 1110 excludes most privately owned aircraft and aircraft owned or leased by non-carrier corporations or individuals, as well as equipment that is not aircraft, aircraft engines, propellers, appliances or spare parts as defined in 49 U.S.C. § 40102.¹⁸

7. THE INITIAL SIXTY (60) DAY PERIOD?

a. The Automatic Stay Remains Applicable

Once a bankruptcy petition is filed, the automatic stay of § 362 of the Bankruptcy Code is in place, barring virtually all actions against a debtor, including the exercise of remedies under a lease or financing agreement. Pursuant to § 1110, during the initial sixty (60) day period following the filing of a chapter 11 petition, the automatic stay remains in effect and the aircraft creditor is prohibited from exercising its available remedies under the applicable contract or applicable law. In this manner, § 1110

14 *Air Vermont*, 761 F.2d at 130–31 (finding that § 1110 does not specifically require that a creditor have a perfected security interest and that § 1110 is “unambiguous in allowing a creditor to repossess once the elements of § 1110 were satisfied”). Such holdings are based on the express language of § 1110, which states, in part, that a creditor’s rights are “not limited or otherwise affected by any other provision of the [Bankruptcy Code] or any power of the court.”

15 The equipment covered by § 1110 is defined as “an aircraft, aircraft engine, propeller, appliance or spare part” as defined in title 49 of the United States Code, which section defines “aircraft” as “any contrivance invented, used, or designed to navigate, or fly in, the air.”

16 *See In re Pegasus Int’l Travel Club*, 15 B.R. 842 (Bankr. M.D. Pa. 1981), and *Feldman v. First Nat’l City Bank*, 368 F. Supp. 1333 (S.D.N.Y. 1974), *rev’d*, 511 F.2d 460 (2^d Cir. 1975) (both finding that § 1110 was inapplicable because the debtors were not air carriers under FAA regulations as required by § 1110).

17 *See, e.g., In re Belize Airways Ltd.*, 7 B.R. 601, 602 (Bankr. S.D.Fla. 1980) (finding § 1110 did not apply when “the equipment conditionally sold does not fall within the terms of the definitions contained in the [49 U.S.C. § 40102] ... since it is not used or capable of being or intended to be used in the navigation, operation or control of aircraft during flight.”).

18 Additionally, Congress amended § 1110 in 1994 and § 1110’s reach is limited with respect to aircraft or parts first placed into service before 1994. As amended, § 1110 applies to all types of qualifying aircraft leases and financing transactions entered into after that time.

is similar to § 365(d)(5) of the Bankruptcy Code, which affords equipment lessees a brief respite of sixty (60) days after a bankruptcy filing before they are required to commence making regular lease payments and otherwise complying with the terms of the relevant financing agreement. This period is intended to give the debtor at least a short breathing spell in order to determine if it wishes to retain the applicable Aircraft Equipment. During this period of time, the air carrier may initiate discussions with aircraft financing parties to determine the willingness of the aircraft creditors to compromise on the terms of their financing agreement and, if an agreement is possible, to attempt to work out the details of a § 1110(b) Stipulation.

In some cases, airlines have initiated “Dutch auctions” offering the first number of aircraft creditors § 1110(b) Stipulations if they would agree to a certain lease rate or compensation scheme going forward. With this information the air carrier can decide whether to make a § 1110(a) Election, whether a § 1110(b) Stipulation has been or can be worked out, or whether it will “go naked” and retain the aircraft subject to the rights of the aircraft creditor to exercise its available remedies. In a Dutch auction the debtor asserts that it only wants to retain a finite number of aircraft of a particular type. Shortly after the bankruptcy filing, the debtor will announce that it will enter into § 1110(b) Stipulations with only a finite number of aircraft creditors, likely at a depressed price or on other unfavorable terms. The stipulation may be coupled with a threat that subsequent offers will be lower and that once a certain number of stipulations are accepted, the remaining aircraft will be rejected or abandoned. In this regard, the debtor attempts to capitalize on the fear that an aircraft creditor may feel in anticipating repossessing an aircraft if it were not to participate in the auction. Communication and coordination among aircraft creditors helps limit the success of a Dutch auction.

b. Considerations for Aircraft Creditors during the Sixty-Day Period

While an aircraft creditor can't exercise remedies during the initial sixty (60) day period, the aircraft creditor or trustee might consider undertaking due diligence with respect to each aircraft in its portfolio during this period. Among other things, aircraft creditors might consider:

- becoming familiar with the terms of the lease or financing, including provisions relating to available remedies
- the competing interests of others to the transactions, *i.e.*, holders of any equity interests in the aircraft or any liquidity provider, or perhaps even the interests and rights of holders of securities in other tranches of a multi-tranche financing
- retaining technical aircraft advisors, including experts to advise on maintenance issues, the value of the aircraft in the current market and opportunities for remarketing, if necessary
- attempting, through technical aircraft advisors, to obtain the relevant and necessary records and documentation to review the maintenance status of the aircraft¹⁹

19 Larger air carriers often have maintenance and record-keeping programs unique to that carrier that have been approved by the FAA. A technical advisor can help evaluate whether the records maintained by the carrier are sufficient to enable a third-party carrier to operate the aircraft or what additional information might be required.

- reviewing and evaluating the current maintenance requirements and “return conditions” set forth in the financing agreement or lease to determine whether they are adequate or whether and how those requirements or conditions could be augmented
- organizing with other similarly situated investors, if any, to the transaction to obtain a controlling position under the terms of the documents, and opening lines of communication with the trustee so that appropriate action can be taken at the termination of the sixty (60) day period
- reaching out to investors in other transactions in an effort to gain leverage in negotiations with the debtor in the bankruptcy proceeding

As we will discuss below, aircraft creditors or trustees may also seek adequate protection during this period.

8. § 1110(A) IS NOT EQUIVALENT TO A LEASE ASSUMPTION

Making a § 1110(a) Election and agreeing to perform under the terms of a lease or financing arrangement is different from assuming a lease under § 365 of the Bankruptcy Code. While the debtor may retain and continue to use the Aircraft Equipment subject to the terms of the original lease, it still may reject the lease prior to the approval of a plan of reorganization.²⁰

Importantly, in contrast to the assumption of a lease under § 365, where a debtor is liable for all future obligations under the lease, under a § 1110(a) Election the debtor only agrees to perform the obligations *as they become due*. Thus, in the event of a postpetition breach under § 1110, only the amounts that are due during the duration of the § 1110(a) Election are a priority administrative expense, whereas when a lease has been assumed under § 365 of the Bankruptcy Code, the entire amount due under the lease constitutes an administrative expense upon breach of the contract or lease.²¹

9. CONSIDERATIONS FOR AIRCRAFT INVESTORS IN CONNECTION WITH THE NEGOTIATION OF A § 1110(B) STIPULATION

There are a number of considerations for aircraft creditors negotiating a § 1110(b) Stipulation with a debtor. First and foremost are the economic terms. What amount is the aircraft creditor willing to

Further, while § 1110 deems records required to be turned over under the relevant lease or security agreement to be part of the equipment and subject to return, an evaluation of the sufficiency of this information is important. Ideally, the production of any other necessary information or records would be made part of a § 1110(b) Stipulation as part of the conditions of return of the aircraft.

20 *In re TWA*, 145 F.3d at 137; *see also In re Air Nat'l Aircraft Sales and Serv., Inc.*, 53 B.R. 310, 317 (E.D.N.Y. 1985) (only where the debtor complies with the requirements of § 1110 is it entitled to retain the aircraft and then move to assume the lease under § 365 of the Bankruptcy Code); *Matter of Florida Airlines, Inc.*, 73 BR 64, 66 (Bankr. M.D. Fla. 1987) (mere payment of monthly charges on an unexpired lease by a debtor in possession does not constitute an implied assumption of such lease under § 1110 giving rise to an administrative expense; court approval is required).

21 *See Airlift*, 761 F.2d at 1509.

accept for the debtor's continued use of the aircraft, and how often will payments be made by the airline debtor? For purposes of the stipulation, the payment period may be adjusted.

The duration of the § 1110(b) Stipulation ought to be considered as well. Considerations include keeping a short leash on negotiations to maintain an incentive to actively negotiate the terms of a more permanent arrangement. Another consideration is the timing of maintenance events — an aircraft creditor may consider whether or not it wants or cares to ultimately accept the return of an aircraft in a depleted maintenance state and determine the expiration date accordingly. Finally, the aircraft creditor might consider when other similar model types might be returned or repossessed as it may be beneficial to have the aircraft returned prior to the release of a number of aircraft of the same model type into the same market. Market saturation may have an adverse effect on the value of an arrangement with a third party if that is the route the aircraft creditor ultimately decides to take.

The negotiation of a § 1110(b) Stipulation may be a good time to acknowledge or improve the maintenance and return conditions provided for in the lease or financing agreement. The § 1110(b) Stipulation could include an agreement to continue to maintain the aircraft in accordance with the relevant agreement or require an improved set of maintenance requirements. It could acknowledge or enhance inspection rights and include provisions requiring the airline to periodically report on the maintenance status of the aircraft and insurance coverage. Section 1110(a)(3)(B) makes it clear that equipment includes certain records and documents relating to such equipment to the extent they are required to be surrendered under the lease or financing agreements. The negotiation period is a good time to mutually agree on what records the airline will turn over upon a repossession or return of the aircraft. Adequate records are an extremely important component of the value of the aircraft.

How and where the aircraft is returned may likewise be important to the aircraft creditor, so the § 1110(b) Stipulation negotiations may be a good time to reach an agreement on the logistics of any return. Collateral engines are often on other aircraft; the negotiations may include discussions as to how to marshal all of the collateral.

This negotiation may be a good time to determine whether the airline debtor and the aircraft creditor can agree on the types of claims that will be allowed the aircraft creditor if the aircraft ultimately does not remain in the airline's fleet under the same terms and conditions as the original agreements, and the manner in which those claims will be determined. Where the airline debtor knows that the aircraft will ultimately be rejected, the parties may be able to agree on the aircraft creditor's claim in the bankruptcy in advance rather than engage in a lengthy and costly dispute later.

Ideally, the rights, remedies, claims and defenses of the aircraft creditor will be preserved. The aircraft creditor ought to give thought to how the § 1110(b) Stipulation should terminate. Is it better under the circumstances to have it terminate on a date certain or shall it renew from time to time? What conditions likewise might trigger the termination of the § 1110(b) Stipulation in addition to a default under the terms of the agreement? Perhaps these conditions can be built around milestones in the case, the economic condition of the airline debtor or the number of like type aircraft remaining in the air carrier's fleet — the value of the aircraft will likely decrease if a number of others of the same model type are rejected or repossessed and are in the market.

10. DEBTOR'S FAILURE TO PERFORM UNDER A § 1110(A) ELECTION OR A § 1110(B) STIPULATION

Failure to comply with a § 1110(a) Election or a § 1110(b) Stipulation will result in creditors' ability under § 1110(c) to exercise the remedies provided under the applicable financing documents and under state law.²² In addition, it should be noted that:

a. Damages Are Administrative Claims

Damages for breach of a § 1110(a) Election or a § 1110(b) Stipulation are administrative claims (both having occurred postpetition), and the amount of damages for failure to perform should be measured by the contract terms. This is consistent with the requirement of § 365(d)(5), which provides that the debtor must generally perform the debtor's obligations under the relevant equipment lease until the lease is rejected.

b. Calculation of Claim and Proration Period

Upon making a § 1110 Election (and in some cases a § 1110(b) Stipulation), the debtor agrees to make payments under the operative agreement as they come due. Although the creditor has the right to remedies, including repossession, if any default under a § 1110(a) Election is not cured within thirty (30) days, nothing in the statute or legislative history suggests that the obligations that arise under the agreement prior to repossession are to be waived. Rather, if the debtor wishes to stop the accrual of damages, it must return the Aircraft Equipment.²³ Until possession is vested in the aircraft creditor, the debtor is obligated to make payments and perform other obligations as specified by the underlying agreement.²⁴ As a result, the aircraft creditor should be permitted to recover amounts due under the governing agreement for a breach of the § 1110(a) Election, and such damages should be prorated for the period the debtor remained in possession or until it formally rejects the lease. These

22 See *In re Western Pacific Airlines, Inc.*, 219 B.R. 298 (Bankr. D. Colo. 1998), *rev'd. on other grounds*, 219 B.R. 305 (D. Colo. 1998). In *Western Pacific Airlines*, the aircraft lessors sought declaratory relief regarding their right to repossess the aircraft following the debtor's postpetition defaults. The Bankruptcy Court held that defaults by the debtor outside the initial sixty (60) day cure period entitled the lessor to immediate repossession of the aircraft. *Id.* at 219 B.R. 298. However, as a matter of equity, the court granted a brief 72-hour period for the airline to cure its postpetition defaults.

23 The terms of the underlying agreement may also specify other return conditions. These may require meeting certain maintenance requirements.

24 The effect of an agreement under § 1110 is to put the debtor in the position of having made a postpetition agreement to carry on a prepetition executory contract without assuming the full burdens of that contract imposed under § 365. In *Airlift*, the court held that, because neither a lease nor mortgage was fully assumed under § 1110, the obligation of the debtor to make installments on a security agreement was embodied in the stipulation agreement itself. *Airlift* at 1513. The court also explained that "mortgagees in the [lessor's] shoes cannot be expected to forego their right of repossession unless they are guaranteed payment by the terms of the agreement during the time the aircraft remains in the possession of the debtor." *Id.* at 1510. Since a § 1110(a) Election is treated as a postpetition agreement by the debtor to meet obligations coming due under unexpired leases, the prepetition lease dictates the terms of the obligation. *Id.* at 1511. Based on this, the appellate court reversed a Bankruptcy Court ruling granting the lessor only actual use value of the aircraft and, instead, awarded an administrative expense in the full prorated amount due the creditor under the § 1110(a) Election, treating the installments (and prorated amounts due therein) as rent.

amounts should also be deemed administrative expenses. This was true in the *In re TWA* and *Airlift* cases. In both instances, the operative documents required monthly payments. To determine the amount outstanding, the court required a simple proration calculation to arrive at a figure of daily rental costs (based on the monthly rental costs per the lease) and multiplied that figure times the number of days from the last installment missed until repossession.

In *Airlift*, the court's proration of damages was calculated as follows. Per the § 1110(a) Election between the lessor and *Airlift*, monthly installments were set at \$130,951.16. The debtor made the required payments for three (3) months but failed to make the fourth payment due on November 26. The creditor repossessed the aircraft on December 7 and requested (and was ultimately awarded) \$178,966 as an administrative expense. This sum represented the fourth installment due (\$130,951.16), plus the prorated portion of the next installment due for the period of November 26 to December 7 (prorated rent for 11 days = \$48,015.44).

In *In re TWA*, the court looked to the 11th Circuit's holding in *Airlift* and found the amount of the lessor's administrative expense claim was to be determined per the terms of the lease rather than the fair market value of the aircraft. In overruling lower courts, the Court of Appeals for the 3rd Circuit in *In re TWA* awarded the lessor an administrative claim for the lease amount of \$160,000 per month for the period of October 1 through December 3, 1992 — the full period missed by the debtor — then prorated damages by calculating such damages from the first day of default under § 1110 (*i.e.*, the first day of a payment missed per the terms of the lease), until the airline effectively surrendered possession of the aircraft.

In *In re TWA*, the court determined the manner of calculating the relevant time period during which the debtor was liable for damages. Pursuant to the § 1110(a) Election, TWA cured its default and continued to make all payments through September 1, 1992 under the applicable agreement, covering the month ending September 30, 1992. TWA made no payments after that and went into default on its election. TWA then took the aircraft out of service as of October 24, 1992 but continued to use the engines on other planes in its fleet. On November 12, 1992, the Bankruptcy Court granted TWA's motion to reject the lease. However, TWA did not make the aircraft available to the aircraft creditor until December 3, 1992. At that time, the aircraft creditor requested that TWA keep the two planes until after the Christmas holiday, and took actual physical possession of the aircraft on December 29 and 30, 1992.

Courts have prorated the full amount due under the applicable agreement from the first day the debtor fails to make a payment (per the § 1110(a) Election) and ends upon surrender of possession (December 3 in this case). Here, the lessor requested that the debtor keep the aircraft for a few more days, but possession was surrendered by TWA on December 3 for purposes of calculating damages under § 1110.

c. Damages for Breach of a Covenant

In addition to administrative claims for payment obligations accruing under the governing agreement that arose prior to repossession, a secured aircraft creditor may also have other administrative claims

arising out of a breach of the § 1110(a) Election. For example, in *In re TWA*, damages stemming from the debtor's failure to meet return maintenance conditions specified by the lease for a subsequently rejected aircraft lease were held to be an administrative expense claim rather than rejection damages (*i.e.*, a prepetition unsecured claim), since the debtor's failure to meet maintenance conditions was a breach of the § 1110(a) Election, which required the airline to maintain the aircraft.²⁵ The failure to maintain records, registration or insurance, or keeping inspection reports and turning them over to the aircraft creditor as required by § 1110, also gives rise to a damage claim given a postpetition § 1110(a) Election. Obtaining adequate records from the debtor is vital to the sale or lease of the aircraft to another party.

11. IS THERE LIFE AFTER § 1110?

As noted above, a § 1110(a) Election or a § 1110(b) Stipulation is only temporary: the debtor and/or the creditors need to determine the final fate of the aircraft in the case. As noted, § 1110(a) Elections and § 1110(b) Stipulations do not qualify as an assumption of the lease under § 365, and although a debtor must fulfill the requirements of the underlying documents (or the § 1110(b) Stipulation) while it retains possession of the Aircraft Equipment pursuant to § 1110, it is still free to assume or reject an unexpired lease or otherwise agree on alternative terms with the aircraft creditor.²⁶ While a debtor may still reject an aircraft lease pursuant to § 365, to the extent that a lease has been subject to a § 1110(a) Election, as part of that election any prepetition amounts outstanding would necessarily have been cured, whereas prepetition amounts would typically be deemed rejection damages and be categorized as unsecured claims absent § 1110. As a result, even if a lease is ultimately rejected, the aircraft creditor may be better off than if the lease had otherwise been rejected initially.

25 See *In re TWA*, 145 F.3d 124.

26 *In re TWA*, 145 F.3d 124. See also *In re Western Pacific Airlines*, 221 B.R. 1 (D. Colo. 1998), appeal dismissed, 181 F.3d 1191 (10th Cir. 1999).

Adequate Protection and Rights under § 365(d)(5)

1. THE AVAILABILITY OF ADEQUATE PROTECTION TO AIRCRAFT CREDITORS

Section § 363(e) of the Bankruptcy Code provides that, at any time, at the request of an entity that has an interest in property used, sold or leased by the debtor, the court shall prohibit or condition such use, sale or lease as is necessary to provide adequate protection of such interest. This section applies to property that is subject to a security interest as well as equipment subject to an unexpired lease. Thus, it is clear that not only secured lenders to airlines, but also aircraft lessors, may have rights to be adequately protected. Whether a bankruptcy court would grant adequate protection to an aircraft creditor or lessor if § 1110 is applicable with respect to an aircraft is uncertain, as a court might view the ability of an aircraft creditor to protect itself through a § 1110(b) Stipulation or the exercise of remedies under § 1110(c) as constituting adequate protection (note that under a § 1110(a) Election the aircraft creditor receives the benefit of its original bargain).²⁷ However, these provisions do apply to aircraft and equipment that do not meet the eligibility requirements for the applicability of § 1110, as well as with respect to aircraft owned and operated by entities that are not “air carriers.”

Where available, adequate protection may take the form of cash payments for the use of the equipment and diminution in value (either by decline in its market value or by wear and tear), the creation of a maintenance reserve to ensure compliance with maintenance requirements, firm commitments to complete scheduled maintenance and/or the adoption of a master plan for orderly repossession of the collateral, including the aircraft records, if necessary. As a practical matter, the plan for orderly repossession and surrender may be the most important consideration for aircraft creditors. Without a plan, aircraft creditors could potentially be forced to engage in a worldwide effort to reclaim their equipment, which may also require sorting out engines and airframes belonging to other parties.

Adequate protection is typically awarded only where the value of the underlying collateral is decreasing and is not available where secured creditors or lessors are protected by a large equity cushion. Aircraft, however, are unique in that the value of an aircraft can have significant swings depending upon where the aircraft is in the maintenance cycle. As a result, adequate protection may still be available even when the creditor appears to be over-secured in the moment. For example, in the Delta Airlines case, the court ordered adequate protection even though the applicable notes were over-secured by the collateral. The court ruled that the airline had to assure proper maintenance, make monthly payments of a specific amount and provide written notice to the trustee in the event of certain major maintenance issues. A monthly report regarding the status of the collateral also had to be provided to the trustee. The order also built in requirements with respect to the delivery of any aircraft subsequently abandoned.

²⁷ However, even in the context of a § 1110(a) Election the creditor may not have the ability to protect itself from a decrease in market value of the aircraft since such an election is not permanent.

Often courts find the existence of a significant “equity cushion” to be adequate protection in and of itself. As noted above, however, an equity cushion may erode rapidly in connection with one or more aircraft depending on the maintenance status of the aircraft. For safety and general maintenance reasons, aircraft are subject to regular maintenance events, some based purely on time and others based upon use of certain parts of an aircraft. Some of these maintenance visits are short, routine and, on a relative basis, inexpensive. However, after the duration of a certain amount of time the aircraft itself needs to have an expensive “major overhaul.” Once the aircraft reaches a certain amount of use, an engine likewise has to go through a major overhaul. Aircraft are often valued on the basis of “half-time” — that is, the point when the various components are midway between their last major overhaul and when the components are subject to their next major overhaul.

If at the time of the petition all of the aircraft and their component parts are above “half-time” with respect to the various maintenance components, and as a result of the passage of time and use of the aircraft during the bankruptcy proceeding the status drops below half-time, the change in the value of the aircraft due to the negative variation in the maintenance status might make take a creditor from an over-secured position to an under-secured position. The aircraft creditor made this argument in the Delta Airlines matter referenced previously, which may have influenced the court’s decision to require the debtor to continue to maintain the aircraft.

2. APPLICABILITY AND BENEFITS OF § 365(D)(5) FOR LEASE FINANCING

Section 365(d)(5) of the Bankruptcy Code covers unexpired leases for non-personal property, including equipment leases, and requires a debtor in a chapter 11 case to timely perform all the obligations of the debtor arising from or after sixty (60) days following a bankruptcy filing until the lease is assumed or rejected unless the court, based upon the equities of case, orders otherwise. This section essentially requires that rental and other lease payments accruing after sixty (60) days from the commencement of a case be treated as administrative expenses. Further, this section expressly provides that it overrides § 503(b)(1), which requires, in order for rent to be deemed an administrative expense, that the equipment at issue be actually used and provide benefit to the estate. As a result, to the extent that an aircraft lease is not subject to a § 1110(a) Election or a § 1110(b) Stipulation or is not the subject of § 1110 in its entirety, § 365(d)(5) provides that rent and other payments required under the applicable lease should be required to be made by the debtor until the lease is assumed or rejected.²⁸

To avoid such payments, a debtor may seek to have a lease transaction recharacterized under state law as a secured financing to which § 365(d)(5) does not apply. In order to ensure that it receives proper payments despite any litigation over a financing’s proper characterization, an aircraft creditor might consider seeking to have its § 365(d)(5) amounts escrowed while at the same time, to the extent a financing is ultimately determined to be a secured loan and not a lease, seeking adequate protection.

²⁸ While amounts accruing during the initial sixty (60) days are not addressed by § 365(d)(5), courts have allowed claims for lease and other payments under § 503 to the extent the use of the equipment confers a benefit on the estate.

3. §§ 1110 AND 365(D)(5) CAN CO-EXIST

Some have claimed that § 365(d)(5) is not applicable for aircraft eligible for the benefits of § 1110 if the debtor does not have the benefit of the continuing stay on remedies relating to the aircraft lease (for example, if there is no § 1110(a) Election or § 1110(b) Stipulation). This position is contrary to the purpose of § 1110 to encourage the financing of Aircraft Equipment or the plain language of § 365(d)(5) itself. Nothing in § 365(d)(5) connects the obligations contained therein to the continuation of the automatic stay. Nothing in the language of § 365(d)(5) requires that the debtor have an absolute, unfettered right to assume the underlying equipment or suggests that the mandate of § 365(d)(5) upon the debtor after sixty (60) days from the petition date should negate the required prompt payment of contractual obligations if the debtor cannot assume the executory contract or if the creditor is not stayed from remedies. By its terms, § 365(d)(5) applies until the lease is assumed or rejected. The fact that remedies are not stayed does not change the reality that the debtor is using the aircraft without assumption or rejection of the executory contract and the price for use should be as provided in § 365(d)(5). Further, there is no limitation on debtors in § 365 on their ability to assume or reject leases or contracts subject to § 1110. Similarly, § 1110 contains no language suggesting that it displaces § 365. To the contrary, the provisions of § 1110 can only be interpreted to reflect a congressional intent that § 1110 work together with § 365. The better reading of § 1110 is that it allows the debtor to assume or reject an aircraft lease at any time after the 60th day until the lessor exercises its remedies and the lessor has the rights under § 365(d)(5) to demand prompt payment of contractual obligations after sixty (60) days from the petition date. Under the legislative history of § 1110, the lessor should not be obligated to repossess to preserve its rights, and there is no reason why § 365(d)(5) should not determine the rent payable until such decision is made to take remedies.

Perhaps the source of confusion regarding this topic is the false premise that aircraft leases cannot be assumed after sixty (60) days if there is no § 1110(a) Election or effective § 1110(b) Stipulation because rights under § 1110(c) trump the right to assume under § 365. This is not the case, however, where the secured creditor has not exercised its § 1110(c) rights — in such a case, the debtor can still assume or reject the lease until such Aircraft Equipment is returned or repossessed. Accordingly, regardless of a § 1110(a) Election or a § 1110(b) Stipulation, aircraft creditors should be able to recover lease and other related payments under § 365(d)(5).²⁹

4. TIMING OF FILING MOTION FOR ADEQUATE PROTECTION AND THE SUBSTANCE THEORY

The filing of a motion for adequate protection may occur at any time after the date of the filing of the petition. When filing a motion, take into consideration the jurisdiction in which the case is pending. There may be interpretive differences as to whether adequate protection protects value from the date of the petition or from the date of the motion.³⁰ The date the motion is filed appears to be the prevailing

²⁹ The right to payment under § 365(d)(5) is automatic and, unlike adequate protection, which requires the authorization of the court, debtors do not need permission from the court to commence making applicable payments on equipment thereunder.

³⁰ *In re Continental Airlines, Inc.*, 146 B.R. 536 (Bankr. D. Del. 1992) (adequate protection awarded only from date the motion is filed); *In re Cason*, 190 B.R. 917 (Bankr. N.D. Ala.) (same); *In re Ritz-Carlton of D.C., Inc.*, 98 B.R. 170 (S.D.N.Y.

view.³¹ Accordingly, many trustees and secured creditors will at least consider filing such motions as soon as possible in the case unless it is clear the court does not subscribe to the *Continental* view. Having said that, whenever you file a motion to lift the automatic stay, one possible result is that the debtor responds by acquiescing in the request. Be careful what you wish for! Sometimes waiting until the case settles a bit may enable the debtor to make a more thoughtful consideration as to whether it wants the subject aircraft.

Generally speaking, if a motion to lift the automatic stay for lack of adequate protection is made under § 362(d), a preliminary hearing must be held within 30 days of the filing of the motion. A final hearing within 60 days in the absence of agreement of the parties or the court, due to “compelling circumstances,” determines that a hearing at a later time is appropriate. Practically speaking, however, the timing of the hearings, in particular the final hearing, is determined to a large degree by the complexity of the matter, need for discovery and the court’s schedule.

There are two types of diminution in value to protect against. First is diminution in the market value of the aircraft — the value of the aircraft changes over time (*i.e.*, an aircraft becomes less valuable as it ages) but also as a result of the supply of and demand for a type of aircraft. In addition to market value, the value of an aircraft varies considerably as a result of the maintenance status of the aircraft.

Standards for maintenance are set by regulatory authorities, principally the Federal Aviation Administration (“FAA”), and are mandatory. The standards are precise and are not measured against a concept of reasonableness. The FAA requires that parts of an aircraft undergo various types of inspection and maintenance on a periodic basis based on the calendar (*i.e.*, 180 days) or based upon the amount of time a part was actually used (“*Maintenance Events*”). Many of the Maintenance Events are expensive to complete. The farther away parts are from their last Maintenance Event (or the closer they are to the next Maintenance Event), the less valuable an aircraft will be. A purchaser will take into consideration how far away the next Maintenance Events are in determining what it is willing to pay for the aircraft.

A motion to lift the stay and for adequate protection ought to cover both types of erosion in value. However, while it appears to be an isolated case, the Bankruptcy Court in the case of *In re Continental Airlines, Inc.*, 154 B.R. 176 (Bankr. D. Del. 1993), *appeal dismissed as moot* 91 F.3d 553 (3rd Cir. 1996), held that to obtain protection against market value decline of the asset serving as collateral, the creditor was required to seek relief from the automatic stay.

1989) (“the general rule is that for adequate protection purposes a secured creditor’s position as of the petition date is entitled to adequate protection against deterioration”); *In re Addison Props. Ltd. P’ship*, 185 B.R. 766, 784 (Bankr. N.D. Ill. 1995).

31 See *In re Alliance Well Serv., LLC*, 551 B.R. 903, 906–907 (Bankr. D.N.M. 2016) (collecting cases).

Following a Default

1. WHAT ARE THE RIGHTS UNDER § 1110(C)?

Section 1110(c)(1) of the Bankruptcy Code provides in relevant part:

... the trustee shall immediately surrender and return to a secured party, lessor or conditional vendor, ... equipment ... if at any time after the date of the order for relief under this chapter such secured party, lessor or conditional vendor is entitled pursuant to subsection (a)(1) to take possession of such equipment and makes a written demand for such possession to the trustee.

In other words, if the debtor has failed to secure an extension of the automatic stay by making a court-approved election under § 1110(a) to comply with the terms of the relevant financing agreements or lease and has not abided by such agreement, or has not entered into a § 1110(b) Stipulation to extend the initial sixty (60) day period, the aircraft creditor can — following a written demand — exercise any right it might have under the relevant lease or security agreement to demand the surrender of the aircraft or repossess it. The surrender is required to be immediate. Section 1110(c) is silent with respect to the method or location of the surrender of the equipment. It is clear that, so long as the security agreement, lease or conditional sales agreement requires it, all records and documents relating to the aircraft are likewise to be returned to the aircraft creditor.

2. WHAT ARE THE COSTS OF REPOSSESSION, MAINTENANCE AND INSURANCE?

Costs of repossession, maintenance and insurance will vary from transaction to transaction. Importantly, the cost of repossession will vary depending upon whether the debtor is required to deliver the aircraft to a specific location, with engines and spare parts attached along with maintenance records. Some original documents have no return conditions, in which case the costs of repossession may be high without help from the debtor. The costs of repossession might be reduced through specific conditions for the return of the aircraft when negotiating the governing documents up front or might provide a good reason for a creditor to enter into a § 1110(b) Stipulation where reasonable return conditions might be added. Return conditions might include (a) the aircraft being returned at an airport on the operator's route system acceptable to the aircraft creditor; (b) the debtor providing free storage at an airport that normally stores aircraft for at least thirty (30) days and for sometimes as much as ninety (90) days; (c) the aircraft being certified as airworthy by the appropriate civil aviation authority; (d) the aircraft being in as good operating condition as and when delivered, subject to ordinary wear and tear; (e) if the airframe is not maintained under a progressive maintenance program, there being some defined percentage of the time remaining between scheduled major Maintenance Events; (f) if the engines are not maintained under an on-condition maintenance program, there being similarly some minimum number of hours available before the next scheduled Maintenance Events; and/or (g) if the airframe and/or engines are on scheduled overhaul programs and do not meet the stipulated time availabilities, payments will be made to accommodate for the shortfall.

Insurance of the aircraft is another expensive element in the repossession of aircraft. Prudence dictates that the aircraft be insured while in storage. To the degree the aircraft is to be maintained in relatively secured circumstances, the cost of the insurance could be mitigated.

The costs of repossessing the aircraft are reduced by having a complete set of the records necessary to enable a third party to operate the aircraft. Without proper records that likewise meet the needs of potential purchasers in connection with their FAA-approved maintenance programs, a purchaser may have to complete what might be unnecessary maintenance to obtain an airworthiness certificate to fly the aircraft. The lack of these records would therefore have an adverse effect on the value of the aircraft and the number of potential purchasers, thereby “increasing” the true cost of repossession.

3. FUNDING AIRCRAFT CREDITORS THAT SERVE IN REPRESENTATIVE CAPACITIES

Repossessing an aircraft can be expensive. Where a trustee holds the interest in the aircraft, funds will need to be made available by the beneficiaries either through a mechanism included in the trust documents or otherwise for the repossession, maintenance and insurance of the aircraft. In a trust situation, investors can also direct the trustee to withhold funds from payments received either under § 1110(a) or under a § 1110(b) Stipulation for such purposes, loan funds to the trustee for these purposes or approve third-party loans so the trustee can take the necessary actions to repossess and manage the collateral thereafter in order to protect the value thereof.

4. DEFICIENCY CLAIMS AND ADMINISTRATIVE CLAIMS

The secured aircraft creditor should have a deficiency claim in the bankruptcy reflecting the difference between the amount obtained from disposition of the collateral and the amount of the debt (or lease claim). Typically, the deficiency claim would be a general unsecured claim. However, the aircraft creditor’s claim should enjoy administrative status to the degree the claim reflects payments due on aircraft the debtor agreed to make pursuant to a § 1110(a) Election or § 1110(b) Stipulation until the date of the return of the aircraft. A discussion on the calculation of damages is set forth in a later section.

5. TIMING AND STRATEGY OF REMEDIES

Prior to exercising remedies, aircraft creditors might consider negotiating with the debtor since a stipulation governing the use and return of the aircraft may be better than exercising remedies given the costs of repossession and the vagaries of that process, particularly in circumstances where “self-help” repossession is not available. However, any negotiation must remain mindful of the status of the market for aircraft (you don’t want to be late to a declining market) and the likelihood of a successful emergence from bankruptcy on the part of the debtor. Still, an evaluation of resolution versus repossession is important in determining the best path forward for any individual aircraft.

6. THE NECESSITY OF GOOD ORIGATION DOCUMENTATION

The exercise of remedies will be helped immeasurably by origination documentation that is clear with respect to the remedies available to the aircraft creditor, specifying unambiguous return conditions;

that includes all records and documents relating to the aircraft as part of the collateral package; and that provides for a source of funds to pay for the repossession of the aircraft. Origination documentation should clearly specify the manner and conditions in which such remedies can be exercised, including the delivery of the aircraft records. The trustee's and creditor's lives are complicated by ambiguous documentation.

Repossession and Aircraft Foreclosure under State Law

1. EFFECTS OF § 1110 OF THE BANKRUPTCY CODE

As noted above, pursuant to § 1110(c), a secured party may take possession of its collateral and enforce its rights and remedies (a) following a bankruptcy filing to the extent that (i) a § 1110(a) Election has not been made and approved after sixty (60) days; (ii) no agreement under § 1110(b) has been made to extend the initial sixty (60) day period; and (iii) the lease or security agreement provides for the taking of remedies; or (b) upon a default under such a § 1110(a) Election or § 1110(b) Stipulation that has not been cured.³² Upon a written demand for the aircraft, the aircraft creditor may proceed to exercise its rights.

2. PERFECTION AND FEDERAL PRE-EMPTION

Federal law pre-empts state law with respect to matters for which there are specific provisions. Under the Federal Aviation Act, 49 U.S.C. §§ 40101–49105 (2002) (the “*Transportation Code*”), the FAA registers aircraft and issues a certificate of registration to its owner.³³ Section 44102(a)(1) of the Transportation Code specifically provides that the FAA shall record (i) conveyances that affect interests in civil aircraft; (ii) leases and instruments executed for security purposes;³⁴ and (iii) interests in certain aircraft engines, propellers and spare parts. The Transportation Code governs perfection of title to aircraft as well as interests in airframes, and engines and propellers, including security interests.

The Transportation Code does not contain any provisions for the procedures that a secured creditor should follow to enforce its remedies against aviation collateral. These matters, as well as the priority of security interests, are matters of state law and are recognized in the Certificate of Repossession, which includes the following representation:

On [date] the aforesaid [creditor] breached the obligation and promises contained in the security agreement and applicable laws of the state of [...], the undersigned repossessed the aircraft described above and foreclosed on the [date], and that pursuant to local law, divested the said debtor, and any and all persons claiming by, through or under them, of any and all title they had or may have had, and the secured party now owns the aforesaid aircraft, or the aircraft has been sold.

32 11 U.S.C. § 1110(c).

33 49 U.S.C. § 44103(a)(1).

34 49 U.S.C. § 44107(a).

The filing of the Certificate of Repossession with the FAA Registry provides the means by which the secured party may obtain or transfer record or legal title for the purpose of a disposition of aviation property. The Certificate of Repossession must be accompanied by an original or certified copy of the security instrument upon which repossession is based unless the instrument is already recorded in the FAA Registry.³⁵ As noted above, however, the filing of a Certificate of Repossession does not, of itself, effect a disposition of collateral or ensure possession.³⁶

Under the Transportation Code, the local law governing the validity of the mortgage or any instrument that is recorded with the FAA Registry is the law of the state in which such mortgage or other instrument is delivered.³⁷

Aircraft creditors may also protect themselves internationally through the Convention on International Interests in Mobile Equipment (commonly referred to as the “*Cape Town Convention*”). The United States adopted the Cape Town Convention on August 9, 2004. The purpose of the Cape Town Convention was to provide greater certainty to aircraft creditors to facilitate the financing of mobile equipment such as aircraft (which can be in multiple countries on any given day). The Cape Town Conventions creates an “international interest” recordable on an electronic international register for the registration of these international interests providing notice to third parties and providing for the order of priority of such interests. In addition, the Cape Town Convention provides the creditor with a range of basic default remedies and a means of obtaining speedy interim relief pending final determination of its claim. The Cape Town Convention contains provisions similar to those found in § 1110 of the Bankruptcy Code.

3. KNOW YOUR RIGHTS — CONTROL UNDER THE TRANSACTION DOCUMENTS

Some transactional structures are complex. Therefore, it is important to know who is in control under any given situation with respect to the exercise of remedies. It is important to know how (or if) a particular investor can wrest control from the current controlling party. In multi-tranche structures, often the most senior tranche is able to control the exercise of remedies, thereby making decisions on behalf of the entire transaction. In some cases this could include the ability to fix the recovery in a manner that allows for senior holders to be paid in full, but does not maximize recovery for junior tranches. Often creditors in a lower tranche have the ability “buy out” the more senior tranche under the terms and circumstances set forth in the agreement. In other cases, sometimes the tranche or pool that has the highest amount of outstanding indebtedness has “buy out” rights.

This may be further complicated by the existence of a liquidity provider. Liquidity providers typically agree to fund the debtor’s obligations for a period of time so that there is no interruption in payment to aircraft creditors. This time period gives all parties breathing space to agree to restructured terms or otherwise preserve the value of the aircraft creditors’ position by providing certainty regarding the

35 U.S. Department of Transportation, “Information to Aid in the Registration of U.S. Civil Aircraft,” paragraph 12.

36 See also U.C.C. § 9-619(c).

37 49 U.S.C. § 44108(c).

payment of interest for a certain number of interest payment periods. However, they often have the ability to control rights and remedies under a transaction after the passage of a certain amount of time if the amounts advanced under the liquidity facility have not been paid. This ability might include control over the decision to give notice under § 1110(c) of the Bankruptcy Code.

Also, aircraft creditors are wise to take note of and understand any subordination provisions or agreements that remains outstanding. Aircraft creditors that hold claims in lower tranches may have limited remedies. In addition, any entity holding the “equity” in the aircraft may or may not have any rights with respect thereto in a default situation. Given that debt must generally be paid before equity holders receive any payments, the equity in the aircraft may have little value and may face foreclosure. The loss to foreclosure by equity holders may be compounded in certain situations where the foreclosure triggers a large tax liability. In certain unique circumstances, these losses can sometimes be mitigated with the assistance of experienced tax counsel. In these circumstances, it may be to the advantage of aircraft creditors to work with the equity holder in order to facilitate a more consensual foreclosure and resolution.

4. REMEDIES AVAILABLE TO SECURED PARTIES UNDER THE UNIFORM COMMERCIAL CODE

As detailed above, the Bankruptcy Code modifies the rights and remedies available to aircraft creditors, while at the same time providing them with unique protections unavailable to other creditors. Outside of bankruptcy, including, inter alia, to get rid of any equity interest of third parties, typically, the rights and remedies of an aircraft creditor (including trustees) upon default are governed both by the transaction documentation and the Uniform Commercial Code (the “U.C.C.”). Section 9-601 of the U.C.C. provides, in relevant part:

(a) After default, a secured party has the rights provided in this part and, except as otherwise provided in § 9-602 [respecting rights which cannot be waived], those provided by agreement. A secured party (1) may reduce his claim to judgment, foreclose, or otherwise enforce the claim, security interest or agricultural lien by any available judicial procedure ... The rights [above] are cumulative and may be exercised simultaneously.

Pursuant to § 9-601, a secured party has three options upon a debtor’s default: (i) foreclosure; (ii) reducing the claim to a judgment; or (iii) utilizing other available judicial procedures.

a. Foreclosure

One of the remedies available to an aircraft creditor is foreclosure on the Aircraft Equipment. Under § 9-609 of the U.C.C., a secured creditor is entitled to take possession of the Aircraft Equipment upon default and under § 9-610 it can dispose of the Aircraft Equipment in a commercially reasonable manner. The U.C.C. provides guidance on what constitutes a commercially reasonable sale and commercially reasonable notice thereof (including guidance on the form of the notice). Public foreclosure auctions subject to an appropriate amount of notice, in terms of both time and publication, are common means of realizing upon the property. These auctions have the advantage of being cost

effective. The U.C.C. may also allow a creditor to retain the collateral in full or partial satisfaction of its claim. Finally, a creditor may seek judicial foreclosure of its security. The benefit of a judicial proceeding is that the sale is “blessed” by a court order, which can minimize the parties’ liability and allow any objections or other issues to be resolved in advance. On the other hand, the process may be more costly and takes more time from start to finish.

b. Reduce Claim to Judgment

The secured creditor alternatively could reduce its claim to a judgment and proceed to collect thereon. Following entry of a judgment, the trustee would cause a writ of execution to be issued, whereby a sheriff levies on the property. The property is then sold at an execution sale and the proceeds of the sale are applied to satisfy the claim. When a secured party has reduced its claim to judgment, the lien of any levy that may be made upon its collateral by virtue of any execution based upon the judgment relates back to the date of the perfection of the security interest in such collateral. Thus, even though the debtor has defaulted within the terms of the security agreement, and the secured party has the right to proceed with collection or repossession, the secured party can nevertheless proceed like an unsecured creditor by suing on the evidence of indebtedness and having the sheriff levy upon and sell the collateral pursuant to the applicable state statutes on execution sales.

c. Other Alternatives

Lastly, the aircraft creditor (which, again, in many transactions is the trustee) may otherwise enforce the security interest by “any available judicial procedure.” Under this language, the secured party has other avenues of recovery besides judgment, levy and foreclosure, including prejudgment attachment, garnishment, receivership and the right of setoff.

5. REMEDIES UPON DEFAULT UNDER THE TRANSACTION DOCUMENTS

As stated in U.C.C. § 9-601(b), the secured party also has those rights and remedies set forth in the relevant transaction documents. While any specific remedies would depend on the specific language of the underlying agreements, typically, those rights will include:

(i) all rights and remedies of a secured party under applicable law;

(ii) to take possession of the collateral;³⁸

(iii) to sell any or all of the collateral at public or private sale (at which the trustee may make a credit bid), *provided* that the debtor shall be given any required prior written notice of its intention to sell the collateral;³⁹

(iv) to “make all expenditures for maintenance, insurance, repairs, replacements, alterations, additions and improvements to and of the collateral, as it may deem proper”; and

38 See U.C.C. § 9-609.

39 See U.C.C. § 9-610.

(v) to sue, in equity, law or bankruptcy, for enforcement of the mortgages and underlying notes; for foreclosure, appointment of a receiver; for judgment; “or for the enforcement of any other proper, legal or equitable remedy available under applicable law.”

6. TAKING POSSESSION OF THE COLLATERAL

U.C.C. § 9-609 grants a secured party the right to take possession of collateral upon a default by the debtor as long as there is no stay in place. Section 9-609 provides, in part:

(a) After default, a secured party: (1) may take possession of the collateral; and (2) without removal, may render equipment unusable and dispose of collateral on a debtor’s premises under § 9-610.

(b) A secured party may proceed under subsection (a): (1) pursuant to judicial process; or (2) without judicial process, if it proceeds without breach of the peace.

(c) If so agreed, and in any event after default, a secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.

U.C.C. § 9-609 places the same limitation on self-help as the common law — in taking possession, the secured creditor must not cause a breach of peace — though with aircraft subject to § 1110, a bankrupt debtor that is in possession of aircraft not subject to an §1110(a) Election or §1110(b) Stipulation, is required to surrender the aircraft, greatly aiding this process. Assuming there is no stay in place, if the secured party is unable to repossess the collateral through self-help, it can seek to repossess it through a judicial action. In the case of heavy equipment, such as aviation collateral, physical removal is impractical. Therefore, the U.C.C. provides that the equipment may be disposed of without removal. A provision in a security agreement requiring assembly of collateral by a debtor has been held enforceable by mandatory injunction.⁴⁰

U.C.C. § 9-207 sets forth the rights of a secured party in possession of collateral. Pursuant thereto, the secured party may use or operate the collateral for the purpose of preserving the collateral or its value, or as permitted by a court, or in a manner and to the extent agreed by the debtor.⁴¹ The secured party will be able to charge to the debtor and secure with the collateral the reasonable expenses incurred in the custody, preservation, use or operation of the collateral, including the cost of insurance and payment of taxes or other charges.⁴² For bankruptcy purposes these amounts should be added to the

40 See *Clark Equip. Co. v. Armstrong Equip. Co.*, 431 F.2d 54 (5th Cir. 1970), *cert. denied*, 402 U.S. 909 (1971).

41 U.C.C. § 9-207(b)(4).

42 U.C.C. § 9-207(b)(1).

claim asserted against the debtor. The secured party must use “reasonable care” in the custody of collateral in its possession.⁴³

7. SALE OR DISPOSITION OF THE COLLATERAL

Having gained possession of the collateral, the secured party must proceed to dispose of it under U.C.C. §§ 9-610 through 9-619 (foreclosure by sale) or §§ 9-620 through 9-622 (strict foreclosure).

a. Notice and Timing of Sale

Section 9-611 requires a secured party to give the debtor, and any secondary obligor, reasonable authenticated notification of the proposed disposition of the collateral. The notice is required to provide the debtor an opportunity to take whatever action is necessary to protect its interest in the collateral, such as taking some action to minimize the possibility that the collateral will be sold for an amount substantially below the underlying debt.

b. Commercial Reasonableness

A secured party must be commercially reasonable in disposing of the collateral. Importantly, § 9-610 requires that every aspect of a disposition of collateral must be commercially reasonable, including the method, manner, time, place and other terms.⁴⁴ A debtor cannot waive the requirement that the secured party dispose of the collateral in a commercially reasonable manner.⁴⁵ However, the parties can establish by agreement the standard by which the performance of the commercially reasonable obligation will be measured.⁴⁶ All aspects of the disposition will be measured against a commercially reasonable standard, including the decision whether to hold a public or private sale, though the Official Comments to the section recognize that a private sale may in fact garner the highest realization for the subject property.

The standard of commercial reasonableness for disposition also pertains to notice. Section 9-611 of the U.C.C. sets forth the persons required to receive the notice, including the debtor, any secondary obligor and those with a security interest in the property. Section 9-612 sets forth the timing of the notice, and § 9-613 sets forth the substance thereof. The notice merely needs to describe the debtor and the secured party, describe the collateral that is the subject of the intended disposition, state the method of the intended disposition, state that the debtor is entitled to an accounting, and state the time and place of the public disposition or the time after which any other disposition is to be made.

43 U.C.C. § 9-207(a).

44 U.C.C. § 9-610(b).

45 U.C.C. § 9-602(7).

46 U.C.C. § 9-603.

8. CALCULATING DAMAGES OR ANY DEFICIENCY — THE DEBATE ON STIPULATED LOSS VALUE

Upon rejection or abandonment of a leveraged lease on an aircraft in bankruptcy an aircraft creditor, using the Owner Participant's (*i.e.*, the equity holder's) rights as lessor, has the right to assert a claim for damages. The damage claim may include an administrative claim for, *inter alia*, the postpetition use of the aircraft, as well an unsecured claim for damages relating to the rejection of the lease agreement.

The total damages available under a lease are typically defined as the Stipulated Loss Value, or "SLV." In the past SLV has been used as a determinant of the damages flowing to the indenture trustee in leveraged lease transactions for the debt in the event the lease is terminated or breached by the airline. In theory, the SLV should be sufficient to pay the indebtedness due on the debt under the indenture, plus provide an additional amount that should be turned over to the owner participant for tax losses, but it doesn't always work out that way where the debtors pay less than 100% of the claims against them in a plan of reorganization.

a. Recent Bankruptcy Cases Have Ruled Damage Calculation Based on SLV as Unenforceable

The use of SLV as a determinant for damages has come under fire recently and claims based on SLV have been denied as unenforceable penalties. In the recent decision *In re Republic Airways Holdings Inc.*,⁴⁷ the United States Bankruptcy Court for the Southern District of New York (the "Court") held that liquidated damages provisions calculating damages based upon SLV schedules designed to provide the lessor/owner participant with a return on investment of 4% (and not as a proxy for actual damages) violated New York public policy and were unenforceable as penalties. The obligations under the related guarantees were likewise held unenforceable because the underlying obligations under the leases were unenforceable.

The leases provided for damages upon an event of default. As is typical for aircraft leases of this type, damages were calculated with reference to an SLV schedule attached to each lease. Generally speaking, the value of the remaining payments due on the leases or the sales value of the aircraft were deducted from the SLV to arrive at the applicable liquidated damages amount. The SLVs were adjusted from month to month in order to account for monthly payments of basic rent and tax benefits, and to provide a 4% return on investment to the lessor under the leases (the "Lessor"). Notably, the Court pointed out that no evidence was presented showing the calculations based on SLV were a proxy for actual damages.

While the Court did not find fault with the myriad of other uses of SLV schedules contained in the Leases (*i.e.*, loss of the aircraft or the early return thereof), when the SLV schedules intersect with the U.C.C.'s mandates on damages upon an event of default, according the Court, such schedules, and the liquidated damages calculations based thereon, must reasonably relate to the expected damages caused by the default.

⁴⁷ *In re Republic Airways Holdings Inc.*, 598 B.R. 118 (Bankr. S.D.N.Y. 2019).

b. Damages Based on Rental Payments and Residual Values under the Lease

The unenforceability of an SLV clause does not render the aircraft creditor without a claim. Typical formulations for the determination of equipment lease claims include permitting a lessor to recover (a) any accrued and unpaid rent at the time of a breach, (b) the present value of the rent for the remainder of the lease term and (c) the residual value of the equipment, less the present value of the net proceeds resulting from the disposition of the equipment. In the context of an aircraft, the calculation may include damages relating to unwinding the accelerated depreciation of the aircraft under any contractual indemnity agreement (to the extent the aircraft creditor has a security interest in the tax indemnity agreement).

c. What If Damages Based on SLV Are Insufficient to Pay Both the Debt and Equity?

In the event of a shortfall under the SLV in bankruptcy, some debtor airlines have balked at paying both the Tax Indemnity Agreement (“TIA”) and the SLV, indicating that they should not have to pay twice. In *United Airlines*, although the aircraft creditors were paid in full based on a negotiated settlement, the court indicated its belief that the airline’s argument was persuasive. In the *Delta Airlines* bankruptcy, the court focused on the fact that the obligations were based in contract, not in tort, and thus the airline might indeed have to pay twice. Disputes can be avoided if the contracts specifically deal with the possible overlap.

Checklist of Lessons Learned from Prior Airline Bankruptcies

Below is a discussion of considerations in connection with airline defaults. A short form of a similar list is attached hereto as Appendix B.

1. PRE-BANKRUPTCY CONSIDERATIONS

a. Assurances of Maintenance Condition of Aircraft

If possible, obtain current maintenance records and then determine where the aircraft and engines are in their respective maintenance cycle. Determine the location of the collateral engines, as they are often affixed to other aircraft. Original transaction documents should include requirements to provide necessary maintenance information. Consider amending documents, if necessary, to require regularly scheduled maintenance which, if not commenced and completed, would require cash payments into a reserve fund. Assure that upon any return, the aircraft will be at half-life from a perspective of all maintenance items or at least will have a reasonable amount of time remaining prior to the next scheduled maintenance visits. Limit the possibility of the return of an aircraft whose maintenance cycle has completely run.

b. Clarify or Establish the Manner and Method of Return

Evaluate and, if necessary, establish appropriate requirements, manner and method for returning the aircraft both before and during bankruptcy (even though such agreement may not be binding on the airline following bankruptcy filing). Return conditions should include not only the condition of the aircraft upon return, but also the location and manner of return.

c. Make Sure Maintenance Records and Configuration Are “Standard”

If the airline does not follow the manufacturer’s maintenance program, negotiate return conditions that make the aircraft usable to a third party without further maintenance. To the extent possible, reject any unique configuration of the aircraft and insist on return to a “standard” configuration. It could be time-consuming and costly to deal with “special cases” for configuration and maintenance records.

d. Seek a Cash Reserve

Seek a cash reserve from the airline for costs and expenses relating to a returned aircraft, including the costs of maintenance, storage and insurance. In the event the airline resists establishing a reserve, work with any trustee and other stakeholders to fund a reserve for these amounts. If cash is not available, consider whether there is additional collateral that may be given to assure payment. It is easier to consider all available alternatives with respect to an aircraft in bankruptcy when there is a “war chest” to fund a return.

2. UPON A BANKRUPTCY FILING

1. *Determine Who Is in Control in the Transaction.*

- a. Promptly establish priority of payment in debt structures.
- b. Consider strategy with respect to control by any Liquidity Provider upon making an advance of interest.
- c. Consider how to deal with any equity holder in the aircraft.

2. *Be Mindful of § 1110 Rights.* All aircraft should be subject to § 1110(a) Election or an agreeable § 1110(b) Stipulation. If not, consider whether the airline should promptly lose the benefit of continued use of aircraft by exercising rights under § 1110(c).

a. Calendar 60 days after the petition date. If the airline fails to make a § 1110(a) Election for the aircraft, consider exercising § 1110(c) rights unless, of course, the market for aircraft dictates otherwise and there is a strong belief that an ultimate deal can be reached.

b. Consider issuing a § 1110(c) demand after any failure by the airline to completely fulfill timely § 1110(a) obligations.

c. A § 1110(b) Stipulation should only be entered into after giving serious thought to: (i) interim payments for use; (ii) reservation of rights (including the right to terminate continued use); (iii) continued and sufficient maintenance of the aircraft; (iv) delivery of proper maintenance records; (v) favorable or at least reasonable return conditions; and (vi) certainty in damage claims if an ultimate resolution is not reached for the aircraft.

d. Consider whether any continued use of the aircraft without a § 1110(a) Election or § 1110(b) Stipulation should be predicated on the condition of adequate protection incorporated into a court-ordered stipulation as a condition of continued use under § 363(e).

3. Retain experts to manage supervision of aircraft maintenance and remarketing.

4. Seek and obtain a release and waiver of claims and causes of action by the airline.

5. Preserve all rights and claims in all dealings with the airline.

a. “It’s not over until it’s over” — early waiver of claims or causes of action can be fatal to full recovery or fair treatment and recovery.

b. Waivers and releases by aircraft creditors are only appropriate upon a final resolution of all claims.

c. Resolve all issues at once and not piecemeal — beware of the death of a thousand cuts.

6. Reserve rights to administrative expense claims for use of the aircraft, and reach agreement on how to calculate and resolve all claims.

a. If the aircraft is not subject to a § 1110(a) Election, then the debtor airline should be required to agree that any interim payments that are less than the contract amount are partial payments, that § 365(d)(5) is applicable and that there is an administrative expense claim for full contract payment at the end of the case.

b. Attempt to reach an agreement that any and continuing erosion in the maintenance condition of the aircraft from use in the bankruptcy proceeding be awarded a § 503(b) claim as an agreed and allowed administrative expense.

c. If the airline will not agree to (a) and (b) above, then either repossess the aircraft or specifically reserve your right to assert later administrative expense claims.

d. Obtain an agreement with the debtor airline on the orderly return of the aircraft and acceptable return conditions (required location; all records; spare parts with aircraft and engines installed and assembled in an airworthy condition).

7. *Prompt and Full Disclosure of Fleet Plans and Aircraft Transactions Terms.* Attempt to require the debtor airline to disclose its fleet plan for the airline (preferably at the start of the case or within 60 days from the petition with updates on changes — particularly if it is seeking a § 1110(b) Stipulation). Further, try and seek clarity on the terms of restructuring agreements on aircraft with others and seek to have them fully and publicly disclosed. This is especially necessary when there are public debt transactions and public trading of securities. Failure to disclose information can lead to insecurity, which may serve to reduce value of debt.

8. *Continued Cooperation of Debtor in Remarketing by Providing Remarketing Assistance and Financial and Operational Information.*

a. In any stipulation for § 1110(b) or adequate protection, there should be a continuing obligation, even after an aircraft's return, to provide documents or information about the aircraft necessary for the remarketing of the aircraft. In addition, there should be an ongoing obligation for the debtor to provide continuing operational, maintenance and financial information.

b. In the absence of a § 1110(a) Election, a § 1110(b) Stipulation or adequate protection stipulation, an agreement for continued cooperation should be a necessary predicate for any restructuring.

9. In the event it is a determinant of damages, be sensitive to the SLV vs. Tax Indemnity Agreement (“TIA”) debate. A key issue in airline bankruptcies is the relationship between the SLV for

damages under an aircraft leveraged lease and the TIA whereby the airline agrees to indemnify the equity participant against tax consequences that differ from those factored into the pricing of the lease. The total damages available under the lease are typically defined as the SLV. This is to govern the damages flowing to the indenture trustee for the debt in the event the lease is terminated or breached by the airline. In theory, the SLV should be sufficient to pay the indebtedness due on the debt under the indenture, plus provide an additional amount that should be turned over to the owner participant for tax losses, but it doesn't always work out that way where the debtors pay less than 100% of the claims against them, such as in a bankruptcy proceeding.

10. *Monitor All Motions and Orders for Effects on the Rights of Aircraft Creditors.*

a. Watch out for a Debtor-In-Possession financing that gives lenders thereunder a lien on the debtor's interest in the equity of aircraft or contract rights. Make sure no liens rank higher than those of aircraft creditors on the collateral. DIP Financing Orders often appear, at least on interim basis, on day one of the case. Therefore, it is important to be ready to go as soon as the case is filed.

b. Be mindful that an excessive allowance of administrative claims to others can threaten necessary payments to aircraft creditors.

c. Similarly, the excessive allowance of unsecured claims can reduce deficiency claim recovery for under-secured aircraft creditors.

d. Watch for and object to related matters that may now affect others but can be used as a precedent against you.

11. Object to any claims-trading order that impairs security holders' rights to freely trade their securities.

3. KEY CONSIDERATIONS FOR RESTRUCTURING TRANSACTIONS IN BANKRUPTCY

a. Final Deal

Try to negotiate a resolution that addresses all issues and also cannot be unwound by the debtor (no future rejections, amendments, administrative issues or claims to fight about); however, the airline creditors should be able to revoke the arrangement if there is a material adverse change in the condition of the airline.

b. Priority of Payment

Any priority of payment issues among debtholders and liquidity providers should be resolved and it should be clear how the money will be paid.

c. Control and Direction

Transactions with multiple tranches and liquidity providers often have a party or tranche with the right to make certain decisions with respect to the transaction. The continued and future control in the “controlling party” should be clear.

d. Security Deposits of Additional Collateral

Consider security deposits or additional collateral to provide assurance of future performance.

e. Maintenance Assurances

It is important to create obligations and economic incentives to maintain aircraft at determined levels and to require (to the extent possible) easily transferable maintenance records and standard maintenance programs. If possible, the restructured transaction should assure continued and sufficient “standard” maintenance, which might include things such as (a) a reserve, (b) a third-party maintenance assurance contractor or (c) maintenance assurance payments at scheduled maintenance times (*e.g.*, designated hours or cycles or calendar dates per aircraft or engine, and determined cash payment for failure to either initiate or complete maintenance on time).

f. Cooperation in Remarketing

Consider including a provision for continued cooperation of the airline in the remarketing or sale of any returned aircraft.

g. Improved Return Conditions

Consider requiring at least half-time condition and a “C” check, which is a maintenance check that requires a large majority of the aircraft’s components to be inspected, typically performed every 20-24 months or based on a number of flight hours. Also, require that, where necessary, “back to birth” records be available and provided in useable and readable form. Missing maintenance records can hamper the resale of the aircraft and/or impose additional unnecessary costs on the aircraft creditors.

h. Cross-Default and Cross-Collateralization

In multiple aircraft transactions, require cross-defaults (this avoids cherry picking § 1110(a) Elections in any future bankruptcy) and cross-collateralization.

i. Provide Quick Take and Unwind Provision If Airline Fails; Agree on Liquidated Damages

The airline should agree that any failure to consummate a plan of reorganization consistent with the restructuring of the aircraft transaction would allow the aircraft creditors to quickly unwind the restructuring and agree upon an administrative claim or cash payment of a significant predetermined amount to deter both default and a “re-trade” and to compensate for all costs. To the degree possible,

the agreement should also address the logistics of getting the equipment back in the event the airline fails.

j. Continued Financial and Operational Information

Obtain the agreement of the debtors to provide up-to-date financial information and operational information on a periodic basis with respect to both the airline and the aircraft.

k. Resolution of Administrative and Other Claims for Rejected Aircraft

Resolve all administrative and unsecured claims for aircraft that are or have been returned and reach agreement with respect to any remaining aircraft in a transaction with respect to rejection or abandonment. Specify the administrative claims and/or how such claims would be calculated in the event of further rejection.

l. Deregistration and Repatriation of Aircraft

If there is foreign registration or use of the aircraft, there should be a clear provision that, upon demand, the foreign registration will be terminated and the aircraft will be returned to an acceptable location. The provision should require the continued cooperation of the airline.

m. Securities Freely Tradable and Rated

The restructuring should provide for assurances that the restructured securities would remain or become freely tradable in the public market and rated (especially if they were previously rated).

n. Use of Court Approval of Fairness and Bar Order

In any public debt transaction, § 316 of the Trust Indenture Act and caselaw may require that non-consenting holders' interests can only be impaired (as to certain matters, including principal and interest payments) after a fairness hearing with notice by a court of competent jurisdiction. In addition, the court order should bar any third party, including non-consenting security holders, the owner trustee and the owner participant, from instituting suit or interfering with the settlement and restructuring. Approval by the Bankruptcy Court likewise protects against other parties in interest that may seek to overturn the transaction.

o. Resolution of Any SLV and Tax Indemnification Disputes

The status of the Stipulated Loss Value should be resolved by the restructuring and, in the event the outstanding debt will not be paid in full, the SLV claim will inure to the benefit of aircraft lenders. Any tax indemnification for equity must be resolved separately by the airline and equity.

p. Other Outstanding Issues That Might Be Addressed

- Indemnities that survive
- Representation and warranties
- Required corporate credit rating of airline
- Payment of fees and expenses of aircraft creditor
- Condition precedent to effectiveness
- Financial covenants
- Covenants (general)
- Terms of court order of approval
- Release of claims and causes of action

Significant Airline Bankruptcy Decisions

Set forth below are summaries of a number of cases relevant to aircraft finance.

1. IN RE CONTINENTAL AIRLINES, INC., I, 146 B.R. 536 (BANKR. D. DEL. 1992) (“CONTINENTAL I”)

Aircraft Creditors Entitled to Adequate Protection Payments for Loss of Market Value Only after Adequate Protection Is Sought. In *Continental I*, the trustees for the holders of certain equipment trust certificates of Continental Airlines sought adequate protection arising from (1) a decline in value of the aircraft due to market conditions and (2) a decline in value due to Continental’s postpetition use and lack of maintenance of the collateral. A stipulation with respect to the latter was entered into. With respect to adequate protection due to decline in market value, the court quoted with approval dicta of the United States Supreme Court in the *Timbers*⁴⁸ case. The Supreme Court held that an under-secured creditor whose collateral was decreasing in value would be entitled to adequate protection payments. However, the court ruled that a secured creditor could only receive adequate protection to the extent that collateral declined in value *after the creditor filed its motion for adequate protection*. Continental presented testimony that the value of the collateral collapsed prior to the bankruptcy filing. The court found that Blue Book values were most reliable in charting general market value. The court further found that the aircraft values had remained flat since the filing of the motion for adequate protection and, therefore, the movants were not entitled to adequate protection based on a decline in market value due to market conditions.

2. IN RE CONTINENTAL AIRLINES, INC., II, 154 B.R. 176 (BANKR. D. DEL. 1993) (“CONTINENTAL II”)

Aircraft Lenders Only Entitled to Adequate Protection after Filing a Motion to Lift the Automatic Stay. In a subsequent ruling, the same bankruptcy judge held that the trustees were only entitled to adequate protection for any decline in market value of the collateral from the date they filed motions *for relief from the automatic stay*. Originally, because the market was depressed (having been flooded with aircraft, owing to the collapse of Eastern Airlines), the trustees had not included a request to lift the automatic stay. Therefore, no adequate protection was granted. Although the case has been widely criticized by some, because the indenture trustees could not post a bond to stay the effect of the court’s order (and the appeal thereafter became moot as a result), the case was not reversed.

3. IN RE UNITED AIRLINES, 411 F.3d 818 (7TH CIR. 2005)

“Excusable Neglect” Can Invalidate a § 1110(a) Election. Aircraft creditors are frequently paid on a biannual basis. Therefore, one byproduct of the timing of the payments is the prospect that debtor airlines can attempt to obtain “free” use of aircraft by making a § 1110(a) Election on aircraft without any real intention of keeping the aircraft. This is because technically there may not be any defaults to cure until the next payment becomes due, which could be months down the road due to the biannual payment schedule. During this time, the debtor airline buys time and continues to keep the plane in

⁴⁸ *United Sav. Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988).

revenue service, racking up maintenance costs that the debtor intends to later shift to the aircraft creditors when it ultimately defaults on its § 1110(a) Election.

In the United Airlines bankruptcy, the debtor made a § 1110(a) Election on aircraft on which no payment was due and owing at the time of the expiration of the sixty (60) day period. The debtor defaulted on its obligations thereunder with respect to a number of aircraft when the payments came due, asserting that the aircraft in question were under water (the market value of each aircraft was less than the amount due under the terms of the financing). The trustee, in cooperation with the aircraft creditors, filed motions to compel the payment of the missed § 1110(a) payments as administrative expenses.

United claimed that it had mistakenly made § 1110(a) Elections regarding aircraft on which payments were due, triggering payment obligations to aircraft creditors. United contended that, had the airline realized that payments were due on these aircraft, and that it would not effectively obtain “free” use of these aircraft, it would not have entered into such § 1110(a) Election. The Seventh Circuit supported United’s position that the § 1110(a) Election with respect to such aircraft should be vacated by reason of excusable neglect under Rule 60(b) and its bankruptcy equivalent. According to the Seventh Circuit, if the mistake was not corrected, the cost of United’s mistake would be borne not by United but by its creditors. The Seventh Circuit ruled that the trustee bank had not relied to its detriment since, upon discovery of United’s error, United and the trustee agreed to a partial payment for that aircraft, reserving the right to litigate the issue of the balance. Therefore, the Seventh Circuit concluded there was no prejudice to the trustee bank. This case sets a dangerous precedent, one which hopefully is limited to the unique set of facts because it arguably validated this type of windfall and relieved the debtor of the consequences of its intentional attempt to obtain free use of the aircraft.

4. IN RE IONOSPHERE CLUBS, INC., 134 B.R. 528 (BANKR. S.D.N.Y. 1991)

Outstanding Amounts of Different Tranches May Be Combined for Purposes of Determining Whether the Senior Tranche Is Over-Secured; Subordination Agreements Must Be Clear. In this case in the Eastern Airlines bankruptcy proceeding, Judge Lifland ruled that the first-, second- and third-priority certificate holders under an indenture held one secured claim against the debtor, rather than three separate secured claims, for purposes of determining whether first-priority creditors were over-secured and thus entitled to postpetition interest. In addition, in that case, the court found that the language of the indenture was too ambiguous to support the payment of postpetition interest to the first-priority certificate holders. Judge Lifland ruled that, in order to be enforceable in bankruptcy, a subordination provision must clearly indicate the intention to have postpetition interest paid to the senior tranche.

5. IN RE REPUBLIC AIRWAYS HOLDINGS INC., 598 B.R. 118 (BANKR. S.D.N.Y. 2019)

Stipulated Loss Value Provisions Used for Damages Purposes Held to Be Unenforceable as a Penalty in Bankruptcy. The United States Bankruptcy Court for the Southern District of New York held that liquidated damages provisions calculating damages based upon SLV schedules designed to provide the lessor/ owner participant with a return on investment of 4% (and not as a proxy for actual damages) violated New York public policy and were unenforceable as penalties. The obligations under the

related guarantees were likewise held unenforceable because the underlying obligations under the leases were unenforceable.

6. IN RE AMERICAN AIRLINES, 730 F.3d 88 (2^D CIR. 2013)

Make-Whole Provisions in Aircraft Indentures May Not Be Enforced (or Apply) in Bankruptcy. The debtor airline sought to refinance certain of its outstanding prepetition debt by paying off prepetition notes with a new, lower-cost secured postpetition financing. The trustee sought payment of a make-whole amount required to be paid in the event of an early pay-off of the outstanding amounts. The Bankruptcy Court, which was later affirmed by the Second Circuit, held that the indenture provided that a bankruptcy filing automatically accelerated the debt, making the debt due and payable, and therefore no payment was required for an early repayment. The courts also found the automatic stay prohibited the delivery of any notice to waive defaults and decelerate the debt. The aircraft collateral was subject to a § 1110(a) Election. The trustee further argued that § 1110(a) had decelerated the debt, thus not making it currently due and payable. The Second Circuit held that debt remained due and payable on account of the automatic acceleration notwithstanding the § 1110(a) Election, and the make-whole payments on account of an early payment were not required. Thus, it appears that while a § 1110(a) Election may prohibit the exercise of remedies, it does not serve to decelerate the debt in the Second Circuit. The case was appealed to the U.S. Supreme Court, which refused to hear the case on its merits.

7. UNITED AIRLINES, INC. v. U.S. BANK N.A., 406 F.3d 918 (7TH CIR. 2005), AND UNITED AIRLINES, INC. v. U.S. BANK N.A., 409 F.3d 812 (7TH CIR. 2005)

Aircraft Creditors in Different Transactions May Act Together. During its bankruptcy case, United attempted to restructure its publicly held aircraft debt. Many of the transactions were Enhanced Equipment Trust Certificates (“EETCs”), Pass Through Certificates (“PTCs”) and Equipment Trust Certificates (“ETCs”) structures. One bank served as trustee for the vast majority of transactions, and there were substantial cross holdings among institutions in these public issues. Aircraft Creditors and United were unable to come to terms on restructuring the leases and financings. Frustrated by stalled negotiations with United, aircraft creditors for several of the transactions delivered § 1110(c) notices to United that covered 14 planes. The indenture trustees took the position that unless United cured all defaults and resumed full contractual rental payments, the aircraft had to be returned. United responded by filing an adversary proceeding, charging that there was improper coordinated action among public debt holders amounting to violations of the antitrust laws. The Bankruptcy Court issued a temporary restraining order against repossession, holding the § 1110(c) notices to be ineffectual in part because of the probability there had been a violation of the antitrust laws. Later, the Bankruptcy Court ruled the trustees were guilty of contempt in their refusal to produce documents covered by the attorney/client privilege. Both of these decisions were appealed. The District Court dismissed appeals of these rulings for want of a final order. The trustees filed for a writ of mandamus in the Seventh Circuit to lift the order the Bankruptcy Court had issued to restrain the trustees from repossessing the aircraft. The Seventh Circuit held that cooperation among a debtor’s creditors in an effort to collect as much as possible of the amounts due under competitively determined contracts is not the sort of

activity with which the antitrust laws are concerned. Moreover, the Seventh Circuit held that under the *Noerr-Pennington* Doctrine (which protects petitioning activity before governmental bodies under the First Amendment, including courts), the trustees and aircraft creditors were entitled to act jointly to restructure the debt, which would require approval of the Bankruptcy Court. In a strong reaffirmation of the scope of § 1110, the Seventh Circuit ruled that § 1110(a)(1) prevents bankruptcy judges from using *any* source of law, including antitrust law, as the basis of an injunction against repossession. Moreover, the Seventh Circuit held that the antitrust claim was “thin to the point of invisibility.”

For More Information

If you would like further information concerning any of the matters discussed in this article, please contact Frank Top, Stephen Tetro, Rick Klein, Jim Heiser, or any other Chapman and Cutler attorney with whom you regularly work.

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Appendix A

Section 1110

In every case, when attempting to understand rights afforded to various parties by statute, the single most important item is the express language itself. Section 1110 states:

- (a) (1) Except as provided in paragraph (2) and subject to subsection (b), the right of a secured party with a security interest in equipment described in paragraph (3), or of a lessor or conditional vendor of such equipment, to take possession of such equipment in compliance with a security agreement, lease, or conditional sale contract, and to enforce any of its other rights or remedies, under such security agreement, lease, or conditional sale contract, to sell, lease, or otherwise retain or dispose of such equipment, 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 section 362 if —
 - (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 security agreement, lease, or conditional sale contract; and
 - (B) any default, other than a default of a kind specified in section 365(b)(2), under such security agreement, lease, or conditional sale contract —
 - (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 security agreement, lease, or conditional sale contract, if a cure is permitted under that agreement, lease, or contract.

- (3) The equipment described in this paragraph —
 - (A) is —
 - (i) an aircraft, aircraft engine, propeller, appliance, or spare part (as defined in section 40102 of title 49) that is subject to a security interest granted by, leased to, or conditionally sold to a debtor that, at the time such transaction is entered into, holds an air carrier operating certificate issued pursuant to chapter 447 of title 49 for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo; or
 - (ii) a vessel documented under chapter 121 of title 46 that is subject to a security interest granted by, leased to, or conditionally sold to a debtor that is a water carrier that, at the time such transaction is entered into, holds a certificate of public convenience and necessity or permit issued by the Department of Transportation; and
 - (B) includes all records and documents relating to such equipment that are required, under the terms of the security agreement, lease, or conditional sale contract, to be surrendered or returned by the debtor in connection with the surrender or return of such equipment.
 - (4) Paragraph (1) applies to a secured party, lessor, or conditional vendor acting in its own behalf or acting as trustee or otherwise in behalf of another party.
- (b) The trustee and the secured party, lessor, or conditional vendor whose right to take possession is protected under subsection (a) may agree, subject to the approval of the court, to extend the 60-day period specified in subsection (a)(1).
 - (c)
 - (1) In any case under this chapter, the trustee shall immediately surrender and return to a secured party, lessor, or conditional vendor, described in subsection (a)(1), equipment described in subsection (a)(3), if at any time after the date of the order for relief under this chapter such secured party, lessor, or conditional vendor is entitled pursuant to subsection (a)(1) to take possession of such equipment and makes a written demand for such possession to the trustee.
 - (2) At such time as the trustee is required under paragraph (1) to surrender and return equipment described in subsection (a)(3), any lease of such equipment, and any security agreement or conditional sale contract relating to such equipment, if such security agreement or conditional sale contract is an executory contract, shall be deemed rejected.

- (d) With respect to equipment first placed in service on or before October 22, 1994, for purposes of this section —
- (1) the term “lease” includes any written agreement with respect to which the lessor and the debtor, as lessee, have expressed in the agreement or in a substantially contemporaneous writing that the agreement is to be treated as a lease for Federal income tax purposes; and
 - (2) the term “security interest” means a purchase-money equipment security interest.

Appendix B

Short Form Checklist of Considerations as Default Nears and Occurs

1. Pre-Bankruptcy Considerations

- A. Evaluate and Obtain Assurances with Respect to the Maintenance Condition of the Aircraft
- B. Clarify and Establish the Manner and Method for Any Return of the Aircraft
- C. Make Sure Maintenance Records and the Configuration of the Aircraft Are Complete or Have a Strategy of How to Handle These Issues Should the Aircraft Be Returned
- D. Seek or Establish a Cash Reserve

2. Upon a Bankruptcy Filing

- A. Determine Who Is in Control in the Transaction
- B. Be Mindful of § 1110 Rights and Prepare for Their Execution
- C. Retain Aircraft Experts to Help Manage the Situation
- D. Evaluate the Condition and Maintenance of the Aircraft
- E. Seek Releases and Waivers
- F. Preserve All Rights
- G. Reserve Rights to Administrative Expense Claims and Reach Agreement on How to Calculate and Resolve All Other Claims
- H. Require Prompt and Full Disclosure of Fleet Plans and Other Aircraft Transaction Terms
- I. Continued Cooperation of Debtors in Providing Remarketing Assistance and Financial and Operational Information
- J. Monitor All Motions and Orders for Effects on Rights of Aircraft Creditors
- K. Object to Any Claims Trading Order Impairing Security Holders' Rights to Freely Trade Their Securities

3. Key Considerations for Restructuring Transactions in Bankruptcy

- A. Finality of the Restructuring
- B. Work out Details on Control and Direction within the Transaction
- C. Clarify Priority of Payments or Waterfall
- D. Adequate Assurance Deposits
- E. Maintenance Assurances
- F. Records — Maintenance or Otherwise
- G. Improved or Clarity in Return Conditions
- H. Remarketing Assistance
- I. Cross Defaults — Cross Collateralization
- J. Material Adverse Events in Bankruptcy
- K. Continued Flow of Information
- L. Resolution of Bankruptcy Claims
- M. Court Approval — Fairness Hearing
- N. Other Contractual Terms

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