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FLYING THE UNFRIENDLY SKIES: A YEAR OF REORGANIZING AIRLINES, AIRCRAFT LESSORS, AND THE BANKRUPTCY CODE*

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PREAMBLE

“A MERICAN AIRLINES Chairman Robert L. Crandall has a favorite line he uses to describe 1991. ‘The only heartening thing we can say is that it’s over.’”¹ Over the last year the U.S. air carrier industry has conclusively proven the oldest adage of aviation: “what goes up, must come down.” And down they have come, directly into the bankruptcy courts in the financial equivalent of a crash landing. The roster of infamy is startling indeed; Eastern, Pan Am, TWA, Continental, Midway, America West, and Braniff (again!). In addition, Northwest has narrowly averted its own emergency landing into insolvency. While apathy on the part of a flying public resigned to such events has apparently taken hold, creditors and lessors

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The author dedicates this article to Emil G. Pesiri, Esq., Jackson, Tufts, Cole & Black, San Francisco, with deepest thanks for providing the encouragement and support that made this article possible.

¹ Wendy Zedlnea, *The Airlines Are Killing Each Other Again*, Bus. Wk., June 8, 1992, at 32.

are much less likely to react so complacently to a carrier's bankruptcy filing or the tension leading up to it.²

This lack of complacency stems from the fact that aircraft lessors in particular, historically viewed as special parties in interest, have been granted unique protections by section 1110 of the Bankruptcy Code. Section 1110 of the modern insolvency law is designed to provide special protections to a secured party with a purchase money equipment security interest (PMESI) in a lessor or a conditional vendor of "aircraft, aircraft engines, propellers, appliances, or spare parts."³ Pursuant to the statute,

² See Larry Reibstein & Dody Tsiantar, *On the Wings of Bankruptcy*, NEWSWEEK, Jan. 21, 1991, at 45. Indeed, some have espoused the view that bankruptcy "more adequately serves the entire airline industry than direct government economic regulation." Jeffrey S. Heuer & Musette H. Vogel, *Airlines in the Wake of Deregulation: Bankruptcy as an Alternative to Economic Regulation*, 19 TRANSP. L.J. 247, 249 (1991). These commentators have concluded that:

Where deregulation has failed, bankruptcy has adequately filled the gap. It has kept some airlines flying and sold off the effective parts of airlines that could not stay afloat. It has balanced the interests of all concerned, including the government and the public on a microeconomic level that has produced positive results on a larger scale. Bankruptcy does not and will not trample the ability of strong airlines to effectively run their business. It is an excellent complement to economic deregulation.

Id. at 286.

³ 11 U.S.C. § 1110(a) (1988). The statute's text is as follows:

The right of a secured party with a purchase-money equipment security interest in, or of a lessor or conditional vendor of, whether as trustee or otherwise, aircraft, aircraft engines, propellers, appliances, or spare parts, as defined in section 101 of the Federal Aviation Act of 1958 (49 U.S.C. 1301), or vessels of the United States, as defined in subsection B(4) of the Ship Mortgage Act, 1920 (46 U.S.C. 911(4)), that are subject to a purchase-money equipment security interest granted by, leased to, or conditionally sold to, a debtor that is an air carrier operating under a certificate of convenience and necessity issued by the Civil Aeronautics Board, or a water carrier that holds a certificate of public convenience and necessity or permit issued by the Interstate Commerce Commission, as the case may be, to take possession of such equipment in compliance with the provisions of a purchase-money equipment security agreement, lease, or conditional sale contract, as the case may be, is not affected by section 362 or 363 of this title or by any power of the court to enjoin such taking of possession, unless—

(1) before 60 days after the date of the order for relief under this chapter, the trustee, subject to the court's approval, agrees to perform all obligations of the debtor that become due on or after such

creditors under its protection may compel a debtor to cure all pre-petition defaults within sixty days following the filing of the bankruptcy petition. If the debtor fails to do so within that period, the creditor is exempted from the automatic stay and may repossess the subject property.

As stated by one appellate court, Congress designed the extraordinary relief accorded certain aircraft financiers by the statute "in order to encourage investment in new equipment for air carriers."⁴ Similarly, another commentary noted that "[i]t is axiomatic among the aircraft financing fraternity that section 1110 of the Bankruptcy Code provides essential protection to those who lease or finance the purchase of aircraft."⁵ Indeed,

[s]ection 1110 stands in stark contrast to sections 362, the automatic stay provision, and 365, the assumption or rejection of executory contracts or leases provision, of the Code. Congress obviously saw a need for this type of special legislation in order to protect certain persons who deal with air carriers.⁶

The unique nature of section 1110's special protections is justified by the singular risks attendant to aircraft financing. As summarized in another commentary, there are four major elements that distinguish financing trans-

date under such security agreement, lease, or conditional sale contract, as the case may be; and

(2) any default, other than a default of a kind specified in section 365(b)(2) of this title, under such security agreement, lease, or conditional sale contract, as the case may be—

(A) that occurred before such date is cured before the expiration of such 60-day period; and

(B) that occurs after such date is cured before the later of—

(i) 30 days after the date of such default; and

(ii) the expiration of such 60-day period.

⁴ *California Chieftan v. Air Vermont, Inc. (In re Air Vermont, Inc.)*, 761 F.2d 130, 132 (2d Cir. 1985).

⁵ James W. Giddens & Sandor E. Schick, *Section 1110 of the Bankruptcy Code: Time for Refueling?*, 64 AM. BANKR. L.J. 109, 109 (1990).

⁶ *In re Pan Am Corp.*, 124 B.R. 960, 965 (Bankr. S.D.N.Y.), *aff'd in part*, 125 B.R. 372 (Bankr. S.D.N.Y.), *aff'd*, 929 F.2d 109 (2d Cir.), *cert. denied*, 111 S. Ct. 2248 (1991).

actions in aircraft from the ordinary commercial deal: 1) the size of the financing - one of the most cost-intensive investments in the business world; 2) the "lengthy economic life and extended financing terms associated with" aircraft; 3) the inevitable rapid deterioration in value if the aircraft is not regularly used and maintained; and 4) its inherent mobility, making location and recovery of the collateral difficult.⁷ In short, a financier "is faced with an exceptionally high-cost, long-term investment secured by collateral that may be subject to rapid deterioration if it remains in the hands of a bankrupt during potentially lengthy reorganization proceedings."⁸

Conversely, there are negative ramifications that would surely follow from not granting exceptional treatment to aircraft financiers.

Restrictions on repossession discourage financing and increase lending rates. Risks to collateral increase the longer a financially precarious debtor maintains control of the asset in question. Moreover, if transaction costs, such as attorneys' fees, are necessary for a lender to regain control of collateral, the overall loan costs may rise accordingly. The practical ramifications in the financial market of restrictions on the lender's right to seize and protect collateral were not lost on the draftsmen of the original bankruptcy laws or the successor Code.⁹

The importance to the economy of maintaining stability in the aircraft finance area cannot be overstated. For instance, since 1985 investors have devoted almost \$2 billion to various public limited partnerships that lease used aircraft.¹⁰ With such huge amounts of capital at risk and the imminent fleet modernizations of this decade hanging in the balance, an appreciation of how close to financial

⁷ Glenn S. Gerstell & Kathryn Hoff-Patrinis, *Aviation Financing Problems Under Section 1110 of the Bankruptcy Code*, 61 AM. BANKR. L.J. 1, 5 (1987).

⁸ *Id.* at 6.

⁹ Louis B. Goldman et al., *Repossessing the Spirit of St. Louis: Expanding the Protection of Sections 1110 and 1168 of the Bankruptcy Code*, 41 BUS. LAW. 29, 29 (1985).

¹⁰ Todd Vogel & Kevin Kelly, *Hold On - Polaris is Trailing Smoke*, BUS. WK., Apr. 8, 1991, at 28.

disaster the airline industry has come in the last few months is vital. These recent airline bankruptcies nearly drove both creditors and air carriers into utter chaos. The industry was saved only by sound judicial reasoning.

Having outlined the essence of the situation, the purpose of this article is first to make a comprehensive review of the historical underpinnings of section 1110, the keystone to this entire discussion. With the benefit and wisdom of more than four decades, we may intelligently analyze the recent flurry of cases dealing with the scope of the statute, particularly as to specific types of modern lease forms not necessarily contemplated by the original drafters of section 1110.

Because our discussion would be unnecessarily limited by their exclusion, this article also examines a number of contemporaneous cases that, while they do not as obviously implicate section 1110, are essential to any discussion of the experiences of creditors and debtor airlines alike in past years. Note is also taken of the recent call by the industry's major players for legislative revision to clarify the various points of fatigue in the framework of the Bankruptcy Code's special protection for airline creditors. With all that having been said, clearance is now given to embark on our airborne journey.

I. LEGISLATIVE HISTORY

The legislative history of section 1110 and the policy concerns upon which it was based flow naturally from the circumstances surrounding its 1978 enactment as part of the modern Bankruptcy Code. In analyzing the statute, however, an understanding of the antecedents upon which it was modeled yields a wealth of knowledge and guidance and sets forth in detail the entrenched history of these exceptional protections for certain creditors.

A. THE BANKRUPTCY ACT'S SECTION 77(j)

Section 1110 has its roots in section 77(j) of the former Bankruptcy Act. Section 77(j), enacted in 1935, applied

to certain transactions involving railroad rolling stock and provided that:

The title of any owner, whether as trustee or otherwise, to rolling stock equipment leased or conditionally sold to the debtor, and any right of such owner to take possession of such property in compliance with the provisions of any such lease or conditional sale contract, shall not be affected by the provisions of this section.¹¹

Previously, the law had permitted federal courts to stay any suit affecting a railroad in reorganization.

This provision was enacted to preserve a form of financing known as the "railroad equipment trust," under which transportation equipment was financed separately from a railroad's other assets. The equipment was placed in a trust and leased or conditionally sold to the railroad. Traditionally, railroad equipment trustees received priority over holders of general liens on a railroad's after-acquired property.¹² This special protection was permitted because the high cost and long life span of rolling stock, combined with the railroads' frequently precarious financial situations, made such equipment an extraordinarily risky investment. Such risks were magnified if the secured property could not be recovered promptly in bankruptcy proceedings.¹³

Congress enacted section 77(j) in response to the Supreme Court's decision in *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway*,¹⁴ which casts doubt upon the ability of equipment trust financiers to repossess their equipment in bankruptcy proceedings. If this ability were denied, financing would become more expensive for the railroads. Thus, Congress passed section 77(j) to ensure that these financiers could act immediately upon their contractual rights of repossession.

¹¹ Bankruptcy Act of 1898, § 77(j), 11 U.S.C. § 205(j)(repealed 1976).

¹² See *United States v. New Orleans R.R.*, 79 U.S. (12 Wall.) 362 (1871).

¹³ See *Gerstell & Hoff-Patrinios*, *supra* note 7, at 5-6.

¹⁴ 294 U.S. 648 (1935).

As one congressional report stated:

In view of the necessity of readily financing purchases of equipment at a time when the development of the transportation art is providing new forms of equipment, particularly in the passenger field, of which in interests of efficiency and economy, the carriers should be able to avail themselves, and because after a depression the carriers are usually required to make large expenditures for equipment in order to accommodate the improved traffic, your committee is of the opinion that any doubt should be removed with reference to the validity of the equipment trust as a means of financing equipment purchases.¹⁵

B. SECTION 116(5) OF THE REVISED ACT

In 1957, Congress extended section 77(j) to the growing airline industry. It enacted into the former Bankruptcy Act section 116(5), which provided, in part, that:

the title of any owner, whether as trustee or otherwise, to aircraft . . . leased, subleased, or conditionally sold to any air carrier . . . and any right of such owner or of any other lessor to such air carrier to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of this chapter if the terms of such lease or conditional sale so provide.¹⁶

The legislative history of this section reveals that Congress was concerned that “[m]any of the Nation’s smaller airlines are today facing serious financing problems resulting from the need to replace obsolete equipment with modern aircraft.”¹⁷ This serious financial condition resulted because “the smaller lines [were] unable to attract the capital necessary for their reequipment requirements.”¹⁸ Congress hoped that the statute “would result

¹⁵ H.R. REP. NO. 1288, 74th Cong., 1st Sess. 1, 4 (1935).

¹⁶ Bankruptcy Act of 1898, § 116(5), 11 U.S.C. § 516(5) (repealed 1976).

¹⁷ H.R. REP. NO. 944, 85th Cong., 1st Sess. 2 (1957), *reprinted in* 1957 U.S.C.A.N. 1926, 1926.

¹⁸ *Id.*

in an increased availability of capital and at a lower interest rate than would be demanded under present conditions," and would cause "extensive use of equipment trust financing as the financial basis for a major reequipment program."¹⁹

In 1968, Congress extended this provision to the shipping industry.²⁰ The legislative history of the section indicated that Congress was concerned with "problems of equipment obsolescence and the resulting need for capital improvements as the industry continue[d] to modernize its fleet for service to the public."²¹ Once again, Congress hoped that these protections would "result in an increased availability of capital, and at a lower interest rate than would be demanded under present conditions."²²

C. SECTION 1110 OF THE MODERN BANKRUPTCY CODE

When the current Bankruptcy Code was enacted in 1978, the new section 1110 adopted the old section 116(5), but in a somewhat altered form. Holders of PMESI's were added to the list of protected creditors, and debtors were given the option of curing their defaults within a specified time period. The addition of the PMESI acknowledged the changes brought on by the adoption of the Uniform Commercial Code, which subsumed the conditional sale contract, and recognized the purchase money priority.²³

As one congressional report stated, "[b]ecause retention of the prior limitation would unnecessarily force equipment financing transactions into outmoded forms, protection of security interests was added to make financ-

¹⁹ *Id.* at 1926-27.

²⁰ See Bankruptcy Act § 116(6), 11 U.S.C. § 516(6) (repealed 1976).

²¹ H.R. REP. NO. 1932, 90th Cong., 2d Sess. 1 (1968), *reprinted in* 1968 U.S.C.C.A.N. 4279, 4280.

²² *Id.*

²³ See U.C.C. § 9-312(4) (1978) (recognizing non-inventory purchase money priority). Official Comment 3 to section 9-312 holds that purchase money priority embodies previous priority for conditional sales and equipment trusts.

ing forms more flexible and more consonant with modern law.”²⁴ The cure period was apparently added to soften the impact of the prior laws, which were considered “harsh in their application.”²⁵

Although Congress noted that “changes in financing practices and in the bankruptcy laws have suggested that the former limitation [of protection] be deleted,”²⁶ lessors and conditional vendors remained protected by section 1110. The House report recognized that the Uniform Commercial Code treated certain purported leases as disguised security interests but made no other distinction among leases.²⁷ Rather, Congress appeared to recognize that the protection for leases and conditional sales contracts was maintained because a holder of such an interest retained title to the property.

The PMESI, which does not transfer title to the holder, was discussed separately. As the House report noted:

An attempt was made to preserve the limitations on the right of the financier contained in current law. However, certain changes were made. First, the proposed sections provide protection for equipment security interests. The term includes only security interests that were granted to finance the acquisition of the covered equipment. A general mortgage is excluded. Under present law, the protection applies only to leases and conditional sales of equipment. The theory behind the present limitation is that under leases and conditional sales, title of the property does not pass to the debtor but remains in the financier. Thus, it is appropriate to exclude what is not property of the estate from the automatic stay in a reorganization case.²⁸

It would therefore seem that section 1110 was based upon two distinct theories: a “title” rationale that applied to

²⁴ H.R. REP. NO. 595, 95th Cong., 1st Sess. 240 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963 and 6200.

²⁵ *Id.* at 239, *reprinted in* 1978 U.S.C.C.A.N. at 6198.

²⁶ *Id.* at 240, *reprinted in* 1978 U.S.C.C.A.N. at 6199.

²⁷ *Id.*

²⁸ *Id.*

leases and conditional sales contracts; and a more contemporary "purchase money" rationale that applied to PMESI's.

The House report also stated that "[t]he protection afforded the financier is similar to that contained in other sections of the bill governing use of collateral by the estate and the treatment of executory contracts and unexpired leases."²⁹ Specifically, the report noted that, when a trustee elects to assume a lease, the lessor is entitled to adequate protection, which ordinarily includes rental payments and the curing of past defaults.³⁰ The House report found that

[t]he major differences for transportation equipment security interests is that the proposed section defines more precisely what constitutes adequate protection. . . . In the case of a lease, the protection is the same afforded to other lessors, but the trustee is required to make a decision within 60 days of the order for relief.³¹

In sum, the term "lease" in section 1110 specifically defined the general treatment of leases elsewhere in the Code.

Also instructive in this area is *GATX Leasing Corp. v. Airlift International, Inc.*³² in which the court summarized the purpose and effect of section 1110. Noting that "changes in financing practices made it necessary to protect different types of security interests in equipment," and that the modern statute extends just such protections, Judge Clark stated:

Section 1110, and its companion statute section 1168 which covers railroad rolling stock, represent amended versions of section 77(j), 116(5) and 116(6) of the prior Bankruptcy Act. These sections generally provided that

²⁹ *Id.* at 239, reprinted in 1978 U.S.C.C.A.N. at 6199.

³⁰ *Id.* See 11 U.S.C. § 363(e) (1988) (on request of a party with an interest in property, the court may condition its use, sale, or lease on "adequate protection" of such interest).

³¹ H.R. REP. NO. 595, *supra* note 23, at 240, reprinted in 1978 U.S.C.C.A.N. at 6199. See generally 11 U.S.C. § 365 (1988) (treatment of unexpired leases).

³² (*In re Airlift Int'l, Inc.*), 761 F.2d 1503 (11th Cir. 1985).

equipment financiers could repossess their collateral upon default despite the filing of a bankruptcy petition if both non-bankruptcy law and the underlying loan agreement permitted repossession. The purpose of those sections was to enhance the borrowing ability of airlines, maritime shippers, and railroads by offering equipment financiers greater certainty with regard to their ability to protect collateral in a bankruptcy proceeding.³³

In sum, section 1110 boasts an established lineage of prior statutory embodiments, each equally blessed with a fairly well-stated legislative history. The consistent themes included therein may be summarized as: 1) exceptional treatment in the bankruptcy laws for aircraft (as well as railroad and ocean vessel) financiers; 2) steadfast protection for lessors and vendors in this area, later augmented by more of the same for purchase money security interests; 3) fleet upgrading as the real aim of Congress in enacting these laws; and 4) segregation of general mortgage interests from those mentioned above and others similarly situated, while limiting the unique protections of section 1110 and its ancestors solely to the latter group of special creditors.

II. SALE/LEASEBACKS — BEGINNING WITH BRANIFF

Although destined to be left in the contrails of the more notorious airline bankruptcies that followed, the insolvency of Braniff, Inc. provided the first major battle of the conflict between debtors and lessors over the application of section 1110. While subsequently overshadowed by later decisions in the circuit courts of appeals, the bankruptcy court in Orlando, Florida put forth a concise and

³³ *Id.* at 1507 (citing H.R. REP. NO. 595, 95th Cong., 1st Sess. 238-39 (1977), reprinted in 1978 U.S.C.A.N. 5787). See 5 LAWRENCE P. KING, COLLIER ON BANKRUPTCY, § 1110.01 (15th ed. 1979); see also *Seidle v. GATX Leasing Corp.*, 778 F.2d 659, 663 (11th Cir. 1985) ("Congress intended that section 1110 encourage new financing of . . . airplanes.").

cogent opinion that laid the cornerstone for jurisprudence yet to come.

In *Braniff, Inc. v. Toren*³⁴ the debtor airline had commenced an adversary proceeding seeking a declaratory judgment that section 1110 did not apply to certain aircraft leases. The unique facts are worthy of mention here, as they set this particular reorganization apart from the ones that followed it. The instant debtor, Braniff, Inc. (Braniff), was actually the successor to Braniff Airways, Inc. (Airways), which had entered into its own Chapter 11 reorganization in 1982. The leases in question were done pursuant to the confirmed reorganization plan of Airways, which called for the leasing to Braniff of jets formerly operated by Airways.³⁵ Unfortunately, history repeated itself and Braniff filed its own petition to reorganize in late 1989.

On cross-motions for summary judgment in the case, Braniff argued that section 1110 applied only to aircraft and equipment "newly acquired by an air carrier lessee."³⁶ The leases, Braniff asserted, "merely permitted the implementation of the plan of reorganization of Braniff Airways."³⁷ The debtor argued that, since the transaction at issue in effect refinanced the assets of its defunct predecessor but did not involve a bona fide acquisition, the special protections of section 1110 did not apply.

In considering this case, Bankruptcy Judge C. Timothy Corcoran III wasted no time in establishing the rule of law to be applied. The court ruled that:

[e]ach of the elements set forth in Section 1110 of the Bankruptcy Code is satisfied on the facts of this case. There is a (i) lessor (ii) of property of the required type (iii) that has been leased to an air carrier debtor of the requisite type, and (iv) the terms of the Lease provide for the lessor to take possession of the property upon default.

³⁴ *In re Braniff, Inc.*, 110 B.R. 980 (Bankr. M.D. Fla. 1990) [hereinafter *Braniff I*].

³⁵ *Id.* at 981-82.

³⁶ *Id.* at 981.

³⁷ *Braniff I*, 110 B.R. at 981.

On its face, therefore, Section 1110 applies.³⁸

Braniff contended that section 1110 did not apply because the aircraft were not new to the airline, and the Congressional intent behind the statute was to specially protect lessors of newly acquired aircraft only.³⁹ "Section 1110 was designed by Congress to encourage the availability of new capital equipment to airlines at costs less than would otherwise be required to be charged," asserted the debtor, not to "facilitate the reorganization of a debtor airline," as in the case at bar.⁴⁰ Braniff urged the court to ignore the face of the statute and to consider instead the legislative record, which they believed demonstrated that the lawmakers limited the scope of section 1110 to acquisition leases alone.

Judge Corcoran was unpersuaded by the debtor's points. Defining the "threshold issue" as the proper construction of the statute, considered in conjunction with the relevant legislative history, the court first declared unequivocally that section 1110 was "clear and unambiguous" and that its prerequisites for usage "obviously ha[d] been satisfied."⁴¹

Examining the legislative history for any contradictions to that precept, the court noted that when aircraft owners were first brought under this umbrella of special protections in 1957, these unique remedies were limited to transactions involving leases and conditional sales.⁴² It was not until the promulgation of the Bankruptcy Code in 1978, commented the bankruptcy judge, that this special treatment was expanded to include purchase money secured transactions.⁴³ It should therefore come as no surprise, said the court, to find that "references to new acquisitions were featured prominently" in the legislative

³⁸ *Id.* at 982.

³⁹ Braniff apparently conceded that section 1110 covered leases of both used and newly manufactured airplanes if the equipment was newly acquired. *Id.*

⁴⁰ *Braniff I*, 110 B.R. at 982.

⁴¹ *Id.* at 982-83.

⁴² *Id.* at 983.

⁴³ *Id.*

history of section 1110.⁴⁴ Yet "without also examining the earlier base from which the expansion was being made," the conclusion drawn from the prior expansion of the statutory penumbra is distorted.⁴⁵

Rejecting the debtor's tunnel vision of the legislative record, the bankruptcy court found "no support for the proposition that new acquisitions were intended to underlie, and be a necessary prerequisite for, the protections afforded lessors" by the statute.⁴⁶ Looking not only to the legislative history of section 1110 but also to its post-war ancestor as well, Judge Corcoran concluded:

[Congress] placed nothing in the bill or in the report suggesting that the benefits afforded by the bill would be limited to lessors of acquisition leases. This is significant because the stated purpose of the bill — protecting lessors and conditional sellers — facilitates the reduction of capital costs to an airline regardless of whether the transaction contemplates the acquisition of new equipment (by a new lease, for example) or the refinancing of existing equipment (by the renewal of an existing lease, for example).⁴⁷

The Judge felt that the lawmakers intent in 1978 as to purchase money security interests did not affect the special protections afforded lessors. In support of this proposition, he noted that "nothing suggests that Congress intended to change the law that had then existed for some 20 years regarding lease transactions."⁴⁸

Almost as an aside, Judge Corcoran found that section 1110 imposed no "acquisition" requirement for a "lessor" of covered equipment.⁴⁹ Nothing, therefore, justified an additional requirement for leases under section 1110.⁵⁰ In concluding, the court ruled that "section 1110 is not limited to leases that permit aircraft to be newly ac-

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 984.

⁴⁸ *Braniff I*, 110 B.R. at 984.

⁴⁹ *Id.* at 984 n.1.

⁵⁰ *Id.* at 984.

quired by the lessee.”⁵¹ Apparently to buttress this finding, the court added that, although Braniff was conceived out of the Airways reorganization, the lease in question involved aircraft new to Braniff. Since the benefits of section 1110 helped Braniff acquire the leased property, this application of section 1110 was consistent with the Congressional intent to encourage acquisition financing.⁵² For these reasons, the court could find nothing in the statute to suggest that the section should not apply to an aircraft lease from an old debtor to a new entity.⁵³

III. CONTINENTAL'S SHORT TAKEOFF FROM THE BANKRUPTCY COURT

The body of creditors who had enjoyed the protection of section 1110 and its ancestors took comfort in the *Braniff I* decision, presuming little could happen to endanger their interests. They were in for a rude awakening.

In a decision that stunned the air finance industry, Bankruptcy Judge Helen S. Balick ruled that the special protections available to aircraft lessors under the Bankruptcy Code do not apply where the transaction in question is a sale-leaseback of aircraft or related equipment.⁵⁴ In *Continental I*, the bankruptcy court concluded that when sale-leaseback transactions do not finance the carrier's acquisition of *new* aircraft or equipment, section 1110 does not apply.⁵⁵

The question before the bankruptcy court was whether a sale-leaseback is the type of transaction entered into by a “lessor” as defined in section 1110. This issue was resolved by examining the other two specially treated creditors: an entity holding a PMESI and a conditional vendor that sold but did not retain title to the equipment.⁵⁶

⁵¹ *Id.* at 985.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *In re Continental Airlines, Inc.*, 123 B.R. 713, 713 (Bankr. D. Del.), *rev'd*, 125 B.R. 399 (D. Del.), *aff'd*, 932 F.2d 282 (3d Cir. 1991) [hereinafter *Continental I*].

⁵⁵ *Id.*

⁵⁶ *Id.* See also *Swiss Air Transport Co., Ltd. v. Texas Int'l Airlines, Inc.* (*In re*

Judge Balick found

no basis to conclude that the term "lessor" should be construed more broadly than the related terms of PMESI and conditional vendor. By that [she meant] the sale-leaseback transaction must be an acquisition transaction, which is the kind of transaction embodied in the terms "PMESI" and "conditional vendors" and not a transaction that smacks of a general mortgage.⁵⁷

The *Continental I* court offered this illustration of what it believed to constitute an "acquisition" transaction specially protected by the statute: if a carrier arranges to buy new aircraft from a manufacturer and, at the same time, enters into a sale-leaseback of the same property with a financing entity, such arrangement constitutes the kind of sale-leaseback transaction that the term "lessor" includes.⁵⁸ If there was not an inclusive deal, however, section 1110's protection would not be triggered.⁵⁹ Critical to the bankruptcy court was that the sale-leaseback must involve new aircraft in order to qualify for protection under section 1110.⁶⁰

The Delaware bankruptcy court further noted that section 1110's predecessor under the former Bankruptcy Act likewise emphasized greater protection for transactions financing the acquisition of new equipment by airlines.⁶¹ Unfortunately, the bankruptcy court's one page opinion is remarkable for its lack of in-depth analysis both of the modern law's predecessors and their collective legislative history.

As could be expected, the leasing industry was outraged over *Continental I* and "vociferously appealed" Judge

Continental Airlines Corp.), 57 B.R. 854, 857 (Bankr. S.D. Tex. 1985) ("The [l]egislative [h]istory of the Bankruptcy Code requires Section 1110 to be narrowly construed.").

⁵⁷ *Continental I*, 123 B.R. at 713. See also Goldman et al., *supra* note 9, at 53 (generally secured lenders are not within section 1110's protection).

⁵⁸ See *Continental I*, 123 B.R. at 713.

⁵⁹ See *id.*

⁶⁰ *Id.*

⁶¹ *Id.* See Bankruptcy Act § 116(5), 11 U.S.C. § 516(5)(repealed 1976).

Balick's decision, contending that the ruling had completely misconstrued section 1110.⁶² *Continental I*, decried the critics, fostered the debtor's reorganization at the expense of lessors and lenders who had relied upon the special protections of the Bankruptcy Code.⁶³ Ironically, during the 1980's airline deregulation boom, a short supply of new planes incited lessors to purchase and lease back older aircraft to the airlines. Continental was a major beneficiary of that trend.⁶⁴ Yet the debtor airline, in effect, turned on its benefactors by evading its section 1110 obligations to the aircraft lessors. To be sure, *Continental I* proved to be but the opening gambit in a full-scale war to be waged on several judicial fronts.

IV. PAN AM - LESSORS TAKE FLIGHT

There was no doubt that the insurgent debtor airlines were emboldened by the quick and stunning victory awarded them by the bankruptcy judge in *Continental I*. Even while that reorganizing carrier was steeling itself for the massive counter-attack already in progress on the appellate battleground, a second front was being opened by debtor airline Pan American. This troubled entity decided to go on the offensive in the bankruptcy court in New York, relying on the *Continental I* decision as its key strategic weapon. But this time, as history now tells us, the outcome was very different for the debtor.

On April 2, 1991, the Court of Appeals for the Second Circuit denied an appeal by Pan Am seeking to exempt certain sale-leaseback transactions from the operation of section 1110 of the Bankruptcy Code.⁶⁵ When the

⁶² Mark Ivey and Michael Oneal, *Continental, Writing The Book On Chapter 11*, Bus. Wk., Mar. 18, 1991, at 335.

⁶³ *Id.*

⁶⁴ Kevin Kelly and Michael Oneal, *All the Trouble Isn't In the Sky*, Bus. Wk., Mar. 11, 1991, at 84.

⁶⁵ Section 1110 Parties v. Pan American Corp. (*In re Pan American Corp.*), 929 F.2d 109, 109 (2d Cir.) (per curiam), cert. denied, 111 S. Ct. 2248 (1991).

Supreme Court refused to stay the tribunal's ruling,⁶⁶ it was all over except for a formal cease-fire. As the Second Circuit did in its affirmance of the courts below,⁶⁷ this article will look to the erudite opinion of District Judge Michael Mukasey in *In re Pan Am Corp.*,⁶⁸ in which he upheld the bankruptcy court's decision below.⁶⁹

The sole issue before Judge Mukasey was whether section 1110 of the Bankruptcy Code includes in its protections "those lessors that acquired such status in 'non-acquisition sale/leaseback transactions.'"⁷⁰ The debtor alleged that Congress intended the statute to apply only in circumstances in which the lessor leases aircraft and related equipment that are new to the airline.⁷¹ Pan Am desperately needed a negative response to that allegation if it were to avoid the burden of curing some \$33 million in aircraft lease defaults, both prepetition and postpetition.

The dispute appeared to present a problem of statutory interpretation and the court immediately set forth its reliance on the "plain meaning" rule.⁷² Finding that its own appellate court had previously ruled that section 1110 is unambiguous on its face,⁷³ the district court agreed and

⁶⁶ *Justice Rejects Delay Sought By Pan Am On Lease Payments*, WALL ST. J., Apr. 8, 1991, at A5.

⁶⁷ *Section 1110 Parties*, 929 F.2d at 109-110.

⁶⁸ 125 B.R. 372 (Bankr. S.D.N.Y. 1991) [hereinafter *Pan Am I*].

⁶⁹ Therefore, the focus here shall not be on Bankruptcy Judge Cornelius Blackshear's initial decision in favor of the lessors, notwithstanding its succinct analysis. See *In re Pan Am Corp.*, 124 B.R. 960 (Bankr. S.D.N.Y. 1991).

⁷⁰ *Pan Am I*, 125 B.R. at 373. In the decision below, the bankruptcy court issued a decretal order that held that nonacquisition sale/leaseback transactions were not disqualified from section 1110 protections merely because they were sale/leasebacks without the acquisition element. Agreeing to decide the debtor airline's appeal therefrom on an expedited basis, Judge Mukasey limited his opinion to this controversy. *Id.*

⁷¹ The debtor conceded that § 1110 included the "acquisition of any equipment new to the airline, even used equipment." *Id.* at 374.

⁷² *Id.* at 374. See also *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-42 (1989) (The "plain language" of the Bankruptcy Code "should be conclusive," and "there generally is no need for a court to inquire beyond the plain language of a statute" contained therein.)

⁷³ *Pan Am I*, 125 B.R. at 374 (quoting *California Chieftan v. Air Vermont, Inc.*, 761 F.2d 130, 134 (2d Cir. 1985)).

then added that the lease terminology contained in the provision was "not modified in any way which suggested that the statute was not meant to apply to lessors in a sale-leaseback transaction. . . . [C]ourts should not impose the additional requirement that the lease also involve equipment new to the airline," as argued by Pan Am.⁷⁴ Concurring with the *Braniff I* decision,⁷⁵ Judge Mukasey refused to edit section 1110.⁷⁶

Buttressed by the holding in *Braniff I*, the district court moved on to analyze the relevant legislative history.⁷⁷ Tracing the evolution of the present day section 1110, Judge Mukasey noted that Congress evinced a consistent desire to encourage "low cost financing of the airline industry."⁷⁸ Indeed, since the 1957 enactment of section 116(5) of the former Bankruptcy Act,⁷⁹ while Congress may have set out to encourage airlines to acquire new aircraft, it has effectuated that goal by the more general method of increasing the availability of working capital and decreasing its cost to the carrier. In no way could that aim be construed as contrary to "the broad language which Congress chose to use" in section 1110 and its forebears.⁸⁰

The court pointedly remarked that the Act's record "fail[ed] to show with any clarity that Congress also intended to add an acquisition element to lease transac-

⁷⁴ *Id.* at 374-75.

⁷⁵ *Braniff I*, 110 B.R. 980, 983 (Bankr. M.D. Fla. 1990).

⁷⁶ *Pan Am I*, 125 B.R. 63, at 375.

⁷⁷ Judge Mukasey noted that the "plain meaning" rule is not to be applied mechanically. "Rather, courts may and should examine legislative history to determine a statute's purpose and then apply that purpose, if the plain meaning produces an 'unreasonable' result 'plainly at variance with the policy of the legislation.'" *Id.* at 374 (quoting *United States v. American Trucking Ass'n*, 310 U.S. 534, 543-44 (1990)). Yet, the court cautioned, a rewriting of that same statute "merely because the court disagrees with the manner Congress chose to further its policy" would be improper. *Pan Am I*, 125 B.R. at 374. See *Louisiana Pub. Serv. Comm'n v. F.C.C.*, 476 U.S. 355, 376 (1986).

⁷⁸ *Pan Am I*, 125 B.R. at 376.

⁷⁹ Bankruptcy Act § 116(5), formerly codified at 11 U.S.C. § 516(5) (repealed 1976).

⁸⁰ *Pan Am I*, 125 B.R. at 375. See *GATX Leasing Corp. v. Airlift Int'l, Inc. (In re Airlift Int'l Inc.)*, 761 F.2d 1503, 1507 (11th Cir. 1985).

tions" protected by the statute.⁸¹ To the contrary, the legislative history demonstrated only that Congress refused to include general mortgage interests within section 1110.⁸² Such clarity of the lawmakers' vision is aptly shown by how they limited the statute's protection to secured creditors with PMESI's. "There [are] no such statutory restrictions on lease transactions within [section] 1110," noted Judge Mukasey.⁸³

This determination led Judge Mukasey to conclude that, "[i]f anything, the legislative history of [section] 1110 suggests that the Congressional omission of an acquisition element in lease transactions under [section 1110] was intentional."⁸⁴ In support of its position, the court looked to section 365 of the Bankruptcy Code, the general lease assumption/rejection statute, as proof that Congress would "distinguish among categories of lessors when it so desired."⁸⁵

The court also rejected Pan Am's argument that, because the statute only protected creditors' security interests arising from aircraft acquisitions, it implicitly limited the protections given leases in the same manner. Judge Mukasey found the argument illogical and contrary to the rules of statutory construction.⁸⁶ He felt that "the logical conclusion [was] that Congress actually did *not* intend so to restrict the class of protected lessors."⁸⁷ Therefore, the acquisition element "explicitly imposed" upon secured creditors of an airline does not imply a similar pre-

⁸¹ *Pan Am I*, 125 B.R. at 376.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 377.

⁸⁵ *Id.* See Anthony M. Sabino & Mary Jane C. Sabino, *Restoring The Necessity of Timely Court Approval for The Assumption or Rejection of Unexpired Leases Under Bankruptcy Code Section 365(d)(4)*, 27 DUQ. L. REV. 35, 42 (1988) (cited by *In re Windmill Farms Management Corp.*, 116 B.R. 755, 765 (Bankr. S.D. Cal. 1990)).

⁸⁶ *Pan Am I*, 125 B.R. at 377.

⁸⁷ *Id.* Traditionally, leases arising out of sale/leasebacks are analyzed in the same manner as ordinary leases. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 (1978) (entitlement of lessor to deduct depreciation for federal tax purposes).

requisite for lessors.⁸⁸

Moreover, the court felt the debtor's hair-splitting distinctions would only precipitate additional litigation as to the scope of section 1110 safeguards.⁸⁹ If he accepted Pan Am's view, Judge Mukasey envisioned disputes over whether section 1110 protected "lessors of brand new equipment, lessors of equipment new to the debtor airline, lessors of equipment new to the debtor airline and also new to any predecessor of the debtor airline, or some other category."⁹⁰

Recognizing that the legislative history of the instant law reflected many seemingly different but actually consistent goals, the district judge stated that courts should be reluctant to rewrite the words of a statute unless the plain meaning of those words leads to a result clearly contrary to Congress' expressed intention.⁹¹ "Otherwise, the benefit sought to be achieved by a statute like section 1110 — the prospect of a quick and predictable remedy that encourages potential financiers to be forthcoming — will be lost in a miasma of potential litigation."⁹² The court then noted that inclusion of all lessors within section 1110 "is directly consistent with Congress' stated policy of increasing capital availability at the lowest possible cost" and with the lawmakers' ultimate goal of fostering airline fleet modernization.⁹³

Taking a markedly pragmatic approach, Judge Mukasey also noted that a sale-leaseback benefits the lessor with available tax deductions and with the "future return on the aircraft's residual value after expiration of the lease."⁹⁴ Additionally, the sale-leaseback has the dual

⁸⁸ *Pan Am I*, 125 B.R. at 377.

⁸⁹ *Id.*

⁹⁰ *Id.* at 378 (footnote omitted).

⁹¹ *Id.*

⁹² *Id.* Parenthetically, Judge Mukasey quoted Justice Frankfurter's comment that "this is a case for applying the canon of construction of the wag who said, when the legislative history is doubtful, go the statute." *Id.* at 378 (quoting *Greenwood v. United States*, 350 U.S. 366, 374 (1956)).

⁹³ *Id.* at 378-79.

⁹⁴ *Id.* at 379.

benefit of permitting the airline to tap its "least expensive source of capital - its own" while retaining use of existing equipment until new equipment is in place to begin service.⁹⁵ While complex sale-leasebacks of the type Pan Am engaged in "may not have been directly contemplated" by the drafters of section 1110 or its predecessors, Judge Mukasey did find that "Congress was certainly familiar with sophisticated leveraged lease transactions."⁹⁶

For these reasons, the sale-leaseback lessor was considered the airline's cheapest source of capital for financing fleet modernization.⁹⁷ The court found such sound results worthy of encouragement by means of section 1110's special remedies, especially since these results are consistent with Congress' ultimate goal of encouraging air carriers to upgrade their inventory of aircraft.⁹⁸ In conclusion, the district court found that neither the law's language nor its history indicated any legislative intent to exclude aircraft sale-leaseback transactions from the purview of section 1110 of the Bankruptcy Code.⁹⁹ By so finding, the court declared victory for the lessors and made clear that section 1110 was sufficiently plain in both its words and its history to encompass within its special protections the sale-leaseback transactions at issue here. Given this position, the *Pan Am I* court "respectfully disagree[d] with the analysis" of Bankruptcy Judge Balick in *Continental I*.¹⁰⁰

Pan Am I, therefore, marked the turning point for the aircraft lessors, so recently on the defensive from *Continental I*.

⁹⁵ *Id.*

⁹⁶ *Id.* at 379 n.6. In addition, the courts have recognized sale-leasebacks for over a century. *Yorkshire Ry. Wagon Co. v. Maclure*, 21 Ch. D. 309, 319 (1882) (holding sale-leaseback of railroad locomotives treated as a bonafide transaction); *In re PCH Assocs.*, 804 F.2d 193, 200 (2d Cir. 1986) (holding sale-leasebacks are a relatively modern, and clever, structure of financing); *Sun Oil Co. v. Comm'r of Internal Revenue*, 562 F.2d 258, 268-69 (2d Cir. 1977) (holding sale-leasebacks "play a useful and accepted role in our economy").

⁹⁷ *Pan Am I*, 125 B.R. at 379.

⁹⁸ *Id.* at 378-79.

⁹⁹ *Id.* at 380.

¹⁰⁰ *Id.*

tal I. The decisive holding of Judge Mukasey was a crippling blow, not only to Pan Am but to other reorganizing air carriers as well. Indeed, while the appellate confirmations were a *coup de grace* to an already beaten Pan Am, it was the "breakout" that led to the subsequent defeat of Continental, the airline that started it all.

V. CONTINENTAL REVERSED - APPELLATE COURTS GROUND THE AIRLINE

A. THE DISTRICT COURT REVERSAL

The lessors had waged a successful campaign on the second front in *Pan Am I*. However, the time had come for an assault on *Continental I*. During the creditor's appeal from the *Continental I* decision,¹⁰¹ Continental moved for authority to cure defaults on transactions, including acquisition leases, for which necessary payments totalled nearly \$108 million. The debtor airline asserted that since non-acquisition leases did not fall within the purview of section 1110, it could continue to use aircraft acquired via sale-leasebacks without making the payments then due of approximately \$58 million. Five airlines, including American West Airlines, American Airlines, Northwest Airlines, United Air Lines, and USAir, and the American Association of Equipment Lessors filed a brief in support of the creditors' appeal. These solvent airlines took the position that "putting off required payments would discourage lessors from entering into sale-leaseback transactions and thus would make it tougher for airlines to raise badly needed capital."¹⁰² District Judge Robert S. Gawthrop, III, of Pennsylvania, sitting by designation, found that the "substantive issue before the court [was] solely one of statutory construction: whether the terms 'lessor' and 'lease' in section 1110 cover lessors who purchase from an airline the very aircraft or aircraft

¹⁰¹ *In re Continental Airlines, Inc.*, 125 B.R. 399, 401 (Bankr. D. Del. 1991)[hereinafter *Continental II*].

¹⁰² Wade Lambert, *U.S. Judge Rules Continental Airlines Must Pay Its Debts on Aircraft Leases*, WALL ST. J., Apr. 2, 1991, at A5.

equipment that they lease back to the airline."¹⁰³

For its first defense, the debtor argued that the bankruptcy court's order was not final and hence not ripe for appeal. The district court quickly resolved that objection, stating:

Section 1110 grants certain creditors the right to be free from the automatic stay of the bankruptcy code. The bankruptcy court's order in this case deprives appellants of these rights forever. Although the lessors retain rights in their property, these rights are fundamentally altered when subjected to the operation of the bankruptcy code. This is the essence of a final decision. This court has jurisdiction thereby.¹⁰⁴

Judge Gawthorp then determined that the legal question was whether the leases fell outside the protection of section 1110 because no new airplanes were brought into Continental's fleet.¹⁰⁵ Acknowledging that both the *Braniff* and *Pan Am I* courts found that non-acquisition leases were covered by section 1110 and that the opinions, while not on point, were "instructive," Judge Gawthorp decided to "take a fresh look at the issue raised."¹⁰⁶

Continental invited this fresh look by invoking the doctrine of *noscitur a sociis*, literally, "that a thing may be known by its associates."¹⁰⁷ The debtor urged that section 1110 included only acquisition leases. This position was taken because the statute's associated terms of conditional seller and secured holder of a purchase money equipment security interest *a fortiori* entailed acquisitions "designed to augment a carrier's fleet and equipment supply."¹⁰⁸

To the dismay of the debtor airline, the court held that *noscitur a sociis* did not apply in this context.¹⁰⁹ The court

¹⁰³ *Continental II*, 125 B.R. at 402.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 403.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

found that “[m]axims of statutory construction are aids in ascertaining the plain meaning of a statute, not tools to contradict plain meaning.”¹¹⁰ The district court held that a word is not necessarily intended “to be treated like its fellows in all respects” simply because the lawmakers place it within a statutory list.¹¹¹ Moreover, the *noscitur* doctrine applied only where the meaning of a term was in doubt, a factor not present in the case at bar.¹¹²

Finding no ambiguity in the word “lease” as used in section 1110, the court acknowledged that while a “lease” may arise in a variety of contexts, sale-leaseback leases are generally considered leases within this context.¹¹³ “The fact that an airline sells a lessor an aircraft, before entering an agreement to lease the same aircraft back from the lessor, does not mean that the agreement is not a ‘lease,’ as the term is commonly understood.”¹¹⁴ In extinguishing the debtor’s spin on the *noscitur* canon, Judge Gawthrop held:

Continental points to no ambiguity inherent to the term “lease” as used in section 1110. Rather, Continental suggests that the meaning of lease must be restricted to avoid a clash with the meaning of the other two terms in the list. However, the fact that lease transactions need not involve new acquisitions, while conditional sales or PMESIs necessarily involve acquisitions, does not mean that the three terms were not intended to have their full and ordinary meaning. Indeed, absent clear indication to the contrary, the plain meaning of the terms controls.¹¹⁵

The court rejected the airline’s public policy argument that a restrictive reading of section 1110 furthered the ultimate goal of reorganization. In reviewing this question, Judge Gawthrop stated:

The policy question here concerns the trade-off of pre-

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* at 403-04.

¹¹³ *Id.* at 404.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

bankruptcy benefits for post-bankruptcy burdens. If sale-leasebacks are afforded [section] 1110 protection, solvent airlines are benefitted with a means to obtain inexpensive financing, enabling them to upgrade operations and stave off insolvency during a credit crunch. At the same time, if the airline goes into bankruptcy, it will be faced with the obligation of having to make payments on the sale-lease-back leases if it wishes to keep operating the aircraft held under these leases. The national economic implications of this dynamic, while subject to debate, are not so clearly undesirable to require that [section] 1110 be read contrary to its literal terms.¹¹⁶

The *Continental II* bench concluded there was nothing on the face of the statute which suggested that the term "lease" carried anything other than its ordinary meaning.¹¹⁷

As did its predecessors, the court looked to the legislative history of section 1110, even though the statute was plain on its face. The district judge set the tone of this portion of his analysis by forewarning that a party attacking "plain meaning" faced a heavy burden of demonstrating that a literal reading of the law "is demonstrably at odds with the legislative intent."¹¹⁸ Following an analysis of section 1110 and its antecedents, the court found that Congress had preserved a special set of protections for lessors in section 1110 "in apparent acquiescence to the financing industry's 'addiction' to equipment trust financing."¹¹⁹ Consequently, *Continental* read "[c]ongressional intent to include only acquisition financing in the exemption, and to exclude lease transactions that do not bring new equipment to an airline, but which are used instead to bring in operating capital."¹²⁰

While conceding that Congress aimed to encourage

¹¹⁶ *Id.* at 406.

¹¹⁷ *Id.*

¹¹⁸ *Id.* Judge Gawthorp felt that this *per force* limits the court's inquiry into the lawmakers' intent.

¹¹⁹ *Id.* at 410.

¹²⁰ *Id.*

carriers to acquire new aircraft, Judge Gawthrop was unable to find that Congress meant to restrict the statute to only acquisition financing, as contrasted with sale-leasebacks.¹²¹ The judge found that the legislative history also contained "various remarks regarding the encouragement of financing in general," especially less expensive forms of financing.¹²² References to the exclusion of general mortgages from the benefits of section 1110 were not relevant, the court stated, because "a mortgage is not a lease."¹²³ Moreover, the court signaled its agreement with *Pan Am I*, stating that "[w]hile non-acquisition leases do not directly result in new aircraft or equipment for a carrier, the conversion of ownership interests in existing aircraft to leasehold interests, frees up capital that an airline can use to facilitate the acquisition of such aircraft."¹²⁴ The district court also acknowledged that section 1110 may seem to work at cross-purposes with the automatic stay, for as section 1110 is interpreted more broadly, the debtor's estate protected from reorganization is diminished in equal measure.¹²⁵ The court, however, found this circumstance to be mitigated by the fact that section 1110 applies only to airline and shipping industry reorganization proceedings.¹²⁶

Judge Gawthrop concluded:

Congress certainly knew that the inclusion of equipment leases within section 1110 would limit the resources available for airlines during reorganization. That Congress nevertheless failed to restrict the type of leases exempted, and failed to suggest a need for such restriction in legislative reports, is evidence that Congress meant what it said.¹²⁷

Judge Gawthrop further noted that "there are numerous

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.* at 410-11.

¹²⁶ *Id.* at 411.

¹²⁷ *Id.*

ways Congress could have written section 1110 in order to further its apparent goal. However, the judicial task is to give effect to what Congress actually did."¹²⁸ Judge Gawthrop gave Congress the benefit of the doubt as to their level of sophistication, commenting in an aside that:

Congress's [sic] knowledge of the use of sale-leaseback transactions in the transportation industries is not certain. Sale-leaseback transactions, however, are not new to the financing industry. That sale-leaseback transactions were used in and prior to 1978, and Congress did not act to exclude them from the coverage of section 1110, is evidence that Congress intended them to be included.¹²⁹

For these reasons, the district court was compelled to reverse the bankruptcy court and find that non-acquisition leases are covered by section 1110.¹³⁰

B. THE THIRD CIRCUIT AFFIRMS FOR THE LESSORS

The sale-leaseback controversy plateaued when the Court of Appeals for the Third Circuit confirmed in *In re Continental Airlines, Inc.* that such transactions fall within the exceptional remedies of section 1110.¹³¹ There the circuit tribunal was unanimous in affirming District Judge Gawthrop's decision. Writing for the panel, Circuit Judge Scirica declared that "[t]his case turns exclusively on the interpretation of [section] 1110."¹³² After resolving the procedural question of finality for appellate jurisdiction, the court turned to the merits of the controversy.

The parties made essentially the same arguments that were put forth in the district court. The debtor contended that the lessors could not avail themselves of section 1110 because sale-leasebacks did not come under the purview of the statute. Continental argued that section 1110 "was intended to apply only to leases which result in

¹²⁸ *Id.* (footnote omitted).

¹²⁹ *Id.* at 411 n.12 (citations omitted).

¹³⁰ *Id.* at 411.

¹³¹ 932 F.2d 282, 294 (3d Cir. 1991) [hereinafter *Continental III*].

¹³² *Id.* at 284.

aircraft that are new to an airline's fleet," thereby excluding sale-leasebacks.¹³³ The lessors countered by asserting that the statute "plainly refers to any lease, whether acquisition or non-acquisition."¹³⁴

The tribunal stated that its task was to determine "whether the word 'lease' in [section] 1110 was intended to apply only to acquisition leases."¹³⁵ From the outset, the court stipulated that it was not writing on "a blank slate."¹³⁶ The very question presented here was considered in both *Pan Am I* and *Braniff*, where similar arguments made by the airlines were defeated. Using the earlier decisions as a guide, the Third Circuit reached the same result and found for the lessors.¹³⁷

As did the other tribunals, the court began with the plain meaning of section 1110, forewarning that "when the statutory language speaks clearly, a party seeking to counter that language must produce other evidence that exhibits at least as much clarity."¹³⁸ On its face, section 1110 "permits a 'lessor of aircraft that are leased to a debtor that is an air carrier' to repossess those aircraft, notwithstanding the automatic stay."¹³⁹

The airline put forth the remarkable contention that "Congress neglected to insert qualifying language that would have explicitly limited the application of section 1110 to acquisition leases."¹⁴⁰ The court noted that "accepting this argument would require us to qualify the plain meaning of the statute's words," something the tribunal could do only if an application of section 1110's plain meaning would yield results "demonstrably at odds with the intentions of the law's drafters."¹⁴¹ Without hesi-

¹³³ *Id.* at 285.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.* at 287.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.* at 284.

¹⁴⁰ *Id.* at 288.

¹⁴¹ *Id.*

tation, the Third Circuit rejected Continental's argument.

Like the district court below, this panel refused to apply the doctrine of *noscitur a sociis* and thereby look to the PMESI and conditional vendor terms within section 1110 "to qualify language that Congress has left unqualified" in the Bankruptcy Code.¹⁴² The panel held that a party seeking to avoid the clear meaning of a statute has the burden of demonstrating an alternative interpretation with at least equivalent clarity.¹⁴³ *Noscitur a sociis* was found inapplicable "in light of the statute's plain language and evidence indicating that Congress did not necessarily intend for the term 'lease' to be qualified."¹⁴⁴ The tribunal found its position supported by the legislative evolution of the statute:

The legislative history of [section] 1110 and the policy concerns upon which it was based do not support the application of *noscitur a sociis*. We do not discern a clear expression of Congressional intent to limit section 1110 to acquisition financing, nor do we foresee patently illogical consequences arising from a contrary interpretation.¹⁴⁵

The Third Circuit then turned fully to the legislative history of section 1110 for its analysis of the purposes behind the modern law and its predecessors. Acknowledging that a goal of section 1110 was to facilitate the airlines' acquisition of new aircraft and equipment, Judge Scirica felt that this was not Congress' sole aim.¹⁴⁶ Rather, the legislative record demonstrates an intent to aid airlines in procuring low cost capital and shows that Congress intended sale-leaseback transactions to be included in the definition of lease.¹⁴⁷ Any other conclusion "would recognize arbitrary distinctions among otherwise similar lease transactions, and create further uncertainties in the

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 289.

¹⁴⁶ *Id.* at 291.

¹⁴⁷ *Id.*

application of [section] 1110.”¹⁴⁸ Writing for the panel, Judge Scirica elaborated by stating:

We recognize that the legislative history of [section] 1110 and each of its predecessors expresses a desire to help the affected industries modernize their fleets. However, increasing the general availability of capital is a means of accomplishing that end. . . . Sale-leasebacks are a major form of financing in the airline industry. Several solvent airlines, supporting the lessors as *Amici*, maintain that denying [section] 1110 protection to sale-leasebacks would severely curtail financing prospects for the entire industry. We believe providing protection to this form of lease financing is consistent with the legislative history of section 1110.¹⁴⁹

Moreover, the prohibition against section 1110 protections for general mortgages was not designed to qualify the word “lease.”¹⁵⁰ Congress’ distinction between leases and security interests in the legislative history also contradicted any reliance upon the *noscitur* doctrine.¹⁵¹

The Third Circuit also spoke convincingly of the reality of the section 1110 dilemma:

We believe that following the plain language of the statute is especially important in this case, where Congress intended that commercial operators rely on [section] 1110 in structuring long-term deals involving costly assets. We agree that (“[o]therwise, the benefit sought to be achieved by a statute like [section] 1110 - the prospect of a quick and predictable remedy that encourages potential financiers to be forthcoming - will be lost in a miasma of potential litigation.”) Section 1110 was intended to facilitate the procurement of low-cost capital by providing an advantage in bankruptcy to holders of certain interests. If the application of [section] 1110 is not predictable, potential lessors may require additional payments to compensate for this risk of uncertainty. If Congress intends to alter

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* at 291-92.

¹⁵⁰ *Id.* at 292.

¹⁵¹ *Id.* at 292-93.

the incentives of [section] 1110, it must do so clearly.¹⁵²

The Third Circuit concluded that "[e]ncouraging acquisition of new equipment was certainly one aim of [section] 1110. But . . . there are many ways in which [section] 1110 could be rewritten to reflect various goals alluded to in the legislative history."¹⁵³ Without a stronger showing of a contrary legislative intent, the court was compelled to follow the plain language of section 1110, leaving it to the lawmakers to qualify the chosen words on another day.¹⁵⁴

In a further blow to the debtor airline, the Third Circuit subsequently retracted any language in its original opinion suggesting that the debtor's leased aircraft could not be repossessed until the bankruptcy court determined whether the leases were true leases or disguised security interests. Apparently, some parties had construed the panel's discussion of the true lease versus disguised security interest dichotomy as meaning that "the lessors would have to wait for a bankruptcy court determination that the leases were true leases before beginning repossession."¹⁵⁵

In a "novel motion for clarification" made to the circuit court, the lessors argued that such delay would eviscerate their rights under section 1110.¹⁵⁶ Within weeks of issuing its original opinion, the Third Circuit declared that nothing in its opinion should be construed as limiting the rights of any lessor to repossess its aircraft or that the genuine nature of any given lease was an issue to be decided on remand.¹⁵⁷

¹⁵² *Id.* at 293-94 (quoting *Pan Am I*, 125 B.R. 372, 378 (Bankr. S.D.N.Y. 1991)).

¹⁵³ *Id.* at 294.

¹⁵⁴ *Id.*

¹⁵⁵ *Continental Airlines May Lose Its Planes*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, July 4, 1991, at A2.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

VI. "BY ANY OTHER NAME" — "POOLING/
INTERCHANGE" LEASES AND
SECTION 1110

We have seen how recent court decisions upheld the special protections of section 1110 to lessors in aircraft sale-leaseback transactions. Yet the statute covers a broader spectrum than just aircraft leases. Indeed, the next case addresses the unique protections that section 1110 affords those creditors who deal with airlines, not only for the airplanes themselves as collateral but also for a host of related and specialized equipment. These parties also derive great benefit from the Bankruptcy Code by reason of the critical nature of the business they transact.

In *In re Pan Am Corp.*,¹⁵⁸ District Judge Michael B. Mukasey ruled that the debtor airline's right to return similar, but not identical, equipment to a lessor does not change the bona fide nature of the lease, nor does it diminish the protections available to the lessor pursuant to section 1110 of the Bankruptcy Code.¹⁵⁹ In this case, the court once again advocated a plain reading of the Bankruptcy Code and, moreover, awarded yet another victory to the leasing community as to its entitlement to the specific protections embodied in the bankruptcy laws. District Judge Mukasey explicitly held that courts must follow the plain meaning of section 1110 in allocating that statute's special protections to lessors.¹⁶⁰ The district court was asked once more to review the ruling below¹⁶¹ of Bankruptcy Judge Blackshear. The district court focused now on the portion of the Article I court's decision and order that leases providing for the pooling or interchange of aircraft equipment could not, *ipso facto*, be denied the protections of the statute. The bankruptcy court made this ruling over the objections of the unsecured creditors' committee of Pan Am, who then brought an instant

¹⁵⁸ 130 B.R. 409 (Bankr. S.D.N.Y. 1991) [hereinafter *Pan Am II*].

¹⁵⁹ *Id.* at 411.

¹⁶⁰ *Id.* at 412.

¹⁶¹ *In re Pan Am Corp.*, 124 B.R. 960 (Bankr. S.D.N.Y. 1991).

appeal.¹⁶²

Judge Mukasey framed the issue before him as

whether a transaction, in which the lessor undertakes to "lease" equipment to the debtor, automatically falls outside the protection of [section 1110] because the debtor has the option of returning similar equipment of similar value and utility to the lessor at the end of the lease term instead of the particular piece of equipment originally leased.¹⁶³

He then described the nature of the disputed transactions in the following manner:

First are transactions in which lessors provide only aircraft engines, and not airframes. Second are transactions in which lessors provide both engines and airframes - *i.e.* complete, usable aircraft. The Committee argues that neither transaction is protected by [section] 1110 because both permit Pan Am to move "leased" engines freely from airframe to airframe during the "lease" term, *and* to return engines at the end of the term other than the particular engines originally provided.¹⁶⁴

The court described these transactions as "pooling/interchange" leases.¹⁶⁵ Pan Am's unsecured creditors argued that, because the airline had the option of returning similar equipment instead of original equipment to its lessors, these leases fell outside the coverage of section 1110.

In his analysis, Judge Mukasey referred to his "plain meaning" doctrine for section 1110, a view affirmed by the Second Circuit and strongly advocated by the Third Circuit in the *Continental III* bankruptcy.¹⁶⁶ In short, the district judge adhered to the view that section 1110 clearly encompassed any true lease of aircraft or aircraft equipment.¹⁶⁷

¹⁶² *Pan Am II*, 130 B.R. at 411.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* See *Continental III*, 932 F.2d at 287-89.

¹⁶⁷ *Pan Am II*, 130 B.R. at 413.

Taking the opportunity to reaffirm his earlier holding, Judge Mukasey utilized his own precedent in the instant controversy.

I declined [in *Pan Am I*] to read into [section] 1110 the unstated requirement that a lease involve the acquisition of equipment new to the airline. That same reasoning applies to the Committee's argument that, with respect to leases, [section] 1110 contains an unstated requirement that the lease provide for the return of the original equipment at the end of the term. The statute does not contain that requirement and I decline to add an additional condition by judicial fiat. Nor does the statute contain any such requirement with respect to the other kinds of transactions protected by [section] 1110 - purchase money equipment security transactions or conditional sales.¹⁶⁸

In this way, District Judge Mukasey held that, to the extent a party is a true lessor, an option for the lessee airline to return similar, but not identical, equipment does not nullify the statute's safeguards.¹⁶⁹

The court also refuted the notion that equipment leases containing pooling/interchange clauses are inconsistent with the concept of a true lease. Admitting that a true lease ordinarily calls for the return of exactly the same equipment, Judge Mukasey nevertheless found no basis for the argument that a lease must provide for the return of the original leased property.¹⁷⁰ The court cited the Uniform Commercial Code (UCC) in support of its conclusion.¹⁷¹ Characterizing the right of the debtor to substitute similar equipment at lease-end as essentially a purchase option, the court noted the UCC states that the inclusion of a purchase option does not automatically convert a lease into a security agreement.¹⁷²

¹⁶⁸ *Id.* at 412 (footnote omitted).

¹⁶⁹ *Id.* at 413.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 413-14 (citing U.C.C. § 1-201(37) (1978)).

¹⁷² *Id.* See U.C.C. § 1-201(37) (1978). The official text of § 1-201(37) provides that "[a] transaction does not create a security interest merely because it provides that . . . the lessee has an option to renew the lease or to become the owner of the goods." *Id.*

Judge Mukasey also observed that a true lease, as opposed to a disguised security interest, is heavily dependent upon individual facts.¹⁷³ While a pooling/interchange option is relevant to such determination, especially if the debtor could substitute virtually worthless equipment for valuable equipment, each case is nevertheless *sui generis*.¹⁷⁴ The court found that this case "concerns the strictly legal question of whether the presence of a pooling/interchange provision automatically takes a transaction outside the protection of [section] 1110."¹⁷⁵ Additionally, the court noted that the bankruptcy court specifically made no factual determination of any particular lease as a true lease or otherwise.¹⁷⁶ Judge Mukasey found that the bankruptcy judge gave the "sensible advice" that lessors may repossess, but at their own risk, and that any doubtful arrangements should be brought before the lower tribunal for a declaratory judgment to resolve that point.¹⁷⁷ For these reasons, Judge Mukasey confirmed the findings of Bankruptcy Judge Blackshear and concluded that a bankrupt lessee's right to substitute equipment at lease-end did not automatically deny the lessor the special protections of section 1110.¹⁷⁸

The court also confirmed that a lessor seeking to exercise its exceptional powers of repossession pursuant to section 1110 could proceed outside the bankruptcy forum. The unsecured creditors' committee requested an order from the bankruptcy judge directing lessors seeking to repossess under section 1110 to direct its claim to the bankruptcy court. The committee argued that, unless all such actions occurred in the bankruptcy court, chaos would ensue.

Treating Bankruptcy Judge Blackshear's refusal to issue such an order as a refusal to grant a preliminary injunc-

¹⁷³ *Pan Am II*, 130 B.R. at 414.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 414 n.4.

¹⁷⁶ *Id.* at 414.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

tion, the district judge noted that the legal standard for such relief is left to the lower court's discretion, a discretion not ordinarily disturbed on appeal.¹⁷⁹ The district court found that the issue was not whether the bankruptcy court could compel parties seeking to repossess under section 1110 into the Article I forum, but whether the bankruptcy judge abused his discretion in refusing to issue such an order.¹⁸⁰ The court reasoned:

Considering that [section] 1110 explicitly states that the right of a lessor to repossess equipment "*is not affected by section 362 or 363 of this title or by any power of the court to enjoin such taking of possession,*" it is unclear whether Judge Blackshear even had the power to issue the type of general order covering all challenged transactions which the Committee claims he was required to issue.¹⁸¹

In short, Judge Makasey rejected the airline's position.¹⁸² If Pan Am believed a lessor was acting wrongfully in seeking repossession outside the bankruptcy forum, it could seek an injunction from the bankruptcy court.¹⁸³ Thus, Judge Mukasey left this segment of the bankruptcy court's order unaltered.¹⁸⁴

By its recognition of pooling/interchange provisions as permissible clauses in a "true lease," the court relieved the leasing community of the concern that such transactions will subsequently be deemed disguised security interests.¹⁸⁵ The court also upheld the rights of aircraft lessors to seek the non-bankruptcy remedy of repossession, a privilege such lessors presumed section 1110 accorded to them.¹⁸⁶ Once again, the special protections allotted to aircraft lessors by the statute were recognized

¹⁷⁹ *Id.* at 415.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* (emphasis added).

¹⁸² *Id.* at 415-16.

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 416.

¹⁸⁵ *See id.*

¹⁸⁶ *Id.*

and upheld. Another crucial battle was thus won by the creditors.

VII. RETURN OF LEASED AIRCRAFT TO TRUSTEE

Aircraft sale-leasebacks were also the subject of controversy in the then near-bankruptcy of Trans World Airlines (TWA). In *Connecticut National Bank v. Trans World Airlines, Inc. (CNB)*, a federal district court vindicated the right of an equipment trustee to the return of its aircraft collateral.¹⁸⁷ The opinion issued in *CNB* dealt directly with the respective rights of debtors and trustees in such equipment lease transactions.¹⁸⁸

The facts of the case were uncontroverted. Connecticut National Bank (CNB) was acting as the trustee pursuant to an equipment trust agreement covering the sale and leaseback to TWA of ten aircraft and over ninety jet engines. CNB was the owner of the property. TWA was required to pay principal and interest on secured notes underlying the transaction directly to CNB. The bank would in turn pay the individual noteholders who were the beneficiaries of the equipment trust. Also, TWA had both guaranteed payment to the beneficiaries and agreed to indemnify CNB.

In early 1991, TWA failed to make a scheduled payment of approximately \$57 million on the notes. CNB then filed the instant action, seeking specific performance in the form of the return of the aircraft and the jet engines, a remedy provided in the sale-leaseback agreement in case of a default by TWA. TWA resisted this remedy, asserting that it had not been afforded an opportunity for discovery on the question of whether CNB was merely a "naked trustee" acting as a mere conduit for a remedy flowing to the trust beneficiaries and, thus, not the proper party to bring suit. The court rejected the airline's position on the

¹⁸⁷ 762 F. Supp. 76 (S.D.N.Y. 1991) [hereinafter *CNB*].

¹⁸⁸ *Id.* at 77.

discovery issue.¹⁸⁹ The court found that there was there was "absolutely no merit" to the argument that CNB was a denuded trustee and that further discovery would not alter that conclusion.¹⁹⁰ Given that CNB owned the property in question, its standing to bring suit was clear.¹⁹¹

In addition, the remedy CNB sought had been provided for in the sale-leaseback agreement.¹⁹² CNB was therefore the only party that could properly seek the return of the chattels. Since the trust beneficiaries lacked such abilities, CNB would be violating its fiduciary duty to the beneficiaries by not seeking return of the aircraft and the engines. The mere fact that some of these beneficiaries had also sued TWA on its guarantee of payment in New York state court did not prevent CNB from protecting its ownership rights.¹⁹³

The airline's next argument was that specific performance was an inappropriate remedy in these circumstances. Judge Goettel characterized the heart of this dispute as whether or not CNB had an adequate remedy at law.¹⁹⁴ The court stated that it did not view this lawsuit as one for specific performance but rather as CNB seeking to enforce a contractual obligation owed by TWA to pay money.¹⁹⁵ A demand for payment "would [have been] futile since TWA has already failed to pay."¹⁹⁶ Instead, CNB sought "to have the property returned, which [was] the precise remedy the parties previously agreed to."¹⁹⁷ Given the contractual arrangement between the parties, CNB was entitled to have its property returned.¹⁹⁸

¹⁸⁹ *Id.* at 79.

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.* at 79-80. Additionally, TWA argued it would be inequitable to require return of the property "in light of the tremendous ramifications such an order might have on both TWA and the public at large." *Id.* at 80.

¹⁹⁵ *Id.* at 80.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

Looking to the New York codification of the Uniform Commercial Code, the court pointed out that the law permits a secured creditor to sue on the debt itself or foreclose on the underlying collateral.¹⁹⁹ The court felt it would have been illogical for the rights of CNB as an owner to be more limited than those of a secured lender.²⁰⁰ Making an analogy to the situation where someone leases a car and then defaults on the required payments, Judge Goettel found it would work an absurd result if the lessor could not demand the return of the vehicle but instead was forced to secure a money judgment against the lessee and then attempt to enforce it by levying on the very chattel it already owned.²⁰¹ "Such a result would turn property law as we know it on its head," and the court refused to apply such unsound reasoning to the instant case.²⁰²

The court went on to declare as "nothing short of specious" the claim by TWA that CNB would be adequately protected by obtaining a money judgment.²⁰³ TWA contended that CNB was not suffering any loss or risk since the bank was only required to pay the beneficiaries what it received from TWA, and since the airline was maintaining the planes in accordance with strict FAA guidelines, the property was not at risk.

Judge Goettel noted that TWA had "been teetering on the brink of bankruptcy for years," and it was therefore unlikely that the company possessed enough cash to satisfy a money judgment in any event.²⁰⁴ Indeed, the court reasoned that if the airline had the money in the first place, most likely it would never have defaulted on the sale-leaseback agreement. Judge Goettel made the cogent observation that, if CNB were to obtain a money judgment, logically it would then attach certain TWA

¹⁹⁹ *Id.* (citing N.Y. U.C.C. Law § 9-503 (McKinney 1964)).

²⁰⁰ *CNB*, 762 F. Supp. at 80.

²⁰¹ *See id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *CNB*, 652 F. Supp. at 80.

property, such as the very planes and jet engines at issue.²⁰⁵ Since "[t]his would return us precisely to the position we are in today," the court rejected that alternative as grossly unfair to the bank in light of the fact that repossession was a remedy provided for in the contract.²⁰⁶ The adequate safeguards that TWA was supposedly exercising to preserve the property were found to be relevant because the property had always belonged to CNB, and the bank had the right to demand its return.²⁰⁷

TWA also argued that the balance of the equities demanded that the company be allowed to keep the aircraft. Rejecting this argument, the court found it difficult to imagine "a more grievous wrong" than permitting the airline to continue to use the bank's property without paying for it.²⁰⁸ Taking notice of news reports that TWA was selling certain of its international routes to another airline, the court additionally found that these reports suggested that "TWA possesse[d] more planes and engines than it [would] actually need."²⁰⁹ Implicitly, the return of the property at issue to CNB would not damage a shrinking TWA. No doubt, the fact that this lawsuit involved only ten jets out of the entire TWA fleet of over 200 airliners had some influence on the court. Additionally, TWA's cause suffered because of its failure to clarify the actual threat posed by repossession or any harmful effect that the return of the engines at issue would cause.

The court also compared this action with an eviction proceeding where the defaulting tenant argues that by being evicted he would experience a greater hardship than the landlord who was simply losing money.²¹⁰ Embracing such an argument would produce "an illogical result" under which a tenant could never be evicted.²¹¹ "Just as a

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 80-81.

²⁰⁷ *Id.* at 81.

²⁰⁸ *CNB*, 762 F. Supp. at 81.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *CNB*, 762 F. Supp. at 81.

tenant can be evicted," held Judge Goettel, "a lessee of property who fails to pay can be required to return the property to the owner."²¹²

In its final argument, TWA contended that the recent Persian Gulf conflict, the public's fear of terrorism, and sharply increased fuel prices had so curtailed its cash flow that it was unable to make the payments due under the agreement. While not doubting the severe financial distress encountered by all airlines because of recent events in the Middle East, the court nevertheless found that "none of these factors excuse[d] TWA from its obligations."²¹³ First, said the court, the airline could have negotiated for a *force majeure* clause in the trust agreement, but it did not.²¹⁴ Secondly, all of the foregoing setbacks, including the escalating price of foreign oil, "were clearly foreseeable and simply represent the risk of doing business in an international forum."²¹⁵ Finally, the court felt that TWA could not argue that "the threat of war in the Middle East is something of which it was unaware."²¹⁶ Judge Goettel noted that "the people of that region have been at war for thousands of years and recent history has been no different."²¹⁷ The judge also cited the threat of terrorism associated with this region and the fact that international airlines for years had factored the various regional instabilities into their fares. Since all of these risks were foreseeable when the parties entered into the sale-leaseback, TWA was not entitled to relief for failing to meet its obligations. For all these reasons, the court granted judgment for CNB.²¹⁸

In analyzing the *CNB* decision, the lessor community

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *CNB*, 762 F. Supp. at 81.

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.* As anticipated, TWA appealed and won a temporary stay of Judge Goettel's order on the condition that it post a \$20 million bond. The Court of Appeals for the Second Circuit is now considering the matter. *Today's News*, N.Y. L.J., May 29, 1991, at 1.

and equipment trustees can take some comfort in the rule of law set forth by Judge Goettel. First, the court recognized the standing of the trustee to commence a lawsuit to protect its interest. Beneficiaries under an equipment trust agreement may rely upon the trustee to pursue appropriate remedies against a recalcitrant debtor. The simple, but nevertheless critical, role of the trustee as the true owner of the property was extremely important. This case shows that in certain instances, it may be advisable to have the trustee in an equipment sale-leaseback arrangement also be the owner of the property. Clearly, that was an important factor for this court in reviewing the propriety of the trustee commencing this action.

The court's comments on the assumption of risk likewise bear notice. Both sides to future transactions should now take a careful view of the relevant burdens each side is expected to shoulder. Clearly, the judge held no sympathy for TWA when it claimed the Gulf War was an excuse for its non-performance. Foreseeability was important on this point. An equipment lessee desiring some protection in the event of financial setbacks is clearly forewarned by *CNB* that such safeguards must be built into the agreement. Conversely, the trustee and the beneficiaries should carefully consider exactly how much latitude they wish to afford to a lessee that may fall upon hard times. If they choose to be generous now, they may be foreclosed in the days ahead from seeking remedies critical to the protection of their interests. In this context, the careful drafting of the *force majeure* clause is vital.

In conclusion, *CNB* represents a timely opinion on the subject of equipment sale-leasebacks and provides sound guidance to lessees, trustees, and beneficiaries alike for future transactions.

VIII. JUDGMENT DAY — TERMINATING AIRCRAFT LEASES PRE-BANKRUPTCY

The previous discussion reviewed the struggle waged between the debtor airlines and their creditors in the

bankruptcy courts, primarily over the scope and impact of section 1110. Of significance is the fact that all the disputes occurred *after* the bankruptcy petition was filed. What would the result be if the lessor attempted to sever ties to the airline *before* the commencement of insolvency proceedings? To answer this question we must travel southward again to sunny Florida and the Braniff bankruptcy, but, unlike before, this particular lessor was given a chilly reception by the Orlando bankruptcy judge.²¹⁹

In *Braniff, Inc. v. GPA Group PLC*,²²⁰ the controversy involved the rights of the debtor airline to twenty-six new Airbus A320 jets, including leaseholds. "The principal issue in dispute was whether Braniff's rights to the aircraft were validly terminated prior to the September 28, 1989 filing by Braniff of a Chapter 11 petition."²²¹ Braniff filed for reorganization at 1:35 a.m. on September 28, 1989. Several hours before the filing, GPA, an aircraft lessor, telecopied various notices to the debtor "purporting to terminate Braniff's rights in and to the 26 aircraft," for reason of alleged unspecified defaults in the agreements concerning the acquisition of the aircraft.²²² Specifically, these termination notices were transmitted at approximately 9:00 p.m. on September 27, 1989, less than five hours prior to the bankruptcy filing.

The critical transactions for the A320s were leveraged leases known as a "Japanese Double Dip."

Pursuant to the Japanese Double Dip, each aircraft was sold to a Japanese entity, which was, in turn entitled to receive tax credits in Japan by reason of [its] ownership of the aircraft. Additionally, through a complicated set of transactions, [an indenture trustee] became the actual owner of each A320 aircraft for United States tax

²¹⁹ See *Braniff I*, 110 B.R. at 985. See also *supra* notes 33-52 and accompanying text.

²²⁰ *In re Braniff, Inc.*, 118 B.R. 1819 (Bankr. M.D. Fla. 1990)[hereinafter *Braniff II*].

²²¹ *Id.* at 828.

²²² *Id.* at 829.

purposes.²²³

The trustee then entered into leases with GPA, and GPA subleased the aircraft to Braniff. GPA now sought to terminate those leases.

Important to Bankruptcy Judge Corcoran was that GPA had previously acquired the right to obtain a ten percent stake in Braniff at a future date, that GPA had substantial amounts of financial data concerning the airline, including such information that made it abundantly clear that Braniff was in financial peril, and that "Braniff might consider filing a petition under the Bankruptcy Code."²²⁴ Moreover, the bankruptcy judge found that GPA's imprecise claims that the debtor was in default of the agreements prior to the commencement of the case were unsupported.²²⁵ Braniff, the bankruptcy court found, was not in default on its agreements with GPA, had been paying its debts as they became due, and, in fact, was owed nearly half a million dollars by GPA on a separate past due obligation.²²⁶ In short, concluded Judge Corcoran, in those dark hours of September 27th, GPA attempted to terminate the leases solely on the belief that Braniff would file for bankruptcy.²²⁷

Of great concern to the court was the value of the aircraft to the debtor. Judge Corcoran found:

The A320 aircraft are extremely valuable assets to the estate. Although at the time of trial Braniff's plans for the A320 aircraft had not been formulated, Braniff may use the aircraft in future operations under a plan of reorganization or may attempt to transfer its rights to such aircraft to obtain critical funds for its reorganization. Without the aircraft, Braniff's ability to reorganize will be frustrated. Contrary to GPA's contentions, Braniff has significant equity in the subleases. If Braniff loses its protected rights to the twenty-six A320 aircraft with the earliest delivery posi-

²²³ *Id.* at 830.

²²⁴ *Braniff II*, 118 B.R. at 831, 835-36.

²²⁵ *Id.* at 842.

²²⁶ *Id.* at 835.

²²⁷ *Id.* at 836.

tions, Braniff may well be unable to reorganize.²²⁸

By way of contrast, the needs of the lessor were slight. The court found that GPA would not be prejudiced by allowing Braniff to proceed to a reorganization that included the twenty-six A320's, the lessor would be the beneficiary of substantial tax credits if the leases were not terminated, and GPA was adequately protected because the aircraft had been well maintained and were not deteriorating in value.²²⁹

Turning to his legal conclusions, Judge Corcoran found that, under the applicable state law, the GPA termination notices were legally insufficient because they had failed to specify a grounds for termination.²³⁰ Moreover, GPA's conduct and acts "were inconsistent with an intention to extinguish such agreements and leases."²³¹ The court also noted that "the possibility of Braniff filing for relief under Chapter 11 had been raised by Braniff."²³² Based on these factors, the bankruptcy judge held that:

[a] creditor should not be permitted to terminate extremely valuable contract rights that belong to a financially distressed debtor "by jumping the gun on what is perceived to be a race to the courthouse." . . . Where a few hours before the debtor files a bankruptcy petition, a lessor sends a termination notice after it heard rumors of the impending bankruptcy, without specifying the grounds for termination, the termination is improper.²³³

The court then ruled that GPA had waived its termination rights because they knew of a possible Chapter 11 filing by Braniff.²³⁴ As an equitable matter, the court would not permit this type of conduct by GPA and estopped its

²²⁸ *Id.* at 837.

²²⁹ *Braniff II*, 118 B.R. at 839.

²³⁰ *Id.* at 841.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.* (quoting *In re Bronx-Westchester Mack Corp.*, 4 B.R. 730, 734 (Bankr. S.D.N.Y. 1980)).

²³⁴ *Braniff II*, 118 B.R. at 841.

rights to terminate.²³⁵

Judge Corcoran also addressed the issue of whether Braniff had breached the lease contract prior to the Chapter 11 filing, thereby justifying its termination. In rejecting this proposition, the court found that:

[h]earsay reports that Braniff's suppliers were not being paid by Braniff and were refusing to deliver product to Braniff does not amount to grounds to claim Braniff's material breach of contract for failing to pay debts as they generally come due. Even though Braniff was delaying payment of some suppliers, the instances in which this occurred were not sufficient in number or amount so as to be material. Accordingly, [GPA] had no right to declare an event of default on that basis.²³⁶

Finally, asserting that "[c]lauses that purport to terminate agreements when action is taken to further a reorganization" are invalidated by section 365(e) of the Bankruptcy Code, the court implied that the pre-bankruptcy acts of GPA constituted a wrongful termination and, if allowed to stand, would "hamper the reorganization process."²³⁷

In sum, the court upheld the lease as an executory contract, "assumable in the future under [s]ection 365(a)" and refused to recognize the lessor's attempt to terminate the lease pre-petition.²³⁸ Given the complexity of the transaction, the court held it inappropriate to require the debtor to assume or reject the lease at this time, for the moment leaving Braniff free to delay that decision until the confirmation of a plan of reorganization.²³⁹ Ultimately, the bankruptcy court entered a declaratory judgment in favor of Braniff and against GPA, declaring the September 27th termination notices "null and void and of no force and effect" and, conversely, reaffirming the air-

²³⁵ *Id.* at 841-42.

²³⁶ *Id.* at 842.

²³⁷ *Id.*

²³⁸ *Id.* at 845.

²³⁹ *Id.* See 11 U.S.C. § 365(d)(2) (1988) (a reorganizaing debtor may assume or reject an unexpired lease "at any time before the confirmation of a plan").

craft leases as "in full force and effect."²⁴⁰

Of concern in this decision is the court's reliance upon that section of the Bankruptcy Code which forbids the termination of a lease for reason of an *ipso facto* clause in the underlying agreement. Specifically, section 365 states that a lease "may not be terminated . . . at any time *after* the commencement of the case" due to, *inter alia*, the filing of a bankruptcy petition by the lessee.²⁴¹ While the statute inarguably voids any attempt to terminate a leasehold under an *ipso facto* clause once a case has been commenced, the provision in no way addresses a pre-petition termination, as was attempted here. To be sure, the slant of *Braniff II* is markedly towards an analysis of the equitable and contract law aspects of the instant controversy. To that extent, the holding is on firm ground. Nevertheless, the ruling appears to be an unwarranted extension of section 365 to the pre-filing acts of a lessor.

The assertion that section 365 comes into play to invalidate contractual clauses "when action is taken to further a reorganization"²⁴² seems to cut with an unnecessarily wide swath through any number of options a concerned party in interest might seek to employ in dealing with a troubled entity that it fears is slipping into bankruptcy. While the court rightfully sought in *Braniff II* to preserve valuable assets of the estate and eradicate any obstacle to the reorganization process, it seemingly did so at the expense of the lessor's freedom to act prior to a bankruptcy filing. Indeed, the opinion's blunt statement that GPA could not rely on its own intelligence that the lessee was in financial straits clearly put the lessor at a disadvantage

²⁴⁰ *Braniff II*, 118 B.R. at 824-25. Although this controversy centered around the leasing of aircraft, § 1110 was not implicated, except for an aside by the court that the statute "does not, in and of itself, create a right to recover possession of aircraft." *Id.* at 844.

²⁴¹ 11 U.S.C. § 365(e)(1) (1988) (emphasis added). See *Prime Motors Inns, Inc. v. First Fidelity Bank N.A. New Jersey (In re Prime Motors Inns, Inc.)*, 123 B.R. 104, 108 (Bankr. S.D. Fla. 1990) (default provisions "are unenforceable and invalid pursuant to the anti-*ipso facto* provisions of section 365(e)(1)").

²⁴² *Braniff II*, 118 B.R. at 842.

by forcing it to ignore valuable information and thus make critical business decisions in a vacuum.

One unwelcome result of *Braniff II* may be a chilling effect on transactions between lessors and distressed lessees. If *Braniff II* is viewed as circumscribing their rights to terminate prior to a bankruptcy filing, lessors may feel compelled for their own protection to terminate at a much earlier point in time. Moreover, for a transaction not yet final, lessors fearful of a *Braniff II* type outcome may be unwilling to continue working with a troubled lessee. If a lessor flees in self-defense from a vital transaction, that lost opportunity may force a lessee over the precipice and into a bankruptcy filing. Neither of these outcomes is desirable. While the court in *Braniff II* may have preserved the rights of that carrier to its leaseholds, it may unwittingly have created a more dangerous situation for other troubled airlines or similarly situated parties.

IX. TRANSFORMATION - NOT A SPLIT PERSONALITY BUT A METAMORPHOSIS

The rather infamous reorganization proceedings and subsequent liquidation of Eastern Airlines have certainly provided a wealth of material to write about, both in the legal and business senses. Almost overlooked, however, was a case in which the bankruptcy court was presented with a novel question as to whether a party who advances funds for the purpose of financing the acquisition of aircraft, which are to be included as part of a larger pre-existing floating collateral pool, is entitled to the special benefits provided in section 1110 of the Bankruptcy Code.²⁴³ While not strictly pertaining to the aircraft lessor controversy under the statute, the fact that this case had important ramifications for airline creditors who finance equipment acquisitions by the carriers makes it worthy of inclusion here.

While the lower court found against the secured lend-

²⁴³ *In re Ionosphere Clubs, Inc.*, 112 B.R. 78 (Bankr. S.D.N.Y. 1990).

ers,²⁴⁴ their rights were subsequently vindicated by the appellate court.²⁴⁵ This case exemplified the difficult issue raised as to the true character of an alleged security interest where "secured revolving credit facilities under which borrowings are used both for acquisition of aircraft and for nonpurchase purposes."²⁴⁶

In the instant case, the moving parties seeking to take advantage of section 1110 were the so-called "Airbus Lenders," a consortium of European banks that has financed Eastern's acquisition of over twenty aircraft from Airbus Industrie.²⁴⁷ The operative document was an indenture naming The First National Bank of Boston indenture trustee,²⁴⁸ whereby Eastern had borrowed funds from these and other lenders, as evidenced by notes, which in turn were secured by "a floating collateral pool consisting of aircraft, aircraft engines, and various spare parts."²⁴⁹ The collateral pool had an approximate fair market value of \$820 million, while the principal sum of the notes held by the Airbus Lenders was less than \$100 million.²⁵⁰ Eastern submitted that the indenture was never intended to grant a PMESI to the Airbus Lenders, and that they were "merely generally secured creditors . . . not entitled to the protections afforded by [section] 1110."²⁵¹ The secured lenders cross-moved the court to find that they did indeed possess a PMESI, and, pursuant to section 1110, Eastern should be compelled to either cure all defaults and maintain current payments or surren-

²⁴⁴ *Id.* at 89.

²⁴⁵ See *First Nat'l Bank of Boston v. Shugrue (In re Ionosphere Clubs, Inc.)*, 123 B.R. 166 (Bankr. S.D.N.Y. 1991).

²⁴⁶ Gerstell & Hoff-Patrinios, *supra* note 7, at 19.

²⁴⁷ The Airbus Lenders consisted of Dresdner Bank, A.G., Bayerische Verinbank, Deutsche Bank, A.G., Westdeutsche Landesbank Girozentrale, Kreditanstalt für Wiederaufbau, Credit Lyonnais, Banque Nationale de Paris, Societe Generale, Banque Francaise du Commerce Exterieur, and Midland Bank PLC. *In re Ionosphere Clubs*, 112 B.R. at 80.

²⁴⁸ *Id.* at 79.

²⁴⁹ *Id.* at 80.

²⁵⁰ *Id.* at 80-81.

²⁵¹ *Id.* at 81.

der the Airbus aircraft.²⁵²

Chief Bankruptcy Judge Lifland ruled that the Airbus Lenders did not possess a PMESI in the specific aircraft at issue and, therefore, could not utilize the special protections of section 1110. In doing so, the court began with the premise that "the terms in [section] 1110 must be narrowly construed . . . before a creditor may receive the protection it offers."²⁵³ For this reason, the bankruptcy court concluded that it must determine if the Airbus Lenders held a PMESI.²⁵⁴ The court held that they did not.

Analyzing the law of secured transactions, Judge Lifland cited the general rule that if collateral secures debt other than its own price, it is not a PMESI.²⁵⁵ The fact that the loan to Eastern was secured by the floating collateral pool, and not by the specific Airbus aircraft, was fatal to the claimed PMESI of the Airbus Lenders.²⁵⁶ In addition, the court found that the indenture instrument itself called for the notes to be equally and ratably secured, without priority or distinction. To be sure, the collateral pool secured the obligations of Eastern to some thirty-eight other lenders for transactions unrelated to the Airbus purchases, but which were nonetheless included in the indenture.²⁵⁷ Likewise, the contention that the notes could be linked to particular aircraft acquisitions was downplayed. The court found the equal and ratable language in the indenture dispositive.²⁵⁸ Lastly, looking to the operative document, Chief Judge Lifland ruled that the indenture reserved the right of enforcing any security

²⁵² *Id.*

²⁵³ *Id.* at 82.

²⁵⁴ *Id.*

²⁵⁵ *Id.* See *Roberts Furniture Co. v. Pierce (In re Manuel)*, 507 F.2d 990 (5th Cir. 1975). *In re Manuel* has been cited as the leading case espousing the "transformation" rule, which holds that "the addition of more collateral or more secured debt to the purchase-money security agreement transforms the PMESI to a non-PMESI." Gerstell & Hoff-Patrinios, *supra* note 7, at 19.

²⁵⁶ *In re Ionosphere Clubs*, 112 B.R. at 82.

²⁵⁷ *Id.* at 83.

²⁵⁸ *Id.* at 84-85.

interest to the indenture trustee, not individual parties.²⁵⁹ The Airbus Lenders were thus left without a remedy, even if they had a right. The court's finding on the last issue is particularly instructive. The court held that the Airbus Lenders, by agreeing to secure their notes by the indenture and the floating collateral pool, relinquished rights they might have otherwise had retained in a separate security agreement.²⁶⁰

In his conclusion, Chief Bankruptcy Judge Lifland stated:

Although the Airbus Lenders undeniably made "equipment specific" loans, they did not however, take back the kind of purchase money equipment security interests afforded protection under [section] 1110. Based upon the express terms of the operative documents executed in connection with the issuance and collateralization of the Airbus Notes, it is clear that the Airbus Lenders do not, and were never intended to, possess a PMESI in the Airbus Aircraft.²⁶¹

For these reasons, the bankruptcy court denied the Airbus Lenders the protection of section 1110, and conversely determined those parties were "merely generally secured creditors of Eastern."²⁶²

The federal district court judge deciding the Airbus Lenders' appeal now faced this troublesome bankruptcy court decision. In *First Nat'l Bank of Boston v. Shugrue*,²⁶³ the Airbus Lenders asked for a reversal of the bankruptcy court's finding that the security interests they held were not exempted from the automatic stay by section 1110 of

²⁵⁹ *Id.* at 88.

²⁶⁰ *Id.* at 89.

²⁶¹ *Id.*

²⁶² *Id.*

²⁶³ *In re Ionosphere Clubs, Inc.*, 123 B.R. 166 (Bankr. S.D.N.Y. 1991)[hereinafter *First Nat'l*]. This case exemplifies the extended time commitment a financier must make in an aircraft transaction. The original indenture was created in 1963, and the Airbus Lenders extended credit to Eastern to finance the aircraft acquisitions in 1978 and again in 1981. *Id.* at 169. In other words, at the time of the airline's bankruptcy filing the relevant financing agreements ranged in age from eight to twenty-six years old.

the Bankruptcy Code. Judge Sweet made his review *de novo*, as "the facts are not in dispute, and appellants challenge only the legal conclusions of the Bankruptcy Court."²⁶⁴

As its opening premise, the district court set out that if section 1110's provisions are complied with, a court is without power to further limit a creditors' statutorily granted rights.²⁶⁵ Judge Sweet stated that the first question before him was whether the Airbus Lenders' security interests in the Airbus aircraft constituted PMESIs.²⁶⁶ Since the Bankruptcy Code did not define "security interest," the court turned to the UCC.²⁶⁷ Section 9-107 of the UCC specifies that a security interest is a "purchase money security interest" to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who, by making advances or incurring an obligation, enables the debtor to acquire rights in or the use of collateral.²⁶⁸ Under this approach the court felt that the relevant question was whether the financing party takes an interest in the collateral as security for the purchase price obligation, not whether the purchased property also served or will serve as collateral for other debts of the purchaser.²⁶⁹

The airline claimed that First National, the indenture trustee, and not the Airbus Lenders as creditors, had sole authority to seize property in the collateral pool.²⁷⁰ Judge Sweet disagreed, holding that section 1110 "by its own terms applies to situations in which a trustee holds the security interest for the benefit of the actual creditor."²⁷¹

²⁶⁴ *Id.* at 171. See also 28 U.S.C. § 158(a) (1978) (appeals to district court of bankruptcy court decisions).

²⁶⁵ *First Nat'l*, 123 B.R. at 169 (citing *In re Air Vermont*, 761 F.2d at 134).

²⁶⁶ In fact, the aircraft themselves had already been sold. The sale proceeds were being held in escrow as the deemed equivalent of the jets, pending appeal to determine the parties' respective rights. *First Nat'l*, 123 B.R. at 170.

²⁶⁷ *Id.*

²⁶⁸ *Id.* See U.C.C. § 9-107 (1978).

²⁶⁹ *First Nat'l*, 123 B.R. at 171.

²⁷⁰ *Id.* at 170.

²⁷¹ *Id.*

The district court, unlike the bankruptcy judge, held that the Airbus Lenders unquestionably took security interests in the aircraft as consideration for the loan.²⁷² In light of the UCC, the court found the banks held PMESIs, and the fact that the jets became part of the floating collateral pool did not take the transaction outside the scope of UCC section 9-107.²⁷³

Judge Sweet then examined the bankruptcy court's conclusion that, even if PMESIs existed initially, they were subsequently eradicated by the inclusion of the Airbus aircraft in the floating collateral pool.²⁷⁴ Judge Sweet noted that the bankruptcy court had relied upon the so-called "transformation" rule, in deciding this issue, that is, when PMESI collateral is commingled with non-PMESI collateral, the PMESI is destroyed.²⁷⁵

Ultimately, the district court found that "the more modern trend is to recognize that only the security interest which secures the non-purchase price debt is not a PMESI, but the interest which secures the purchase price debt retains its PMESI character."²⁷⁶ In so doing, the court rejected the "transformation" rule in favor of the "dual status" rule.²⁷⁷ Judge Sweet stated that:

The important point here is that it is the security interest which has the dual status, not the loan which it secures. To the extent that the security interest gives the creditor the right to seize the collateral because of a default on the purchase price obligation, it is a PMESI, and to the extent that it allows seizure because of defaults on other loans, it is non-PMESI.²⁷⁸

²⁷² *Id.* at 171.

²⁷³ *Id.* at 170-71.

²⁷⁴ *In re Ionosphere Clubs*, 112 B.R. at 84-86.

²⁷⁵ *First Nat'l*, 123 B.R. at 171.

²⁷⁶ *Id.* (followed by *In re Pan Am Corp.*, 124 B.R. 960, 971 (Bankr. S.D.N.Y. 1991) (Blackshear, J.), *aff'd in part*, 125 B.R. 372 (Bankr. S.D.N.Y.), *aff'd*, 929 F.2d 109 (2d Cir.), *cert. denied*, 111 S. Ct. 2248 (1991)).

²⁷⁷ See *Pristas v. Landaus of Plymouth, Inc.*, 742 F.2d 797, 800-01 (3d Cir. 1984) (holding that "a security interest can have a 'dual status' and that the presence of a nonpurchase money security interest does not destroy the purchase money aspect.").

²⁷⁸ *First Nat'l*, 123 B.R. at 172.

Taking a pragmatic approach, the court observed that for this principle to be workable, the debtor's payments must be "clearly allocated to each of its obligations. . . . Of course, where the obligations are owed to different creditors, there is no problem in allocating payments to each individual loan."²⁷⁹ Given the relative sophistication of these parties, the less complex nature of the instant situation was in sharp contrast to the "typical consumer credit case," where lump sum payments are not clearly allocated to the purchase price of individual pieces of collateral, thereby complicating any utilization of the "dual status" rule.²⁸⁰

The court also reversed the bankruptcy court's finding that an allocation of Eastern's payments to specific loans was not possible. Rather, Judge Sweet found that particular loans financed the purchase of each individual Airbus jet, making the apportionment task relatively simple.²⁸¹ Lastly, Judge Sweet focused on the fact that the bankruptcy judge had indicated below that section 1110 did not apply because any recovery by the Airbus Lenders would be shared with Lazard Brothers & Co., Ltd., another holder of notes from Eastern.²⁸² District Judge Sweet easily disposed of that holding, ruling instead that the Airbus Lenders were "free to share the benefits of their PMESIs" with other Eastern creditors secured by the indenture, "without destroying the purchase quality of those interests. . . . [T]he situation is at least analogous to

²⁷⁹ *Id.*

²⁸⁰ *Id.* at 173 n.4. A leading commentary has opined as follows:

While the dual status rule appears to be gaining dominance among both commentators and courts, there is even more reason to prefer this rule in the sophisticated context of aircraft financings. Unlike consumer debtors, air carriers are sophisticated borrowers in heavily negotiated transactions, and can surely be presumed to know the importance of granting a PMSI in aircraft. Use of the transformation rule, which terminates purchase-money status regardless of the intent of the parties, would harm the ability of air carriers to refinance debt.

Gerstell & Hoff-Patrinis, *supra* note 7, at 21 (footnote omitted).

²⁸¹ *First Nat'l*, 123 B.R. at 173.

²⁸² *Id.* at 173 (citing *In re Ionosphere Clubs*, 112 B.R. at 85-87).

a partial assignment of the benefits of the benefits of the PMESI to Lazard, and Eastern has offered no justification for rejecting that analogy."²⁸³

In conclusion, the district court explicitly advocated the "dual status" rule, finding a majority of cases have chosen to apply that principle rather than the "transformation" rule. Since the lenders' PMESI's were therefore unaltered, their security interest qualified under section 1110 for exemption from the automatic stay.²⁸⁴

The relevance of Judge Sweet's ruling is its application of the "dual status" rule to the complex world of aircraft finance. His opinion highlights the rising pre-eminence of that doctrine and the decline of the competing "transformation" rule. To secured creditors financing aircraft and other "floating collateral" in the airline industry, such judicial acceptance of a rule more favorable to the preservation of PMESI's will assist such lenders in enforcing their rights to valuable collateral, even when confronted with the intervention of the debtor airline's bankruptcy.

X. THE FUTURE IS NOW FOR SECTION 1110

As we near the end of this discussion, we can review the last year's controversies with the unmistakable clarity of hindsight. The tremors caused by the airline bankruptcies of the past year have underscored the critical need for judicious use of the Bankruptcy Code, with an enlightened view towards creditors and lessors, as well as the reorganizing debtor and the flying public.²⁸⁵ Subsequent cases proved that *Continental I* misconstrued the Congressional purpose behind section 1110, as the legislative history does state that the "protection of security interests was added to make financing forms more flexible and conso-

²⁸³ *First Nat'l*, 123 B.R. at 174.

²⁸⁴ *Id.*

²⁸⁵ See James T. McKenna, *Bankruptcy Laws Misused in Attempts to Stop Grounding of Eastern, Pan Am, Av. Wk. & SPACE TECH.*, Jan. 13, 1992, at 47.

nant with the modern law.”²⁸⁶ While this must be balanced against the legislative intent to exclude general mortgages from the statute’s special protections,²⁸⁷ the better reasoned opinions of *Braniff II*, *Pan Am I*, *Continental II*, and *Continental III* tell us that a sale-leaseback qualifies as one of the modern “financing forms” Congress intended to protect in section 1110. An additional point to be made here is that normally the lessor and the carrier still create a one-to-one relationship between the debt and the collateral in a sale-leaseback, an aspect of no small importance when distinguishing the acquisition from an ordinary mortgage interest.²⁸⁸

What remains to be seen, however, is how successful the lessors are in lobbying Congress to reaffirm and strengthen the special attributes of section 1110.²⁸⁹ Given the competing interests of certain airlines struggling to survive, lenders and lessors seeking to increase their protections, and healthy air carriers wanting to maintain the *status quo* in the capital markets, the coming debate in the halls of Congress should be an interesting one. Even as the controversy made its rounds through the circuit courts of appeals, “[m]ore than a dozen transportation companies, lessors and lenders involved in sale-leaseback transactions” formed a group to jointly lobby Congress to clarify section 1110.²⁹⁰

To be sure, aircraft lessors have joined forces with the manufacturers, purchasers, and financiers of aircraft and railroad equipment to urge the Congress to “remove a cloud of uncertainty that is now preventing some transactions from going forward, needlessly delaying others, and raising the costs of all other capital equipment financing

²⁸⁶ H.R. REP. 595, *supra* note 23, at 240, reprinted in 1978 U.S.C.C.A.N. at 5963, 6200.

²⁸⁷ *Id.*

²⁸⁸ See *Southtrust Bank of Alabama, Nat’l Assoc. v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1243 (11th Cir. 1985).

²⁸⁹ Wade Lambert & Ellen J. Pollack, *Airlines and Lenders Join To Lobby For Bankruptcy - Law Clarification*, WALL ST. J., Apr. 23, 1991, at B16.

²⁹⁰ *Id.*

transactions.”²⁹¹ The aircraft lobby reminds Congress that the lawmakers have historically recognized the need to encourage equipment financing transactions, and so provided special protections in section 1110. Without that aegis, the costs of financing would rise in accordance with the perceived risk of entering into unprotected aircraft leases. The dramatic rise of recent airline bankruptcies merely served to exacerbate that confusion, and the lobby contended that “[i]t is a demonstrated fact . . . that the resulting uncertainty has raised the cost of financing.”²⁹² In particular, the members of the lobby do not want their equipment tied up for months or years in bankruptcy court disputes.²⁹³ In testimony, this group emphasized the very real danger that, given the time expended on discovery, trial, and appeals, the sixty day period of section 1110 would have long evaporated, leaving the lessor with none of the protections it envisioned when it entered into the transaction.²⁹⁴

The lessor community is concerned that the recent airline bankruptcy litigations have shrouded the special protections of section 1110 in uncertainty. To dispel any doubts as to the continuance of the privileges Congress originally legislated, the aircraft lessors have now asked Congress to strengthen the statute.²⁹⁵ To be sure, the les-

²⁹¹ *Senators Mull Proposals to Clarify Code with Regard to PBGC, Trusts, Aircraft*, 3 Bankr. L. Rep. (BNA) 895, 897 (Aug. 1, 1991) (quoting testimony of John J. Salmon).

²⁹² *Id.*

²⁹³ *Id.*

²⁹⁴ *Id.* at 898.

²⁹⁵ *Id.* at 897. While not authoritative, various proposals to amend section 1110 are in circulation. One call for a rather simple set of modifications is to delete references to “purchase money,” thereby including generic security interests within the statute’s protection. This minor change may alleviate some of the technical disputes as to the threshold matter of the classification of the security interest. Under this provision, section 1110 would simply protect all security interests, conditional sales, and leases. Other proposals seek to protect lessors by extending monetary compensation. These revisions would permit lessors to file a priority administrative claim for monies expended to protect the aircraft, in the event the debtor-in-possession or the trustee does not fulfill its obligations to cure defaults within the first sixty days after the bankruptcy petition is filed. Letter from Eloise L. Morgan, attorney, Winthrop, Stimson, Putnam & Roberts, to Anthony Sabino,

sors concerns may be well placed. The financing of fleet acquisitions is sure to remain an issue of major import, with the stakes ranging into the billions of dollars.²⁹⁶ As the airlines, lessors, and financiers are still sorting through the wreckage of the defunct carriers, the pace of technology and global expansion demands an immediate response to the next phase of fleet modernization.

As an example of what is at stake, consider Airbus Industrie, the subsidized European consortium, that recently reported a backlog of orders for 1,600 planes, "worth a cool \$70 billion."²⁹⁷ In addition, industry behemoth Boeing estimates that the world airlines "will spend \$617 billion on new planes over the next 15 years."²⁹⁸ Without a doubt, financing the modernization of the airline fleets that will carry passengers into the 21st century demands a comprehensive and conclusive review of section 1110. Certainly, recent judicial rulings have had a calming influence and allayed many of the creditors fears caused by *Continental I*. But with the current talk of bankruptcy reform, surely a fine tuning of the special protections of section 1110 is appropriate and necessary.

Few would argue that recent litigation developments now compel a re-examination of section 1110, with a view towards augmenting the special protections now provided airline creditors. This is simply a healthy result of the fractious court cases and is already underway. Nonetheless, one must be mindful that the same rulings which have led to the present call for reform also exemplify the durability of section 1110. Notwithstanding some early concerns, the statute and, furthermore, its underlying legislative history, have proven themselves solid under the

attorney, LeBoeuf, Lamb, Leiby & MacRae (Oct. 16, 1991) (on file with Southern Methodist University Law Review Association) (regarding proposed amendment to section 1110).

²⁹⁶ Kelly & Oneal, *supra* note 67, at 84. "[T]he aircraft finance business faces a major shakeout" given the hard times that have befallen air carriers. *Id.*

²⁹⁷ Stewart Toy and Michael Oneal, *Zoom! Airbus Comes on Strong*, BUS. WK., Apr. 22, 1991, at 48.

²⁹⁸ *Id.* at 49.

light of judicial scrutiny. Not only did section 1110 continue to extend its enhanced protections to its own special class of creditors, the law also proved itself progressive enough to include within its statutory penumbra ultra-modern transactional forms that its forbear could not have conceived.

For these reasons, it is suggested here that the current efforts directed at retooling section 1110 generally should leave the law intact. Instead of instituting major change, minor mid-course corrections would be more appropriate. Such remedial measures would clarify the fact that the statute prevails over all forms of leases, both established and innovative. Concurrently, the somewhat confusing reference which includes only PMESI-type mortgages within the unique protections of section 1110 could be restated to make it plain that this acquisitions-only restriction is intended for secured creditors, and not lessors or vendors. Indeed, a more definitive statement of what exactly constitutes a PMESI would not be beyond the scope of such revisions.

Another point of great trepidation in the recent cases was the impact of the true lease versus disguised security interest controversy on creditors' rights pursuant to section 1110. Here, some provision may be made to assure creditors that their ability to, among other things, repossess collateral should continue unabated, notwithstanding the stalling tactics of a desperate debtor. To do otherwise would eviscerate the special protections of the law, as the judicial rulings have pointed out. In fairness to a debtor who may ultimately prevail on the allegation that the creditor is merely a disguised general creditor unworthy of section 1110's unique aegis, procedures to expedite that determination or otherwise ameliorate the harm to the debtor (such as an enhanced recovery of property or money damages to dissuade abusers of the statute) might be incorporated into a revised section 1110.

To be sure, all of the foregoing is consistent with the history and present structure of the statute, and also accu-

rately reflects recent judicial interpretations. In sum, section 1110 is an eminently sound provision, which has proven to work well. For that reason, a precise fine-tuning is all that is necessary.

As a parting thought, it is asserted here that any reformation of section 1110 must be guided by this unassailable truism:

The bankruptcy laws traditionally have afforded special treatment to certain lenders to targeted transportation industries, to encourage the financing necessary to capitalize and equip industries deemed vital to the nation's growth and survival.²⁹⁹

XI. CONCLUSION

The turmoil in the airline industry for the last year has most certainly exacted its price, not only in defunct and dismembered carriers, but in the heavy legal and business expenses associated with the battles between debtor airlines and creditors over their respective rights to assets. Yet some long-term good has come from this painful and laborious process. Notwithstanding the initial anxiety, aircraft lessors and similarly situated creditors gained conclusive court victories that interpret section 1110 of the Bankruptcy Code in their favor. Not only did these decisions maintain the unique protections of the statute for the benefit of these special creditors, the judicial outlook was one of willingness to accommodate new and innovative constructs of aircraft finance, as long as the legislative goal of fleet modernization was served.

This bodes well for the stability of past transactions that have been or shall be questioned in airline bankruptcies. In an otherwise bleak economy, the financial community can at least be confident that the enormous amounts of capital it has committed to the air carriers still possess some degree of safety. This inures not only to the benefit of the creditors but also to solvent airlines who thereby

²⁹⁹ Goldman et al., *supra* note 9, at 30.

find a stable marketplace when they seek out fresh capital. A safe course has now been charted for future aircraft financings, offering hope that the next generation of superjets will be able to join the fleets of the increasingly global airlines.

As a general matter, the court opinions discussed herein are relevant to the general laws of bankruptcy and creditors' rights as well. Witness the firm adherence to the "plain meaning" doctrine of statutory interpretation, accompanied by the judicious use of legislative history. No less important was the rejection of marginal doctrines or even the temptation to engage in judicial tinkering with the letter of the law. Again, these troubled times demand some certainty and consistency in the application of the Bankruptcy Code. While dealing primarily with but one specialized provision of that enactment, these courts have nevertheless provided an example well worth following elsewhere.

Of course, legitimate concerns have arisen as to the structure of section 1110 and related provisions. Such is the natural outcome of the tumult of litigation that highlighted the recent airline bankruptcies. No doubt, a little fine-tuning of the Bankruptcy Code is in order. However, it would seem that the paramount result of these reorganization proceedings is to prove the resiliency of section 1110. Certainly, the provision made it through the most foul of weather to achieve a safe landing. It demonstrated it is just as applicable to the latest in corporate finance inventions as its predecessors were to the comparatively straightforward transactions of years past. For these reasons, a mild refinement, carefully thought out and considered, is all that is needed. To do otherwise might risk hard-won victories and assure an uncertain future for the entire airline industry.

In closing, this was at first a year of very unfriendly skies for creditors. The worst may be forthcoming for the air carriers. The all-important parties who finance the airlines, however, can proceed with confidence, knowing that

this was the year they emerged triumphant in maintaining the special protections given them by section 1110 of the Bankruptcy Code.

Comments

