7th Circuit Holds Facility Lease is Treated as Secured Debt in Bankruptcy

United Airlines has won the litigation of a test case on the treatment of its airline facilities leases. The critical issue of whether United is required to make current payments on its tax-exempt bonds during the bankruptcy case depends on whether the specific leasing arrangement is characterized as a so-called "true lease" or as a secured financing arrangement. If a leasing arrangement between a revenue authority and an airline is a "true lease," then the airline is required to make current payments of rent. If, on the other hand, the arrangement is characterized as a secured financing, then the debtor airline need not make current payments otherwise required under the terms of the facilities lease.

In *United Airlines v. HSBC Bank USA, N.A.*, the Seventh Circuit recently reversed the District Court judge and ruled that the UAL facilities lease transaction described below was not a "true lease" but was instead a secured financing. Specifically, the court held that the form in which a leasing arrangement is documented does not determine its substantive treatment under the Bankruptcy Code, even if the underlying state law gives precedence to the form of the transaction.

The transaction the Seventh Circuit opinion addressed was a sublease-leaseback arrangement between United and the California Statewide Communities Development Authority ("CSCDA"). Under a lease agreement, United had rights to use a 128-acre parcel of land at the San Francisco International Airport. In 1997, United arranged with the CSCDA to issue a series of revenue bonds to finance improvements of United's facilities at the airport. To accomplish this purpose, United sub-leased 20 acres to the CSCDA for $1, and the CSCDA leased back the property to United for a term to expire upon payment in full of the revenue bonds and for rent equal to interest on the bonds plus an administrative fee. The leaseback also included a balloon payment to be made at the end of the lease term and a "hell or high water" clause, which required United to pay rent even if the underlying lease from the airport was terminated.

The Seventh Circuit cited the following factors to support the conclusion that this arrangement was, in substance, a secured financing despite the fact that it had been documented as a lease:

- The "rent" is measured not by the value of the property but by the amount United borrowed;
- CSCDA had no reversionary interest in the property at the end of the lease;
- The balloon payment is a common feature of secured credit, but had no parallel in a "true lease"; and
- Prepayment of the "rent" resulted in a termination of the purported lease.

The decision of the Seventh Circuit reinstates the prior decision of the Bankruptcy Court that a transaction of this type is not a "true lease" but a financing arrangement. It is also worth noting that these factors and the general rule favoring substance over form are rules of general application that are not limited to airport revenue bonds.

In light of this recent decision, investors in limited recourse obligations secured by leasing arrangements should reexamine their portfolios to better understand the possible treatment of these obligations in bankruptcy.

- *True lease.* If the underlying lease transaction is a true lease, the debtor will be required to make ongoing post-petition payments of rent until the debtor decides whether to assume or reject the lease. If the debtor elects to assume the lease, the debtor must cure any defaults and provide adequate assurance of future performance. Lease assumption does not permit the debtor to unilaterally restructure the lease, but rather requires the debtor to accept the lease in its entirety as written. If the debtor rejects the lease, then the lessor is left with a general unsecured claim for pre-petition arrearages and rejection damages (which in most cases are limited to the greater of one year's rent or 15 percent of the rent reserved under the lease).

- *Secured financing*. If the purported lease is recharacterized as a secured financing, then the lender is not entitled to the debtor's timely performance under the financing documents and is therefore unlikely to receive periodic payments during the chapter 11 case. Furthermore, secured lenders will not receive post-petition interest unless they are oversecured, i.e. unless the value of the collateral exceeds the amount of the secured obligation. If the value of the collateral is less than the amount of the secured obligation, the lender is secured only to the extent of that value. The remaining balance will be treated as a general unsecured "deficiency" claim. In this situation, the debtor may also unilaterally restructure its obligations through a chapter 11 plan of reorganization. The Bankruptcy Code permits a debtor to retain property purchased through a secured financing simply by paying the lender an amount equal to the current value of the property.

As the *United Airlines* case suggests, leaseback arrangements are particularly susceptible to recharacterization as secured financings, and investors should be alert to any investments they hold that are secured by limited recourse to such arrangements.

Contact Information

If you would like to learn more about the issues raised by the Seventh Circuit's recent decision in the *United Airlines* case, please contact your regular Ropes & Gray advisor.