Terminal Valuation: Will the Seventh Circuit Decision on Valuation of United Airlines Bond Collateral Bring Closure to Recharacterization Litigation?

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On May 5, 2009, the U.S. Court of Appeals for the Seventh Circuit issued a decision, written by Chief Judge Easterbrook, reversing the Northern District of Illinois District Court's ruling on the valuation of collateral for United Airlines bonds.[1] While this decision is interesting in its own right, for its approach to valuing collateral in bankruptcy, it is also an important development in municipal conduit finance recharacterization litigation—litigation that has spanned the better part of the last decade in the United Airlines, Delta, and Northwest bankruptcy cases.

In its recent *United Airlines* decision, the Seventh Circuit held that the District Court had undervalued the collateral for bonds issued by the Los Angeles airport authority to finance improvements at facilities leased by United Airlines in Los Angeles International Airport (LAX) terminals. The Seventh Circuit increased the collateral value for the $60 million in bond claims from $35 million to over $60 million, dramatically increasing the recovery on the bonds. The Seventh Circuit found that the District Court had improperly tied its valuation methodology to the value of unimproved airport terminal space under constrained market conditions, rather than improved space like that comprising the bond collateral on an open market.

In addition, the Seventh Circuit criticized the District Court's selection of a discount rate for the collateral value—the District Court had averaged the discount rates proposed by United Airlines and the representatives for the bonds, rather than choosing the legally correct discount rate.

Background Financing

The United Airlines litigation is grounded in the structure of the bond financing at issue. The bonds were issued not by United Airlines, as would be the case for ordinary corporate bonds, but rather by the Regional Airports Improvement Corporation (RAIC), a governmental entity created for the purpose of issuing such bonds and using the proceeds to finance airport improvements. However, United Airlines was the sole source of payment on the bonds, through payments made by United Airlines to RAIC under a lease for the LAX terminals, between United Airlines as lessee and the City of Los Angeles as lessor (who assigned its right to payment as lessor to RAIC). The reason for this "conduit finance" structure was to qualify the interest on the bonds for tax exemption as municipal bond interest.

Recharacterization Litigation

When United Airlines (and other airlines) filed bankruptcy cases, they challenged the status of the terminal leases providing the revenue stream for the bonds. The airlines argued that the leases were not "true leases" for the terminal space, subject to assumption or rejection in bankruptcy, but rather components of a financing transaction for terminal improvements. As a corollary, the airlines took the position that the terminal improvements were owned by the airlines, rather than owned by the airport authorities and leased to the airlines. The airlines argued—successfully in the case of United Airlines at LAX—that the bond claims were not lease claims but rather should be "recharacterized" as loan claims.[2] If the United Airlines bond claims were loan claims, RAIC would not own the lease improvements but would, at best, be able to argue that the loan claims should be secured loan claims and that the court should impose a retroactive lien to make the lease improvements collateral for the bond claims.

A key premise of United Airlines' recharacterization strategy was its need to maintain operations at the LAX terminals for business reasons. Had United Airlines been willing to vacate the leased terminals, it could have sought to treat the terminal leases as "true leases" and reject those leases under Section 365 of the Bankruptcy Code—leaving the bondholders with a general unsecured claim for rejection damages. But, since United Airlines needed to maintain the leased terminal space, "true lease" treatment would have required assumption of the leases and payment of the bonds in full under Section 365. Recharacterization was a potential means for United Airlines "to have its cake and eat it too" by remaining in the premises and reducing the amount payable on the bonds.

After the recharacterization was upheld by a separate decision of the Seventh Circuit,[3] the case was remanded to the Bankruptcy Court to determine the scope of the collateral for the deemed "secured loan" and to value that collateral. Each of these issues was both controversial and crucial to the bondholders' recovery. If the collateral were broadly defined and valued highly enough, the bonds would be fully secured and eventually paid in full. If the collateral were narrowly defined or valued low enough, the bonds would be undersecured and paid only a portion of their face amount.

The scope of the collateral was in dispute because no collateral was ever expressly granted to secure the loans, given that the claims were not structured as secured loans (or as loans at all)—they were simply "recharacterized." Thus, the court, in imposing a lien after the fact, was required to approximate what might have been the collateral had the lease structure been a loan structure—that is, what a lender might have required for collateral if the transaction had been initially structured as a secured financing. This approximation was not an easy task because while United Airlines was a tenant of LAX with respect to a large area of improved terminal space, only certain terminal improvements were financed with the proceeds of the bonds.

The Bankruptcy Court defined the scope of the collateral to include a portion of the United Airlines terminal space at LAX and valued the collateral at only $33 million, meaning that the remaining $27 million of the bond claims were unsecured.[4] Because United Airlines' right to the collateral was that of a tenant, the Bankruptcy Court valued the collateral by judging the cost of a replacement rental ($17 per square foot) and applying a discount rate to the term for which the collateral would be rented (11.64%). The District Court affirmed the Bankruptcy Court's decision.[5] The determination of the scope of the collateral was not appealed to the Seventh Circuit—only the determination of the rental rate and discount rate remained in dispute.[6]

The Seventh Circuit focused first on the rental rate. The bond representatives argued that a rate of $17 per square foot was not the correct basis for the bond collateral valuation because the $17 rental rate did not reflect the fair market value of improved terminal space at the airport. The bondholders' collateral, however, included the improvements that United Airlines had made to the terminal space, which would necessarily increase the rental rate. Moreover, the $17 per square foot rate was the product of constrained market conditions. While the Seventh Circuit did not adopt a specific higher rate, it explained that the $17 rental rate was far too low and stated that the rate should be at least $30—a rate that would make the bond claims fully secured even at the discount rate selected by the lower courts. The Seventh Circuit also criticized the District Court's analysis in selecting a discount rate. The District Court selected a rate that simply split the difference between the competing experts, rather than seeking to determine the correct discount rate. The Seventh Circuit, in a more empirical analysis, determined the correct discount rate could not exceed 8% (the airport's actual cost of unsecured borrowing)—meaning even a rental rate of $23 per square foot would make the bond claims fully secured. Overall, the Seventh Circuit increased the value of the collateral by more than 100% as compared to the lower courts.

The Bottom Line

The Seventh Circuit decision in *United Airlines* is only the most recent event in a long saga of airline conduit finance recharacterization litigation. In a sense, it brings the initial litigation issues full-circle by ordering payment in full of the bond claims at issue in that case, a result that may have also occurred had the recharacterization litigation never been commenced. However, because of the years of recharacterization litigation leading up to the recent Seventh Circuit decision and the complicated facts that were components of each court decision along the way, the Seventh Circuit decision does not resolve all aspects of recharacterization. Instead, the Seventh Circuit's reliance on specific facts in determining the components of valuation—the rental rate and discount rate—emphasizes the importance of rigorous valuation analysis in bankruptcy litigation of this type.

[1] *United Airlines, Inc. v. Regional Airports Improvement Corporation and UMB Bank, N.A.*, Nos. 08-2736, 08-2751, 08-2752, 08-2824 & 08-2905 (7th Cir., May 5, 2009).

[2] The results in the various recharacterization cases were not always the same as between different airlines or even as between different airports in which a single airline operated. The results varied on the basis, among others, of the details of the conduit finance structure and documentation.

[3] *United Airlines, Inc. v. U.S. Bank National Association, Inc., City of Los Angeles, et al.*, 447 F.3d 504 (7th Cir. 2006). This decision reversed a District Court decision to the contrary (finding no recharacterization), which in turn reversed a Bankruptcy Court decision (finding recharacterization).

[4] *United Airlines, Inc. v. UMB Bank, N.A.*, 374 B.R. 625 (Bankr. N.D. Ill., August 24, 2007).

[5] *UMB Bank, N.A. and Regional Airports Improvement Association v. United Airlines, Inc.*, 2008 WL 4866188 (N.D. Ill., June 13, 2008).

[6] Under different circumstances, the scope of the collateral might have been determined to be narrower (*e.g.*, only the lease improvements themselves, such as fixtures, and not the leased space) or broader (*e.g.*, all of the leased terminal space and improvements occupied by United Airlines at LAX).

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