

**Courts Override Underlying Contractual Obligations in the Chapter 11 Surrender and
Abandon of Aircraft Equipment and Vessels**

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Introduction

When chapter 11 airline debtors seek to abandon and surrender collateral under a financing agreement, they are not required to do so in any particular condition under the Bankruptcy Code. This leaves the question of who bears the burden of associated costs unresolved. This memo will discuss how courts interpret the issue of costs associated with the surrender and return of aircraft and related equipment.

Financiers of aircraft and related equipment receive special privileges under section 1110 of the Bankruptcy Code (“the Code”).¹ Section 1110 permits a party to take possession of an aircraft in the custody of a debtor despite the automatic stay.² The debtor can prevent repossession by curing its defaults under the financing agreement and agreeing to perform its obligations.³ This gives the debtor a choice. However, where the debtor chooses not to affirm its obligations and cure its defaults by application of section 1110, the automatic stay will not

¹ See 11 U.S.C. § 1110(a).

² See *id.*

³ See 7-1110 COLLIER ON BANKRUPTCY ¶ 1110.01 (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2016).

prevent the financier from taking possession of the aircraft under the terms of the underlying agreement.⁴ However, this right to take possession of any equipment must be present in the underlying lease or security agreement in order to be effective after the debtor files for reorganization.⁵

This provision gives aircraft financiers immediate access to either cash or their collateral during the debtor's reorganization, rather than waiting until confirmation of a plan or reorganization.⁶ While this is favorable to the financiers, the debtor is forced to take abrupt action despite the automatic stay.⁷ The trustee or debtor-in-possession can either return the collateral to the possession of the financier, or perform under the security agreement according to its pre-bankruptcy terms.⁸ However, section 1110 limits its protections to a class of financiers that can meet four threshold requirements, specifically: (1) the party must be a lessor, conditional vendor, or secured party with a purchase-money equipment security interest; (2) the subject of the loan, lease or conditional sale must be aircraft or related equipment; (3) the debtor must be an airline operating under a certificate of public convenience and necessity⁹; and (4) the security, lease, or conditional sales agreement must expressly provide for repossession in the event of default.¹⁰

Airline debtors are tasked with the burden of choosing their own fate – they must decide to cure the defaults under the prebankruptcy lease or security agreement or, risk losing the protection of the automatic stay. Where performing under the prebankruptcy agreement is not a

⁴ See 11 USC 1110(a).

⁵ See *id.*

⁶ See *id.*

⁷ See *id.*

⁸ See *id.*

⁹ Section 1110 also applies to vessels documented under 46 USCS § 12101. 11 USC 1110(a)(3)(A)(ii).

¹⁰ See 11 U.S.C. § 1110(a)(3).

viable option, alternatively, the debtor can assume or reject these contracts under section 365 of the Code. In surrendering and abandoning burdensome property, debtors and creditors are left to argue over who bears the costs associated with these surrender and abandon procedures. This memo will discuss the implications between these Code provisions and how courts interpret this area on a case-by-base basis.

I. Purpose of 11 U.S.C. § 1110 and 11 U.S.C. § 365

In circumstances involving equipment as collateral, section 1110 of the Code gives a transportation debtor the choice between retaining the equipment by performing under the terms of the prebankruptcy agreement or risk having the equipment repossessed.¹¹ If the debtor seeks to retain the equipment, subject to court approval, the debtor must agree to perform all of the debtor's obligations that become due on or after the date of the order for relief under the security agreement or lease in question.¹² The parties can agree to terms other than all of the obligations under the agreement, as long as the court approves the election itself.¹³ These stipulated-to terms will be subject to a "business judgment standard" when reviewed by the court.¹⁴

Further, section 365 of the Code allows a debtor in possession to assume or reject any executory contract or unexpired lease of the debtor.¹⁵ The purpose behind section 365(a) is to permit the trustee or debtor-in-possession to use valuable property of the estate and renounce title to and abandon burdensome property.¹⁶ Courts have deferred to the trustee's business judgment regarding the trustee's decision to reject an executory contract.¹⁷

¹¹ See 5 NORTON BANKR. L. & PRAC. 3d § 101:4.

¹² See *id.*

¹³ See *id.*

¹⁴ See *id.*

¹⁵ See 11 U.S.C. § 365(a).

¹⁶ See *In Re Orion Pictures Corp.*, 4 F.3d 1095, 1098 (2d. Cir. 1993).

¹⁷ See 3-365 COLLIER ON BANKRUPTCY ¶365.03.

II. The *In re Republic Airways* Decision

On February 25, 2016, Republic Airways Holdings, Inc. filed for chapter 11 bankruptcy relief in an effort to restructure its debt of nearly \$3.5 billion in aircraft and equipment financing commitments, \$91.8 million in two secured credit agreements and \$15.3 million in proceeds from industrial revenue bonds.¹⁸ Although profitable at the time of filing, Republic Airlines sought to consolidate as a result of aircraft failing to meet the company's needs, as well as labor contracts putting pressure on the company's business.¹⁹

Republic owned or leased approximately 300 aircraft, many of which were subject either to secured debt or lease financing agreements.²⁰ In an effort to meet their obligations under the reorganization plan, Republic sought court permission to transfer title to and abandon certain of these aircraft. Section 1110 of the Code limits the ability of secured parties to take possession of aircraft equipment as collateral under the terms of an agreement in certain circumstances.²¹ Further, recognizing the burden on debtors-in-possession, section 365 provides that a debtor-in-possession may assume or reject any executory contract or unexpired lease of the debtor.²²

Republic sought an order authorizing them to: (i) transfer title to and abandon aircraft and engines and reject a related aircraft lease, and (ii) to fulfill their obligations under a certain engine purchase agreement.²³ Republic also requested that the Court direct Citibank to cooperate with the closing of that agreement.²⁴ At the time the motion was filed, the principal amount outstanding under the credit agreement was approximately \$23 million and was secured by the

¹⁸ See *In re Republic Airways Holdings, Inc.*, 547 B.R. 578, 578 (S.D.N.Y. 2016).

¹⁹ See *id.*

²⁰ See *id.*

²¹ See 11 U.S.C. §1110.

²² See 11 U.S.C. §365.

²³ See 547 B.R. at 580.

²⁴ See *id.*

aircraft and engines as collateral subject to the proposed order.²⁵ Republic asserted this collateral was not necessary for Republic’s long-term business plan.²⁶

Certain aircraft and engines that Republic sought to surrender, return, transfer title to, or abandon were subject to liens of Citibank, pursuant to a mortgage and security agreement.²⁷ Citibank did not object to the surrender and return of the collateral, but rather to the surrender and return procedures, stating they do not satisfy section 1110(c) of the Code.²⁸ Citibank argued that Republic must remove any third-party engines from the Citibank airframes and replace them with the Citibank engines, at Republic’s own cost.²⁹

The Court determined that Republic is not required to return the aircraft and related equipment in a particular condition in order to satisfy the surrender and return procedures. *Id.* at 586. The Court did not, however, foreclose Citibank from later asserting a claim for costs associated with the surrender and return. The Court declined to split the cost associated with the surrender and return of the aircraft between the parties, but recognized Citibank’s future right to file a claim for any associated expenses.³⁰ In addition, the Court expressed concern about this type of ruling given Citibank’s lack of due diligence in addressing the surrender and return procedures.³¹

In acknowledging the balance between debtors and creditors, as well as the protections afforded by the Code, the Bankruptcy Court for the Southern District of New York clarified

²⁵ *See id.*

²⁶ *See id.*

²⁷ *See id.* at 580.

²⁸ Section 1110(c)(1) provides, in relevant part, “the trustee shall immediately surrender and return to a secured party equipment described in subsection (a)(3).” 11 U.S.C. § 1110(c).

²⁹ *See* 547 B.R. at 580.

³⁰ The court noted it was “not convinced that a splitting of such costs is appropriate here given the court’s lack of information about the actual conditions associated with these aircraft and engines.”

³¹ *See id.*

Republic's obligations as a debtor, reserved the rights of the creditors to file an administrative claim for associated costs, all while avoiding an arbitrary monetary award.

III. Consistency Among Courts Regarding Debtor's Underlying Contractual Obligations

Other courts have taken a similar approach to the frequent issue of terms of surrender and abandon procedures. In *In re US Airways Grp., Inc.*, the court was confronted with a debtor's motion seeking to reject a number of aircraft and equipment leases and to abandon a number of aircraft and equipment.³² Financing parties argued that the debtors should not be permitted to abandon or reject aircraft without complying with the requirements in the underlying loan or lease agreements, including reinstalling any original engines that were not currently on the aircraft.³³ The court did not require compliance with the underlying contractual requirements for return of the collateral, but instead held that aircraft lenders and lessors were not foreclosed from asserting a claim arising from non-compliance with such requirements.³⁴

Similarly, in *In re Northwest Airlines Corp.*, the court rejected the argument that the debtors must comply with all the return provisions of a given lease or security agreement, noting "this is precisely what section 1110 does not provide."³⁵ The court acknowledged that Congress recognized the cost and burdens placed on the debtors and creditors by not requiring surrender and return procedures to comply with the underlying security agreement or lease.³⁶

Deferring to legislative intent, the court in *In re Delta Air Lines, Inc.* refused to require the debtors to repair aircraft or transport unserviceable aircraft to the section 1110 parties, concluding that the statute does not give lenders and lessors a "miracle right to have [the debtors]

³² See *In re US Airways Grp., Inc.*, 287 B.R. 643, 645 (Bankr. E.D.VA. 2002).

³³ See *id.* at 647.

³⁴ See *id.*

³⁵ See *In re Northwest Airlines Corp.*, Case No. 05-17930 [ECF No. 500-1].

³⁶ See *id.*

put it all back together again.”³⁷ The court noted that the intent of section 1110 seemed to mean that parties are entitled to the parties immediately, as is, rather than require the aircraft to be returned in a particular condition.³⁸

Courts have consistently ruled that while section 1110 may entitle the parties to the return of the collateral, it does not guarantee a particular condition of the collateral, nor does it hold the debtors to all of the terms of the underlying security agreement or lease. Instead, courts have recognized the right of creditors and secured parties to seek administrative claims for their costs in later proceedings in the case.

IV. Implications on the Issue of Associated Costs

Less clear, however, is the issue of administrative costs associated with surrender and abandon procedures. Questions have arisen with respect to applying and enforcing the provisions of section 1110 in conjunction with section 365 and the power of the trustee to reject an executory contract or unexpired lease. Courts have declined to determine the issue of cost in Section 1110 cases for several reasons. As was the case in *In re Republic Airways Holdings, Inc.*, the court was concerned with a lack of information about the conditions associated with the return of the aircraft. The court expressed further concern involving Citibank’s lack of prompt action, which made it more difficult to determine a reasonable approach to the costs associated with the return.

While initially it may seem more judicially efficient to decide the issue of associated costs at the time the section 1110 motion is filed, the court may be forced to make these decisions without sufficient necessary information. Further, if the court awards costs prior to the return, the creditor would be able to assert a claim for additional costs if the collateral is not

³⁷ See *In re Delta Air Lines, Inc.*, 2010 Bankr. LEXIS 233 (S.D.N.Y. 2010).

³⁸ See *id.*

returned within a reasonable amount of time. This will counteract any efficiency achieved in the first instance and force courts to decide matters absent necessary information. Because issues may arise with the actual return of the collateral, including the promptness of the return, a claim later asserted by the creditor will represent a more accurate reflection of the costs and burdens associated with the surrender and return process, rather than a mere splitting of the costs.

Not only will costs associated with the surrender and abandon procedures be a looming issue, but any late charges, legal fees, and other amounts owed under the prebankruptcy agreement may be raised as well. The complexity of associated costs may encourage the parties to enter into settlement negotiations regarding these costs if bankruptcy courts decline to rule on them in the first instance. In *In re Eastern Air Lines*, with bankruptcy court approval, the airline debtor entered into stipulations with certain section 1110 financiers concerning a settlement of administrative expense claims which provided that unpaid legal fees and expenses to the extent provided for in the prebankruptcy agreement are within the realm of a section 1110 agreement.³⁹ Similarly, certain courts have held that payment of late charges and reasonable attorney's fees are conditions to assumption of an executory contract, where provided by the underlying contract. In *In re Pan Am Corp.*, the court deferred ruling on the issue of whether a "cure" under section 1110 includes late charges and legal fees.⁴⁰ The reluctance of courts to rule on the issue of costs associated with section 1110 and section 365 provide that they either be decided by the court at a later time when more accurate and representative information is available or that the parties settle these costs by their own efforts, decreasing litigation expenses in the long run.

This result benefits both the debtor and creditor, as neither party is held liable for expenses upon the initial ruling. When the claim for associated costs is asserted, it will be

³⁹ See *In re Eastern Air Lines, Inc.*, Ch 11. Case No. 89-B-10449 (Bankr. S.D.N.Y. 1989).

⁴⁰ See *In re Pan Am Corp.*, 124 B.R. 960 (Bankr. S.D.N.Y. 1991).

decided more accurately and will avoid duplicative litigation. Further, this result will incentivize a more cost-efficient surrender and return procedure. Similarly, encouraging or merely permitting the parties to negotiate a settlement with respect to these claims will mitigate their overall costs. With the reservation of creditor's rights to assert claims for later costs, this approach is consistent with the Code's deference to the debtor and trustee's business judgment recognized within both section 1110 and 365.

Conclusion

By declining to rule on the issue of associated costs and award an arbitrary splitting of outstanding expenses, courts reserve the creditor's right to later assert a claim for administrative costs associated with surrender and return procedures. This practice not only provides for a more accurate ruling, but also incentivizes debtors to return the collateral in a prompt and cost-effective matter consistent with the ultimate goal of reorganization