Second Circuit Rules in Favor of Tax Indemnity Agreement Claims

On June 22, 2010, in response to arguments advanced by a Kaye Scholer team led by Richard Smolev, Piper Brock and Sydney Unger, the U.S. Court of Appeals for the Second Circuit reversed two lower courts to uphold Tax Indemnity Agreement bankruptcy claims raised by Owner Participants in leveraged leases of aircraft to Delta Air Lines, Inc. In so doing, it ruled that the leveraged-lease debtholders' claims based on Stipulated Loss Value did not require that the Tax Indemnity Agreement claims be excluded under the terms of the Tax Indemnity Agreements.

Background

In a leveraged aircraft lease, the Owner Participant, traditionally either a subsidiary of a bank, an industrial company or a freestanding leasing company, purchases an aircraft and immediately thereafter leases it to an airline. The Owner Participant finances perhaps 80% of the purchase price of the aircraft through a non-recourse loan secured by an aircraft mortgage and security assignment of the lease rent. During the lease term, the Owner Participant is entitled to collect the portion of lease rent that is in excess of the amount required to satisfy scheduled principal and interest payments on the loan. The Owner Participant, as owner of the aircraft, also expects to realize a significant portion of the return on its investment by being able to claim income tax deductions for depreciation on an accelerated schedule, based on the full cost of the aircraft, against the Owner Participant's other taxable income.

In the event of a bankruptcy of the airline and the rejection of the lease, in addition to the lessor's right to return of the aircraft, the lessor should be allowed a large unsecured claim against the estate, computed under a formula provided in the lease, for "Stipulated Loss Value" (or "Termination Value"), less perhaps the current market value of the aircraft. Stipulated Loss Value is typically computed as the amount that is necessary to repay the leveraged-lease debt, to return the Owner Participant's investment plus a return to the date of payment, and to compensate the Owner Participant for the loss or recapture of its anticipated tax benefits.

Along with the mortgage on the aircraft, the claim for Stipulated Loss Value under the Lease constitutes part of the lender's collateral package securing the repayment of its loan. Because the claim will be paid in "bankruptcy dollars," it likely will not yield proceeds that (together with the proceeds of the disposition of the aircraft) will repay the lender in full. Therefore no part of that claim would provide funds that would be available for distribution to the Owner Participant.

In a leveraged lease, the airline and Owner Participant (and not the lender) will enter into a Tax Indemnity Agreement. In this agreement, the airline agrees to indemnify the Owner Participant against the loss of its anticipated income tax benefits due to events within the control of the airline. If an airline becomes bankrupt, the leveraged-lease debt will be in default and the lender may foreclose the Owner Participant's investment in the aircraft. To add insult to injury, the foreclosure is treated for income tax purposes as a sale by the Owner Participant for a purchase price equal to the outstanding balance of the lease debt. This deemed sale results in immediate taxable income to the Owner Participant in the amount of the debt balance less the Owner Participant's tax basis in the aircraft (which will be zero in the middle to later years of a typical leveraged lease).

In the recent airline bankruptcies, Owner Participants facing foreclosure filed unsecured claims under their Tax Indemnity Agreements for the tax on this income. The Owner Participants, rather than their lenders, made the claim because rights under a Tax Indemnity Agreement are retained by the Owner Participant and not assigned to the lender as part of the lender's collateral package.

In the current case, Delta Air Lines (as well as other airlines in bankruptcy) resisted the Tax Indemnity Agreement claims on the ground that they were already built into the lenders' Stipulated Loss Value claims. As noted above, Stipulated Loss Value includes a component to compensate the Owner Participant for the immediate income tax liability that it realizes when Stipulated Loss Value is paid. The lease documents often acknowledge the overlap by:

- providing in the Tax Indemnity Agreement that an otherwise indemnifiable claim will not be paid, if the event giving rise to the claim results in the actual payment by the lessee of (or sometimes just the obligation to pay) Stipulated Loss Value; and
- providing in the lease that Stipulated Loss Value is reduced if a claim is paid under the Tax Indemnity Agreement.

The Delta Tax Indemnity Agreements covered by this case provided, respectively, that the Tax Indemnity Agreement claim would be excluded if Delta either (i) was "required to pay" Stipulated Loss Value, (ii) "pays an amount equal to" Stipulated Loss Value, or (iii) "pays Stipulated Loss Value ... or an amount determined by reference thereto."

In the Delta bankruptcy, the lenders' claims had the upper hand because they typically were paid or compromised earlier than the Tax Indemnity Agreement claims. When Delta settled with the lenders, it typically allowed them to maintain all or a portion of their Stipulated Loss Value claims, which would receive a distribution of Delta shares along with other general unsecured bankruptcy claims. In this case, Delta's settlement with the leveraged lease lenders included an allowed claim based on Stipulated Loss Value, less future rent, less the future residual value of the aircraft. Delta then opposed the Owner Participants' claims on the grounds that they were excluded because Delta paid or was required to pay — even though in bankruptcy dollars — Stipulated Loss Value or an amount computed with reference thereto.

History of the Case

Delta was faced with hundreds of Tax Indemnity Agreement claims totaling over $1.5 billion, and objected to them in the bankruptcy court. As a result, the bankruptcy court approved a procedure allowing for test cases based on the wording of the Tax Indemnity Agreement exclusions as discussed above. In 2008, the bankruptcy court upheld these exclusions on the ground that the term "payment" did not require payment in cash in full, but rather could include the discharge of the lenders' Stipulated Loss Value claim in bankruptcy. On appeal, the district court affirmed in 2008.

The Second Circuit Decision

The Court first identified the purpose behind the Tax Indemnity Agreement: the right of the Owner Participant to be compensated if the tax benefits of the transaction, a key feature of the Owner Participant's expected return, were lost. In turn, the Court recognized that the most likely scenario for triggering the Tax Indemnity Agreement claim would be a bankruptcy of the lessee, and the foreclosure and consequent taxable income. The Court recognized that the Tax Indemnity Agreement exclusion, however worded, was designed to prevent the Owner Participant from receiving a double recovery of its claim in the event that it also received payment on its claim out of Stipulated Loss Value. But if the return on the claim for Stipulated Loss Value were less than the debt balance, then the Owner Participant would not receive any portion. Therefore it would frustrate the parties' intent if the Owner Participant's Tax

Indemnity Agreement claim could be excluded in a circumstance in which the Owner Participant did not receive any portion of the Stipulated Loss Value.

The Court ruled that the construction of the word "payment" could not be allowed to lead to this result. Although the Owner Participant would not realize full value on its Tax Indemnity Agreement in a lessee bankruptcy, it should not be precluded from maintaining the claim at all. It would be anomalous, the Court reasoned, if the very event (the lessee bankruptcy) that caused the Owner Participant to suffer the loss at the same time operated to bar the Owner Participant from maintaining the claim.

On the other hand, the Court did suggest that if full Stipulated Loss Value were recovered through a combination of payments by or on behalf of the lessee and recovery of the residual value of the aircraft, the Tax Indemnity Agreement exclusion would indeed apply. By implication, if a portion of Stipulated Loss Value were received in excess of the debt balance, any portion of Stipulated Loss Value then payable to the Owner Participant under the loan agreement waterfall would likely reduce the Owner Participant's Tax Indemnity Agreement claim dollar-for-dollar.

Finally, the Court was unmoved by Delta's argument that the tax loss claim could not be maintained both through the Stipulated Loss Value claim and the Tax Indemnity Agreement claim; this is what Delta agreed to in its contracts and had to live by.

Conclusion

After many years of litigation, the Second Circuit has decidedly ruled in favor of Owner Participant Tax Indemnity Agreement bankruptcy claims arising out of leveraged aircraft leases. It is likely to be the final word in this case, because contract-construction cases are infrequently heard by the U.S. Supreme Court. With airline and other major bankruptcy cases tending to be brought in the Bankruptcy Court for the Southern District of New York, this decision will be controlling in future cases brought in such court, and probably highly persuasive in other circuits. In addition, the principles articulated in the case are easily applicable to leveraged leases of other equipment, such as power plants, manufacturing equipment, and railcars, where the documentation is often quite similar to aircraft leveraged-lease documentation. Because the opinion only addressed liability and not damages, it remains to be seen whether Delta now will object to the amount of the claims.

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