

# The Banking Law Journal

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**EDITOR'S NOTE: BANKING MERGERS**

Victoria Prussen Spears

**BANKING MERGERS: THE CASE TO REPLACE THE 1995 BANKING MERGER GUIDELINES –  
PART II: MARKET DEFINITION ISSUES**

Michael D. Noel

**FDIC FINAL RULE: CONSOLIDATED SUPERVISION FOR INDUSTRIAL BANKS AND  
INDUSTRIAL LOAN COMPANIES**

David E. Teitelbaum, Michael D. Lewis, and Stephen Wallant

**BANKRUPTCY SAFE HARBORS ARE NOT NECESSARILY SAFE FOR FINANCIAL INSTITUTION  
CUSTOMERS**

Scott A. Lewis and Franklin H. Top III

**PROTECTING A LESSOR AGAINST THE RECHARACTERIZATION IN BANKRUPTCY OF A FULL  
PAYOUT AIRCRAFT LEASE AS A DISGUISED SECURITY AGREEMENT**

Stewart B. Herman and Timothy J. Lynes

**BANKRUPTCY COURT FINDS LANDLORD'S LENDER HAS NO RIGHT TO ENFORCE  
LANDLORD'S LEASE WITH BANKRUPT RETAILER**

Ronit J. Berkovich and Justin Kanoff

**SUPREME COURT GRAPPLES WITH FTC'S AUTHORITY TO PURSUE RESTITUTION UNDER  
SECTION 13(b)**

Anthony E. DiResta, Brian J. Goodrich, and Benjamin A. Genn

**A GREEN WAVE: STATE MARIJUANA INITIATIVES CREATE COMPLIANCE CHALLENGES FOR  
FINANCIAL INSTITUTIONS AND IMPETUS FOR POSSIBLE FEDERAL ACTION**

Winston M. Paes, Satish M. Kini, Paul D. Rubin, David G. Sewell, Brenna Rae Sooy,  
and Melissa Runsten



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April 2021

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**Editor's Note: Banking Mergers**

Victoria Prussen Spears 193

**Banking Mergers: The Case to Replace the 1995 Banking Merger  
Guidelines—Part II: Market Definition Issues**

Michael D. Noel 196

**FDIC Final Rule: Consolidated Supervision for Industrial Banks and  
Industrial Loan Companies**

David E. Teitelbaum, Michael D. Lewis, and Stephen Wallant 214

**Bankruptcy Safe Harbors Are Not Necessarily Safe for Financial Institution  
Customers**

Scott A. Lewis and Franklin H. Top III 223

**Protecting a Lessor Against the Recharacterization in Bankruptcy of a  
Full Payout Aircraft Lease as a Disguised Security Agreement**

Stewart B. Herman and Timothy J. Lynes 231

**Bankruptcy Court Finds Landlord's Lender Has No Right to Enforce  
Landlord's Lease with Bankrupt Retailer**

Ronit J. Berkovich and Justin Kanoff 237

**Supreme Court Grapples with FTC's Authority to Pursue Restitution  
Under Section 13(b)**

Anthony E. DiResta, Brian J. Goodrich, and Benjamin A. Genn 241

**A Green Wave: State Marijuana Initiatives Create Compliance Challenges for  
Financial Institutions and Impetus for Possible Federal Action**

Winston M. Paes, Satish M. Kini, Paul D. Rubin, David G. Sewell, Brenna Rae Sooy,  
and Melissa Runsten 247

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# Protecting a Lessor Against the Recharacterization in Bankruptcy of a Full Payout Aircraft Lease as a Disguised Security Agreement

*Stewart B. Herman and Timothy J. Lynes\**

*This article describes the holding in King v. Bombardier Aerospace Corporation, which demonstrates the challenge in surviving a lease recharacterization in a transaction with a U.S. lessee involving aircraft in the fleet of a charter airline, and offers suggestions for documenting the transaction to survive such a recharacterization attempt.*

Often an aircraft financier will structure a secured aircraft loan as a full payout lease in order to facilitate the exercise of remedies in the case of a default by the borrower airline. Specifying that the lease is governed by English law facilitates this structure because English law recognizes the lessor as the absolute owner of the aircraft. The legal systems of many foreign airlines' home countries may well take the same view. By contrast, in the United States, under Uniform Commercial Code ("UCC") principles, courts may take the position that because a full payout lease is economically a secured loan despite the lease structure, the lessor should have the remedies of a secured lender rather than that of a true lessor.

## **BACKGROUND**

In the case of a secured loan documented as a lease, the "lessee" pays periodic "rent" for the lease term and is given the right to purchase the aircraft from the "lessor" at the end of the term for a nominal purchase price. Thus, the payment profile is the substantially similar to that for a fully amortizing loan. If the transaction is a lease and the lessee defaults near the end of the term, the lessor could repossess the aircraft and sell it or re-lease it and retain the full benefit of the residual value of the aircraft. If, however, the transaction is recharacterized

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\* Stewart B. Herman is an aviation partner at Katten Muchin Rosenman LLP in New York, representing clients in commercial and business aircraft transactions, including structuring, negotiating, and documenting transactions for aircraft and other asset classes. Timothy J. Lynes is managing partner of the firm's Washington, D.C., office, and chair of Aviation Finance, representing manufacturers, airlines, lessors, financial institutions, equity investors, and insurers in the sale, leasing, and financing of aircraft. The authors may be reached at [stewart.herman@katten.com](mailto:stewart.herman@katten.com) and [timothy.lynes@katten.com](mailto:timothy.lynes@katten.com), respectively.

by a court as a secured loan, the lessor would have to pay over to the lessee the excess of the sale proceeds over the balance of the implied loan, representing the lessee's imputed equity in the aircraft.

A recent bankruptcy case, *King v. Bombardier Aerospace Corporation et al.*,<sup>1</sup> decided by the U.S. Bankruptcy Court for the Central District of California, Los Angeles Division, shows the challenge in surviving a lease recharacterization in a transaction with a U.S. lessee, involving aircraft in the fleet of a charter airline.

The bankruptcy court ruled over the vigorous objections of the bankruptcy trustee that the lease, which commercially was a disguised security agreement, was actually a lease for purposes of the debtor's bankruptcy, thus allowing the lessor to repossess and retain the full residual value of aircraft to the detriment to the unsecured creditors of the debtor. The court's rationale was that this was the intent of the lessor and lessee, as expressed by their choice of English law to govern the lease.

However, this is at odds with the interpretation of disguised security agreements under the UCC and any lease terms that expressly provide that the lessee is building equity in the aircraft, which may support the lessee's taking depreciation on the aircraft. It is also at odds with the Federal Aviation Administration's interpretation of the lease that then supports a U.S. registration of the aircraft in the name of the lessee.

This article describes the court's holding in *King v. Bombardier Aerospace Corporation* and offers suggestions for documenting the transaction to survive such a recharacterization attempt.

## THE CASE

In 2017, Zetta Jet USA, Inc., a California corporation ("Zetta USA" or "Sublessee") and its affiliate Zetta Jet PTE, Ltd. ("Zetta PTE", together with Zetta USA, the "Debtors") filed for protection as debtors under Chapter 11 of the U.S. Bankruptcy Code. CAVIC Aviation Leasing (Ireland) 22 Co. Designated Activity Company ("CAVIC") had provided financing for the purchase and use by Zetta USA of four new Bombardier Global 6000 Aircraft. The transactions for the four aircraft were structured identically.

In a representative transaction, CAVIC extended a loan to a special-purpose trust called ZJ6000-3 Statutory Trust ("Head Lessor") controlled by CAVIC. The Head Lessor purchased and held title to one new Bombardier BD-700-

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<sup>1</sup> Case No. 2:17-bk-21386-SK; Adv. No. 2:19-ap-01147 SK (October 15, 2020).

1A10 aircraft bearing U.S. registration no. N246ZJ (the “Aircraft”). The Head Lessor leased the Aircraft to TVPX ARS Inc. (“TVPX” or “Head Lessee” or “Sublessor”), acting as trustee for the benefit of Zetta PTE. In turn, the Sublessor subleased the Aircraft to Zetta USA pursuant to an Aircraft Sublease Agreement (the “Sublease”). Each of the Head Lease and the Sublease had an 84-month term and recited that it was governed by English law.

The rent payable under the Head Lease consisted of an initial payment before commencement of the lease term calculated with respect to the purchase price payable to the manufacturer and the loan facility used to finance the purchase of the aircraft by the Head Lessor. The Head Lease recited that this amount was payable by the Head Lessee directly to the manufacturer. The Head Lease rent also consisted of 28 consecutive quarterly installments starting three months after delivery.

A rent schedule included in the Head Lease recited that the rent consisted of an “Interest” component and a “Principal” component. The schedule also recited the “Outstanding Principal Balance” remaining after each rent payment. The Head Lease further recited that the quarterly rent was calculated to amortize the outstanding principal of the loan advanced under a secured loan agreement between Export Development Canada as lender and the Head Lessor as borrower (the “Facility Agreement”).

In several other locations, the Head Lease recited that changes to the repayment terms of the Facility Agreement passed through as changes to rent payable under the Head Lease. Finally, the Head Lease required that on the last quarterly rent payment date, the Head Lessee also pay an amount equal to the balance of the loan under the Facility Agreement. No Head Lease rent was available for distribution to CAVIC, the beneficiary of the Head Lease trust.

The Head Lease granted Head Lessee the option to purchase the Aircraft on the last day of the Head Lease term for a price of US\$100, plus any costs then due and payable under the Facility Agreement such as make whole and break costs, provided the Head Lessee had made all other payments due during the Head Lease term.

The Head Lease provided that if an event of default occurred under the Head Lease, the Head Lessor was permitted to repossess the Aircraft and sell or otherwise dispose of it in the absolute discretion of the Head Lessor, free and clear of any interest of the Head Lessee, as though the Head Lease had never been entered into.

The payments under the Head Lease passed through to the Sublessee under the Sublease. The Sublease was otherwise substantially the same as the Head Lease, except that only the Head Lease contained the purchase option. Because



the Head Lessee trust was controlled by Zetta PTE, Zetta PTE could direct the Head Lessee to exercise the purchase option under the Head Lease and acquire title to the Aircraft. Zetta PTE could then retain or terminate the Sublease and either retain title to the Aircraft or convey title to the Sublessee.

The obligations of the Head Lessee under the Head Lease were secured by (1) a guarantee issued by the Debtors and related guarantors in favor of the Head Lessor (which also included the obligations of the Sublessee under the Sublease), and (2) a security interest granted by the Head Lessee to the Head Lessor of the rights of the Head Lessee as Sublessor under the Sublease. Once the Debtors were under bankruptcy protection, the Head Lessor as security assignee of the sublease, repossessed the Aircraft.

The bankruptcy trustee asserted that one or both Debtors should be considered the owner of the aircraft because U.S. law would recognize that the Head Lease/Sublease arrangement as a disguised security agreement, and that the aircraft should be sold so that any remaining equity could be applied to satisfy the claims of the Debtors' unsecured creditors once the principal portion of the remaining Head Lease payments was repaid. By contrast, CAVIC argued that under English law, which the parties chose to govern the Head Lease and Sublease, the Head Lessor as titleholder was the absolute owner of the Aircraft. CAVIC argued that acting through its Head Lessor it had the right to repossess the Aircraft and own it outright, without any duty to return to the Debtors any excess in value of the aircraft or proceeds of disposition of the aircraft.

The court wrestled with the question of whose law to apply. Ultimately, the court upheld the choice of English law set forth in the Head Lease and Sublease. The court held that although the law of the parties' jurisdictions of formation governed whether they validly entered into a contract, once it was determined that they did validly enter into a contract, the parties were free to choose the terms of that contract.

Because the parties were free to choose English law, all of the contract interpretation rules that applied under English law were to be applied as though the parties had set forth all of those rules in the contract itself. The court stated that English law recognizes the lessor under an agreement denominated a lease as the absolute owner of the leased asset, as between lessor and lessee. Therefore, unless and until the lessee exercised and consummated the purchase option, the lessor remained the absolute owner of the aircraft. That meant that the lessor could repossess the aircraft from a defaulting lessee, terminate the lease, and have no obligation to sell the aircraft and remit any excess over the loan balance to the lessee.

## **ANALYSIS**

The court plainly upheld the principal of freedom of contract and the parties' choice of law. It upheld CAVIC's right to absolute ownership of the aircraft unless and until the Head Lessee exercised the purchase option. The choice of English law, which dictated this result, must therefore have been an expression of the parties' intent for this to be the result. Otherwise, they would not have chosen English law.

This is ostensibly a harsh result. It means that a lessee could make most or even all payments under an English law lease with a bargain purchase option, default, have the aircraft repossessed, and not have any rights at all in the aircraft despite having made substantial payments. The lessor could sell the aircraft, repay its outstanding small or zero implicit loan balance, and retain the excess proceeds as a windfall.

By contrast, if that same lease were governed by the New York UCC, the lessee would be recognized to have built up substantial equity in the aircraft and the lessor would not be permitted to retain the windfall. Why would a lessee choose English law then? The most likely reason is that the lessor required it to facilitate the repossession and disposition of the aircraft in the case of a default, and would not have entered into the lease otherwise, or would have offered less favorable terms if the lease could be deemed a secured loan. Perhaps the Debtors assumed that if the Sublessee became a debtor in a Chapter 11 bankruptcy, the Sublessee would be able to assume the lease under the Bankruptcy Code, make the remaining payments, allow the Head Lessee to exercise the purchase option, and become the owner.

However, in relying on the choice of English law as the definitive expression of the parties' intent, the court did not adequately consider other expressions of the parties' intent. The one other expression of intent the court did consider was the fact that the aircraft was registered in the United States in the name of the Sublessee. The Federal Aviation Regulations allow an aircraft to be registered in the name of a lessee under a lease that is a contract of conditional sale, meaning a contract in which the lessee pays the value of the aircraft and becomes or has the option to become the owner of the property upon performing the agreement.

This is because in the United States, the civil aircraft registry is an owner registry, and the lessee under a disguised security agreement is economically the owner. But the court mistakenly seized on the word "lessee" in the regulations to conclude that if Zetta USA registered as a "lessee" that must mean that its agreement was a true lease.

Moreover, the court did not consider whether Zetta USA carried the aircraft on its books for accounting and tax purposes as an owned asset. In all likelihood it did. This also is an expression of the lessee's intent, though outside of the four corners of the lease, that may be stronger than the choice of law, and would support the conclusion that the parties intended a disguised security agreement rather than a true lease.

It also is significant that even though the rent payment schedule recites a debt balance, the remedies section did not require that after repossession, the lessor sell the aircraft and pay the lessee any sale proceeds in excess of the scheduled debt balance. This is a common feature of a lease that is a disguised security agreement. The fact that the remedies did not so provide supports the court's conclusion. However, the court did not consider this factor.

In the case of a full payout lease to a U.S. lessee with a bargain purchase option, to overcome the presumption that this is not a true lease for bankruptcy purposes, the parties should recite language indicating their intent, in addition to stating the choice of English law. The lessor and lessee should consider including a clear statement that unless and until the purchase option is exercised, the lessee (1) waives and relinquishes any right following an event of default to the ownership of the aircraft or to any distribution of proceeds of the sale or other disposition of the aircraft by the lessor, and (2) waives any right to hull insurance proceeds paid in the case of an event of loss to the aircraft.

Another court could still very well conclude, however, that the lessee's accounting and tax treatment, and the registration of the aircraft in the name of the lessee, are stronger indications of the parties' intent.