

Structuring and Practice for Aircraft Leases to Prevent Lease Payments From Being Clawed Back in a Lessee Bankruptcy

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KEY POINTS

The risk that prepetition lease payments made by a lessee that is a debtor in a US bankruptcy will be clawed back from an aircraft lessor can be reduced if:

- the lease is a true lease rather than a disguised secured loan or finance lease
 - one or both of basic rent and maintenance reserves are payable in advance (i.e., at the beginning of a rent period rather than at the end)
 - basic rent and maintenance reserves are payable monthly rather than quarterly or semiannually
 - the lessor enforces the lease's payment obligations consistently
 - any payment made by a third party on behalf of the lessee is clearly allocated by the payor to a specific amount payable under the lease.
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Overview

In certain circumstances, a payment made by a debtor in a US bankruptcy within 90 days before the date the bankruptcy petition was filed can be avoided and recovered from the recipient as a preference payment under 11 U.S.C. §§ 547(b) and 550(a). This feature of the Bankruptcy Code is intended to prevent any creditors of the debtor from being favored unfairly, so that all creditors' claims are resolved in an orderly manner within the bankruptcy and similarly situated creditors are treated similarly.

In a recent US bankruptcy case, *King v. Bombardier Aerospace Corporation et al.* (Adv. No. 2:19-ap-01147 SK; US Bankruptcy Court for the Central District of California, Los Angeles Division) (cited herein as "*King*"), the bankruptcy trustee overseeing the debtors' estates vigorously argued that the bankruptcy court should order a lessor to disgorge aircraft lease rent payments that the lessor had received within the 90-day preference period.

This advisory describes the arguments by the trustee and the lessor and the court's ruling. It also offers suggestions for structuring and practice for aircraft leases so that a lessor can survive a preference challenge.

Transaction Structure

Parties

In 2017, Zetta Jet USA, Inc., an aircraft charter operator, ("Zetta USA" or "Sublessee") and its affiliate Zetta Jet PTE, Ltd., a Singapore company, ("Zetta PTE", together with Zetta USA, the "Debtors") filed for protection as

debtors under Chapter 11 of the US Bankruptcy Code.¹ Before the bankruptcy filing, Zetta USA had acquired three new Bombardier Global 6000 aircraft for its fleet with purchase-money financing under a head lease/sublease structure.

Agreements

Each aircraft was financed in a structure under which the aircraft was owned by a special-purpose trust as head lessor (Head Lessor) controlled by a special-purpose company called CAVIC Aviation Leasing (Ireland) 22 Co. Designated Activity Company (CAVIC). The Head Lessor leased the aircraft to TVPX ARS Inc. (“Head Lessee” or “Sublessor”), acting as trustee under a trust having Zetta PTE as beneficiary, under an aircraft lease agreement (each, a “Head Lease”). In turn, the Sublessor subleased the aircraft to Zetta USA under aircraft sublease agreements (each, a “Sublease”). Each Head Lease and Sublease had an 84-month term and recited that it was governed by English law.²

Rent Payments

The rent payable under the Head Lease consisted of (1) an initial payment before commencement of the lease term; (2) 28 consecutive quarterly installments, in arrear, starting three months after delivery; and (3) an additional payment on the last quarterly rent payment date. The payment obligations of the Head Lessee under the Head Lease passed through as payment obligations of the Sublessee under the Sublease.

The Trustee’s Claim

Before the Debtors filed their Chapter 11 petition, rent payable under each Head Lease had become overdue. On June 27, 2017, the day after Zetta PTE received a loan from a shareholder, Zetta PTE paid CAVIC approximately US \$1.5 million in rent for each aircraft, approximately equal to one quarterly rent payment for each aircraft.

The Debtors filed for Chapter 11 protection on September 15, 2017, meaning that the June 27, 2017 payment fell within the 90-day preference period provided for in section 547(b). The bankruptcy trustee filed a complaint against CAVIC under §§ 547 and 550 of the Bankruptcy Code³ to avoid the payment as a preference and recover it from CAVIC. In order to prevail on such a claim, the trustee was required to establish under § 547(b), among other things, that the payment was made for an antecedent debt. An antecedent debt is a debt incurred before the payment in respect of it.⁴ The trustee asserted the antecedent debt was the amount owed by Zetta PTE through the Head Lessee under the Head Lease, which the trustee argued was not a true lease but a disguised secured loan agreement. Thus, the antecedent debt was the loan balance under this disguised loan agreement.

¹ *In re Zetta Jet USA, Inc.* (Case No.: 2:17-bk-21386-SK, Bankr. C.D. Cal. Los Angeles Div.); *In re Zetta Jet PTE Ltd.* (Case No.: 2:17-bk-21386-SK, Bankr. C.D. Cal. Los Angeles Div.). The case was eventually converted to one under Chapter 7 of the Bankruptcy Code.

² See King, n. 8 for where copies of the Head Leases and Subleases may be found.

³ 11 U.S.C. § 547; 11 U.S.C. § 550. See n. 4 for the relevant provisions of section 547. 11 U.S.C. § 550(a) provides:

Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from –

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
- (2) any immediate or mediate transferee of such initial transferee.

⁴ 11 U.S.C. § 547(b) provides the elements which must be established for a payment to be characterized as a preference and states as follows:

Except as provided in subsections (c) and (i) of this section, the trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party’s known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property–

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made –
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if –
 - (A) the case were a case under [chapter 7 of this title](#);
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

CAVIC's Reply

CAVIC filed a motion with the court to dismiss the preference claim. CAVIC asserted:

- **Nature and Amount of Antecedent Debt.** That the trustee had not sufficiently shown the nature and amount of the antecedent debt, as required under § 547(b)(2).
- **Subsequent New Value.** The statutory defense under 11 U.S.C. § 547(c)(4)⁵ to a preference claim under §547(b), that CAVIC provided the Debtors new value after Zetta PTE made the payment.
- **Ordinary Course of Business.** The statutory defense under 11 U.S.C. § 547(c)(2)⁶ to a preference claim under §547(b), that Zetta PTE had made the payment in the ordinary course of business.
- **Earmarking Doctrine.** The judicially created defense to a preference claim under §547(b), that under the earmarking doctrine, the payment should not be clawed back because the payment had been funded by a loan from a third party (here a shareholder of the Debtors).⁷

Analysis

Nature and Amount of Antecedent Debt

The trustee asserted that it had sufficiently shown the nature and amount of the antecedent debt by showing the payment was made on account of amounts owed under the Head Leases. The court found that the trustee had sufficiently shown the amount paid but had not sufficiently shown the nature and amount of the antecedent debt for which such payment was made.

Subsequent New Value

CAVIC asserted that after Zetta PTE made the rent payment for the three aircraft, CAVIC provided new value to the Debtors, being the continued possession of the aircraft by Zetta PTE (through the Head Lessee) under the Head Leases (and Zetta USA under the Subleases). The subsequent-new-value defense is designed to encourage trade creditors to continue to deal with businesses in distress, and to treat them fairly when they have added value to the estate after receiving a preferential payment from the debtor. A claim of a preference can therefore be defeated to the extent of the new provided by the creditor. The subsequent new value must be advanced after the alleged preferential transfer, the amount of new value must be unsecured, and the creditor must not otherwise have received payment for the new value. *See* 11 U.S.C. § 547(c)(4).

CAVIC claimed that the value it had provided was equal to the pro-rata portion of the rent for the aircraft from the payment date of June 27, 2017 at least to the petition date of September 15, 2017, as evidenced by the Head Lease rent schedule. CAVIC argued that because the lease provided that rent would be paid in arrear, not in advance, the rent paid on June 27 could not have been a payment for the possession of the aircraft by Zetta PTE during the period from June 27 onward. Therefore CAVIC had not otherwise received payment for the new value.

The trustee argued that CAVIC could not have provided new value because the Head Lease was not a true lease but a disguised security agreement. What Zetta USA was obligated to pay under the Head Lease was not actually

⁵ (c) The trustee may not avoid under this section a transfer —

(4) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was —

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;...

⁶ (c) The trustee may not avoid under this section a transfer —....

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or

(B) made according to ordinary business terms;...

⁷ *King* at 55 and 65. This is a judicially created doctrine that provides if a debtor receives a loan from a third party for the purpose of paying a specific creditor, the payment by the debtor to that creditor may not be clawed back. *King* at 65. It requires (i) an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt; (ii) performance of that agreement according to its terms; and (iii) that the transaction viewed as a whole does not result in any diminution of the debtor's estate. *Id.*

rent, but principal and interest under a purchase-money financing.⁸ Accordingly, the trustee alleged that CAVIC could not have provided new value in the form of possession under a true lease because CAVIC had provided value only at the time CAVIC extended the loans, at the commencement of the term of the Head Lease. However, the court ruled that each Head Lease constituted a true lease because it recited that it was a lease and governed by English law, which respects the form of the document over its commercial terms. Therefore, the court ruled that CAVIC could have provided and did provide new value. Moreover, the amount of new value (the continued possession of the aircraft) was unsecured (because the lease was a true lease) (see §547(c)(4)(A)), and CAVIC had not otherwise received payment for such new value (see §547(c)(4)(B)). The court, therefore, upheld CAVIC's subsequent-new-value defense to the preference claim.

Ordinary Course of Business

The court next addressed CAVIC's defense that the payment was made in the ordinary course of business. The court noted that the ordinary-course-of-business defense is construed broadly.⁹ Its purpose is to discourage creditors from putting a struggling debtor into bankruptcy, and instead enable the debtor to continue in business.¹⁰ To determine if a prepetition payment was in the ordinary course requires an analysis of the facts surrounding the payment. The courts examine whether the payment was ordinary in the context of the past business practices of the debtor and the creditor (the **subjective test**) or ordinary in relation to prevailing business practices (the **objective test**). The ordinary course defense can be established by satisfying either the subjective test or the objective test.¹¹

The subjective test considers, among other factors, (1) the length of time the parties were engaged in their transactions; (2) whether the payment by the debtor differed from past practices of the parties; (3) whether the debtor or creditor engaged in any unusual collection or payment activity before the debtor made the payment; and (4) whether the creditor took advantage of the debtor's deteriorating financial condition.¹²

Relying on the subjective test, CAVIC argued that the payments on at least two aircraft were ordinary-course payments because Zetta PTE had made them on or within a few days after the scheduled payment date and because the payments were not made in response to any unusual collection or payment activity.

However, the court focused on two emails from CAVIC:

1. On June 14, 2017, a CAVIC representative emailed the managing director of the Debtors who was also one of the issuers of the guaranty of the Head Lease obligations, stating things were reaching a "critical point" and threatening to notify the finance party holding a security interest in the aircraft about unpaid overdue rent. The representative added that he was "not bluffing."
2. On June 23, 2017, in response to a request from the managing director for more time to make payments (in which he said CAVIC would "get him from all angles"), which response itself had followed CAVIC's forwarding of an email from the holder of the security interest saying that it was considering issuing a default notice, the CAVIC representative replied that the payments had to be made "today not Monday or Tuesday."¹³

CAVIC argued to the court that the emails did not constitute unusual collection activity because CAVIC had requested payment in this manner only after learning about Zetta PTE's financial problems. That, CAVIC argued, made it consistent with industry practice and prior dealings between the parties.

However, the court sided with the trustee in finding that the large dollar amount of the payment on June 27, 2017, which followed this threatening email traffic from CAVIC to Zetta, was not consistent with any past collection practice between Zetta and CAVIC shown by CAVIC. Similarly, the court ruled that CAVIC had not

⁸ CAVIC could also have used this line of reasoning to explain the nature and amount of the antecedent debt under §547(b)(2).

⁹ *King* at 62, citing *In re Cent. Valley Processing, Inc.*, 2007 SL 2119002 at *3 (Bankr. E.D. Cal. July 19, 2007).

¹⁰ *Id.*

¹¹ *King* at 62, citing *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497 (8th Cir. 1991); *Cent. Valley Processing*, 2007 WL 2119002, at *3 and n.4.

¹² *King* at 63 (citations omitted).

¹³ *King* at 63.

shown that the payment was within prevailing business standards (and satisfying the objective test) merely because the payment was in accordance with the terms of the Head Lease.¹⁴

So according to the court, CAVIC satisfied neither the subjective test nor the objective test to sustain an ordinary-course-of-business defense.

Earmarking Doctrine

Regarding the earmarking-doctrine argument, the court allowed that the Debtors had received a \$15 million loan from their shareholder and paid CAVIC the next day. However, there was no evidence that the shareholder loan was intended to be used to pay CAVIC specifically as opposed to any other creditors. So the court refused to apply the earmarking doctrine as a defense to the clawback of the preference payment.

Court's Conclusion

Thus, with respect to CAVIC's motion to dismiss the trustee's preference claim, the court found:

- the trustee had not satisfactorily shown the nature and amount of the antecedent debt, an element of the preference claim;
- CAVIC had sufficiently shown it added subsequent new value to the Debtors to support a dismissal of the preference claim;
- CAVIC had not sufficiently shown the payment was in the ordinary course of business, under either the subjective test or the objective test, to support a dismissal of the preference claim; and
- CAVIC had not sufficiently shown facts to support an earmarking defense to support a dismissal of the preference claim.

Because of the first two findings, the court dismissed the trustee's preference claim but gave the trustee leave to amend its complaint to provide additional arguments on the antecedent-debt and subsequent-new-value issues.

Practice Recommendations

True Lease Versus Disguised Security Agreement and Choice of Law

Although the court ruled that the Head Lease was a true lease because it was governed by English law, the Head Lease was, commercially, a disguised secured loan agreement (and would likely be so viewed had the court applied Article 9 of the Uniform Commercial Code). If the court had ruled that Article 9 of the Uniform Commercial Code and not English law governed the Head Lease, or if the Head Lease had recited that it was governed by the law of New York or another state, the commercial terms of the Head Lease, those of a secured loan agreement, would have provided the bankruptcy trustee the antecedent debt – the outstanding principal of the loan – to support the trustee's preference claim.

Similarly, a disguised secured loan agreement makes it harder for a lessor to support a new-value defense. The trustee here argued that CAVIC could not have provided new value to the Debtors by allowing possession of the aircraft to continue under the Head Lease; the value was provided only upfront when Zetta PTE became the commercial owner of the aircraft at the beginning of the term of the Head Lease – i.e., when the loan was extended. The court rejected this because it had concluded that the Head Lease was governed under English law. But if it had ruled the Head Lease was governed by US law, or the Head Lease provided that it was governed by US law, this argument may have prevailed.

So for a lease that is commercially a secured loan, a preference claim is easier to maintain. But choosing English law for such a lease if feasible would tend to defeat a preference claim because it is harder under such a lease for the trustee to show an antecedent debt and easier for the lessor to show it provided the debtor new value.¹⁵

¹⁴ *King* at 65 (citations omitted).

¹⁵ It could also allow the lessor to repossess the aircraft without any duty to sell it and account to the lessee for any portion of the proceeds.

Advance Versus Arrear Payments

The rent scheduled to be paid under the Head Lease matches a typical loan repayment schedule. A loan repayment schedule will set forth debt-service payments of principal and interest. Each payment date will be at the end of an interest period, the period from one payment date to the next. The interest payable on a payment date will generally be the interest accrued on the outstanding principal of the loan during the interest period ending on such date. The debt service is therefore by definition payable in arrears.

A true lease may also provide for rent to be paid on each payment date in arrears for the use of the aircraft since the immediately preceding rent payment date. Even though a true lease does not have a loan balance that could constitute antecedent debt, if each rent payment applied to the period ending on the rent due date rather than the period beginning on such date, there would be an antecedent debt on the due date equal to the value of the rent for the period just ended. This however is not favorable for the lessor. Fortunately, a more typical rent schedule for a true lease provides for rent to be paid in advance on the first day of a rent period. This does not allow a trustee to point to any antecedent debt. Similarly, payments of rent in advance made during the preference period would also allow the lessor to credibly assert the defense under 11 U.S.C. § 547(c)(1)¹⁶ that in exchange for each payment, the lessor **contemporaneously** provided new value to the debtor in the form of continued possession of the aircraft for the rent period beginning on the payment date.

A typical operating lease with rent payable in advance would nevertheless typically feature maintenance reserves payable in arrears. This is because maintenance reserves payments are normally calculated based on the actual utilization of an aircraft during the month that immediately precedes the date on which reserves are payable. It is possible to have the lessee pay reserves in advance of utilization, and have a reconciliation against actual utilization periodically or at the end of the lease term. This would help avoid a preference claim against reserve payments but would have to be squared with the parties' commercial expectations and market practice.

So structuring a true lease with advance rent payments and, if possible, advance reserve payments would help to defeat a preference claim.

Periodicity of Payments

The Head Lease featured quarterly payments. The history of the major US airlines is that they have stayed current on rent payments until the filing for Chapter 11 protection. Smaller airlines, however, may be more likely to miss rent payments for some period before filing for bankruptcy protection. Given that, scheduling rent payments monthly rather than quarterly should reduce the lessor's preference risk by reducing the dollar amount of payments likely to be made within the preference period and increasing the dollar amount of payments likely to be made before the preference period.

Enforcement Action

It is important to be able to demonstrate a consistent record in taking enforcement action against a defaulting lessee. If the lessee misses a payment of rent, the lessor should promptly send a demand notice, or at least do a formal amendment of the rent schedule. The danger for a lessor is in not taking prompt action in the face of a default, and then after some time has elapsed, pressuring the lessee to make a payment. Such a payment may be hard to justify as made within the ordinary course of business under the subjective test.

Documenting Payments by Third Parties

Any funding for rent provided by a shareholder or other third party to a lessee should be well documented to show that the funding is intended to be, is required to be, and indeed was, paid by the lessee to the specific lessor

¹⁶ 11 U.S.C. § 547(c)(1) provides:

(c) The trustee may not avoid under this section a transfer —

(1) to the extent that such transfer was —

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange[.]

for specific rent. It would be even better to provide for the transfer of the funds by the third party directly to the lessor, so that the funds are never the property of the debtor at all. In that way, not only does the creditor have the earmarking defense, but also the defense that the funds are not subject to clawback because they were not the property of the debtor at any time.

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