

Aviation - USA

Applicability of Tax Indemnification Agreements after Chapter 11 Reorganization

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Introduction

The May 8 2008 decision in *Lone Star Air Partners, Inc v Delta Air Lines, Inc* may have important implications for leveraged leasing transactions involving aircraft.⁽¹⁾ On appeal, the US District Court for the Southern District of New York reversed the decision of the US Bankruptcy Court for the Southern District of New York and reinstated an owner participant's claims in an action to enforce tax indemnification agreements (TIAs).⁽²⁾ The decision has been appealed to the US Court of Appeals for the Second Circuit and may be reversed. However, the opinion in *Lone Star* may signify ultimate relief for owner participants that have been litigating TIA claims in recent US airline bankruptcies.

In *Lone Star* the parties disagreed about the interpretation of TIAs related to the leveraged leasing of three aircraft. Leveraged lease transactions for aircraft are used so that a third party - the owner participant - may take advantage of accelerated depreciation deductions that an airline would otherwise be unable to exploit. In return, the aircraft is leased to the airline at a reduced rate. Normally, parties entering into a leverage leasing transaction also execute a TIA to protect against the occurrence of certain events that may give rise to unexpected inclusions of taxable income and loss of deductions due to the early termination of the transaction (eg, bankruptcy).

Facts

An owner participant, Lone Star Air Partners, LLC, and Delta Air Lines, Inc disagreed about the exact scope and applicability of the TIAs they had executed. The TIAs protected against the risk that Lone Star might incur an unexpected increase in taxable income if the lease agreement between Lone Star and Delta were terminated prematurely.⁽³⁾ Specifically, the parties agreed that:

"Delta would indemnify Lone Star if any act or omission of Delta or the indenture trustee (defined below) caused Lone Star to lose the tax benefits of the arrangement."⁽⁴⁾

Controversy ensued when Delta filed for Chapter 11 bankruptcy in September 2005.

As part of Delta's reorganization, Delta and the trustee acting on behalf of the lenders (the indenture trustee) agreed to restructure the leases of three aircraft in which Lone Star held the owner participant interests. The bankruptcy court approved the agreement between Delta and the indenture trustee in February 2006. Although the agreement had court approval, the leases could not be restructured without either Lone Star's approval or foreclosure of Lone Star's interests; Lone Star did not approve the restructuring of the leases. Consequently, in May 2006 the indenture trustee informed Lone Star that it planned to foreclose on Lone Star's interests in two of the aircraft and sell them at auction, with an auction of the third aircraft planned for the near future.

In anticipation of the auction of the aircraft, Lone Star began looking for a buyer to ensure the highest possible

price at auction. Lone Star identified Vx Capital Partners, LLC as a potential purchaser of its interests in the three aircraft at acceptable terms, provided that the debt holders would accept repayment at par. The deal, however, could not be consummated because the debt holders required repayment above par.

The indenture trustee auctioned two of the aircraft in July 2006. At the auction, Vx was the highest bidder, although the purchase was contingent on the negotiation and execution of sales documents. The debt holders refused to approve the sale to Vx unless Lone Star consented to paying a premium. Eventually, in October 2006 Lone Star and Vx reached a separate agreement in which Lone Star sold its interests in the three aircraft to Vx. The sale of the interests to Vx resulted in Lone Star incurring tax losses in excess of \$15.6 million.

Lone Star filed claims against Delta in the bankruptcy court pursuant to the TIAs to recover for the adverse tax consequences it suffered when it sold its interests in the three aircraft. Lone Star argued that it was entitled to indemnification under the TIAs “because [the losses] arose from a sale of its ownership interests that was ‘attributable to’ the exercise of remedies” under the leases by the indenture trustee.⁽⁵⁾ Delta objected to these claims, arguing that provisions in the TIAs excused it from indemnifying Lone Star for its tax losses, because the ultimate sale of the owner participant interests to Vx was voluntary and was not pursuant to the “exercise of remedies” as required by the terms of the TIA. The bankruptcy court agreed with Delta and disallowed Lone Star’s claims, finding that:

“there had been no exercise of remedy under the relevant leases and that Lone Star’s sale of its interests in the aircraft was purely voluntary and was not attributable to Delta’s default or any other remedial action.”⁽⁶⁾

Decision

On appeal, the district court disagreed and reinstated Lone Star’s claims.

Indemnification under the TIAs

The TIAs required that Delta indemnify Lone Star for any tax losses it might suffer “as the result of...any act or omission” by Delta as lessee.⁽⁷⁾ However, Delta was not required to indemnify losses that arose from:

“any voluntary or involuntary sale or other disposition (other than a substitution or replacement) by [Lone Star] of the aircraft...unless a [default] shall have occurred and be continuing at the time of such sale or disposition and such sale or disposition is attributable to the exercise of a remedy available to [Lone Star]...in response to the occurrence of such [default].”⁽⁸⁾

Since it was clear that “Delta defaulted on its obligations as lessee [and] that Lone Star’s sale of its interests in the [a]ircraft constitute[d] an excluded event”, Lone Star was required to show that the sale of its interests in the aircraft to Vx was “attributable to the exercise of a remedy” in order to be indemnified for its losses.⁽⁹⁾

Exercise of a remedy

Upon an occurrence of a default by Delta, the lease provisions allowed Lone Star (and thus the indenture trustee by way of the trust indenture) to “exercise any...right or remedy [that] may be available under applicable law”, including the sale of the aircraft.⁽¹⁰⁾ Lone Star never claimed that the indenture trustee sold the aircraft, but claimed that the actions taken by the indenture trustee constituted the “exercise of a remedy”. Lone Star argued, and the district court agreed, that the indenture trustee’s agreement to restructure the loans, and the indenture trustee’s “notice to Lone Star of foreclosure, including publishing notice, registering bidders and conducting an auction”, each constituted an exercise of a remedy.⁽¹¹⁾

The district court reasoned that the indenture trustee’s agreement to restructure the loans was an exercise of a remedy under the terms of the lease, because it was a “step...authorized by law and taken by Lone Star (and, by extension, the indenture trustee) to remedy a default”.⁽¹²⁾ In accepting this conclusion, the district court dismissed the bankruptcy court’s conclusion that the renegotiation of the loans was “the future exercise of a remedy” and thus did not qualify as an actual exercise of a remedy.⁽¹³⁾

Moreover, the district court found that the indenture trustee’s actions of giving notice and holding an auction constituted an exercise of a remedy under the pertinent contractual language. Specifically, the lease provided that as a remedy for breach, the lessor could elect “with or without taking possession thereof, [to] sell or otherwise dispose of the [a]ircraft...at public or private sale”.⁽¹⁴⁾ The court reasoned that giving “notice and holding an auction are part of the activity of selling the [a]ircraft” and thus would be an exercise of a remedy, regardless of the fact that a sale was never consummated.⁽¹⁵⁾ A contrary conclusion, the court expounded,

"would impose an unduly formalistic approach that is not supported by the plain language of" the contract.⁽¹⁶⁾

"Attributable to" the exercise of a remedy

Once the district court found that there was an exercise of a remedy, it was necessary to determine whether the sale of Lone Star's interest was "attributable to" that exercise of a remedy. The court concluded that Lone Star's sale of its interests was "attributable to" an exercise of a remedy because its actions were clearly in response to the indenture trustee's proposed sale of the aircraft.⁽¹⁷⁾

The court reasoned:

"Once the indenture trustee exercised a remedy under the leases, it was evident that Lone Star's beneficial interest in the trusts would be extinguished, either through its consent to the restructuring or, absent consent, by foreclosure."⁽¹⁸⁾

When this became apparent, Lone Star's sale of its interests was "the natural product" of the circumstances and "the option that best preserved the value of its assets". It was therefore "attributable to" an exercise of a remedy.⁽¹⁹⁾

Implications

The reasoning employed by the district court in *Lone Star* stands in stark contrast to that of the bankruptcy court. Where the lower court took a formalistic approach to interpreting the contract language, the district court took a more pragmatic approach. For example, the bankruptcy court found that when the indenture trustee gave notice of and held an auction to sell the aircraft, no remedy had been exercised because the title to the aircraft never changed hands.⁽²⁰⁾ To come to this result, the bankruptcy court interpreted the indenture trustee's actions as an "attempted" exercise of a remedy, not an "actual" exercise of a remedy.⁽²¹⁾ This formalistic reasoning was quite different from that of the district court, which found that an exercise of a remedy had occurred despite the fact that a sale was never consummated, because the indenture trustee "took steps to bring about a sale".⁽²²⁾

The difference in interpretation between these two courts suggests that the district court will not accept an "unduly formalistic approach that is not supported by the plain language" of the TIAs.⁽²³⁾ This could prove important to other parties litigating TIA claims in recent airline bankruptcies that have been subject to similar rulings by the bankruptcy courts.⁽²⁴⁾ Furthermore, this and similar issues may arise more frequently considering the potential increase in defaults and airline bankruptcies during the current market downturn. However, Delta appealed to the Second Circuit on June 6 2008 and it remains to be seen whether the decision will ultimately be upheld. Nonetheless, at least for now, the decision represents a rare victory for owner participants litigating TIA claims.

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Endnotes

(1) *Lone Star Air Partners, Inc v Delta Air Lines, Inc*, 387 BR 426 (SDNY 2008), rev'g *In re Delta Air Lines, Inc*, 05-17923, 2007 WL 2932774 (Bankr SDNY October 5 2007).

(2) *Id.*

(3) See *Delta*, 2007 WL 2932774, at *2.

(4) *Lone Star*, 387 BR at 429.

(5) *Id* at 431.

(6) *Id* at 427-28 (citing *Delta*, 2007 WL 2932774, at *7).

(7) *Id* at 432 (citing TIA § 6); *Delta*, 2007 WL 2932774, at *4.

(8) *Lone Star*, 387 BR at 432 (citing TIA § 7(a)).

- (9) *Id* at 432.
- (10) *Id*.
- (11) *Id* at 432-34.
- (12) *Id* at 433.
- (13) *Id*.
- (14) See *Lone Star*, 387 BR at 433 (citing TIA § 15(b)).
- (15) *Id*.
- (16) *Id*.
- (17) *Id* at 434.
- (18) *Id* at 435.
- (19) at 435.
- (20) *Delta*, 2007 WL 2932774, at *6.
- (21) *Id*.
- (22) *Lone Star*, 387 BR at 433.
- (23) See *id*.
- (24) The bankruptcy court used a similar formalistic approach to interpret the meanings of 'pay' and 'paid' within the context of other TIA provisions that extinguished the right to bring a TIA claim. See *In re Delta Air Lines, Inc*, 381 BR 57 (Bankr SDNY 2008); *In re Delta Air Lines, Inc*, 370 BR 552 (Bankr SDNY 2007).

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