



## **National Federation of Municipal Analysts**

### **POSITION PAPER ON RECHARACTERIZATION OF AIRLINE SPECIAL FACILITY LEASES IN BANKRUPTCY**

#### **Introduction**

The purpose of this document is to set forth the position of the National Federation of Municipal Analysts (“NFMA”) regarding recharacterization of airline special facility leases in bankruptcy proceedings. The NFMA is a professional association of over 900 municipal research analysts with specialized knowledge of municipal finance transactions, including airline special facility issues. These individuals are drawn from a broad cross-section of institutions engaged in municipal bond transactions including broker/dealers, rating agencies, insurance companies, mutual funds, large corporations and other institutional investors. One of the main initiatives of the NFMA is to promote accurate, timely and complete disclosure of credit information pertaining to municipal bond transactions. The NFMA’s advocacy efforts have ranged from global disclosure-related issues to more detailed, sector-specific work.

The need to address the issue of lease recharacterization arises due to recent developments in the airline industry. On December 9, 2002 United Airlines, Inc. (“UAL”) filed a voluntary petition in bankruptcy in the U.S. Bankruptcy Court for the Northern District of Illinois, Eastern Division (the “Court”). UAL is currently operating its businesses at various airport facilities throughout the United States as a debtor in possession. Pursuant to legal briefs filed with the Court, UAL is seeking a declaratory judgment to recharacterize facility lease agreements as loans, potentially depriving bondholders of important legal rights and remedies. It is the position of the NFMA that in instances where airline special facility bonds are secured by lease agreements, UAL should not be permitted to recharacterize these agreements as loans because recharacterization violates the reasonable expectations of investors by altering the basic terms of the security pledge, will result in huge investment losses to bondholders and is grossly unfair and inequitable. For the reasons set forth below, the NFMA strongly believes that judicial acceptance of UAL’s petition to recharacterize lease agreements as loans would contravene the manifest intent of the parties as stated in the financing documents, is incorrect as a matter of law, would prove highly disruptive and injurious to the entire municipal marketplace and should therefore be denied. Based upon these legal considerations as well as important public policy issues, the NFMA urges the Court to deny UAL’s request to alter the terms of the agreement.

## Rationale for Denying United Airlines Motion to Recharacterize Lease Agreements as Loans

1. **Disclosure of Risks was Grossly Inadequate**: Investors were not informed that facility lease agreements entered into between UAL and governmental instrumentalities were susceptible to potential recharacterization as loans that could be voided in bankruptcy. A careful review of official statements indicates that the facility lease agreements were represented to be valid leases, subject to Section 365 of the Bankruptcy Code. These disclosure documents fail to: (a) provide accurate and complete information about the material terms of the lease agreements; (b) provide any factual information that would lead an ordinary reasonable investor to infer that the facility lease agreements were anything but true leases; or (c) alert investors about the possibility that the underlying agreements pledged to support debt service on the bonds were subject to the risk of being recharacterized by a bankruptcy court as an unsecured loan. Recharacterization of facility lease agreements as unsecured pre-petition loans has a material adverse impact upon investors in two decisive ways: (a) if these agreements are construed to be loans rather than leases, bondholders are deprived of pledged lease rental payments during bankruptcy because such payments would be disallowed as payments on unsecured pre-petition debt, and not viewed as permissible rental payments on non-residential property under Section 365; (b) since the agreements would be classified as unsecured loans, investor recovery in bankruptcy would be limited to that of an unsecured creditor.
2. **Recharacterization of Lease as Loan Contravenes the Manifest Purpose and Terms of the Transactions and Intent of the Parties**. Based upon a careful reading of the underlying financing documents in conjunction with applicable law, recharacterization of UAL facility leases as loans contravenes the manifest purpose and terms of the transactions as well as the intent of the parties. As noted in legal briefs filed by counsel to the bond indenture trustees, UAL's argument that the transactions constitute disguised financings is incorrect and severely flawed for a number of reasons: (i) as noted by legal counsel to the indenture trustee, the leases constitute true leases under the so-called economic realities test; (ii) although UAL is vested with the right to use and occupy airport facilities, these facilities are owned by governmental instrumentalities which retain fee simple ownership; (iii) at no time does UAL acquire an equity interest in the facility improvements; (iv) consistent with Section 142 of the Internal Revenue Code, transactions are structured to ensure that terminal value of facilities must equal 20% of original value upon expiration of the lease and reversion of the project to the owner; (v) the lease agreement does not provide UAL with a purchase option upon the expiration of the lease or in any way serve to transfer ownership to UAL; and (vi) most importantly, as evidenced in numerous portions of the lease agreement which reinforce the notion that the issuer and not UAL retained permanent ownership of the facilities, the intent of the parties was to enter into a lease agreement to convey to UAL a limited right of use and occupancy, and not a financing agreement designed to transfer fee ownership.

3. **Legal Precedent and Custom in the Industry are Premised upon Enforceability of Airline Lease and Relet Provisions:** Investor expectations that facility lease agreements are enforceable contracts to be accorded the protection and sanctity of the law are deeply engrained in the municipal marketplace. On the one hand, enforcement of airline facility leases is supported by legal precedent. Airline bankruptcies involving Braniff Airlines, Continental Airlines, Eastern Airlines, Pan Am and TWA allowed issuers to evict tenants or to relet facilities, enabling bondholders to remain largely unimpaired. Moreover, examination of established practice in the trade reveals a clear differentiation by industry participants between different legal structures that secure Airline Special Facility debt. This reflects the widespread belief that legal structures backed by airline facility leases afford better protection than an unsecured loan. Rating agencies assign higher credit ratings for airport transactions backed by airline lease agreements versus non-lease transactions. Insurers base underwriting decisions upon the strength of underlying leases. Trading data has shown that lease-backed bonds command prices significantly higher than non-lease deals. The current spread for UAL lease-backed and unsecured special facility debt is significant (*e.g.* Los Angeles Special Facility Revenue Bonds trade as low as 23 cents for unsecured and as high as 60 for lease-backed).
  
4. **An Adverse Decision Would Violate the Reasonable Expectations of Investors.** Investors in special facility lease transactions that contained residual relet protection purchased these securities with the expectation that if United Airlines ever filed a bankruptcy petition, Section 365 of the Bankruptcy Code would apply to facilitate ongoing payment of lease rental payments. If UAL assumed or assigned the lease, either UAL or its assignee would be required to continue to make lease payments. If UAL rejected the lease, the governmental issuer would be obliged to exercise reasonable effort to locate a replacement tenant to facilitate ongoing lease payments. The Court is urged to take into account important equitable issues. Basic notions of fairness strongly dictate that UAL, as a party to these financings, should be required to abide by the terms of the transaction as represented to investors in the disclosure documents and not be permitted to alter the fundamental terms of the transaction.
  
5. **Recharacterization of Facility Leases as Loans Would Likely Preclude Future Market Access for Special Facility Projects.** Over the last several decades, large domestic airports and major network carriers have benefited from the use of tax-exempt airline special facility debt to facilitate expansion of passenger terminals, concourses, aircraft maintenance facilities and other capital improvements at airports throughout the nation. In form and substance, many of the facility lease agreements negotiated in behalf of these carriers are based upon lease agreements that essentially mirror UAL transactions. If the UAL agreements are recharacterized as loans, enabling it to restructure or even abrogate these payments entirely, given the precarious financial condition of other network carriers, this could set off a chain reaction leading to wholesale repudiation of all airline special facility debt. As a consequence, two deleterious effects would result: (i) bondholders would be forced to

absorb staggering investment losses amounting to billions of dollars; and (ii) in the future, airlines would likely be precluded from gaining capital market access using this form of lease payment structure. At bottom, an unfavorable decision poses considerable risk to the financial well-being and ongoing vitality of the national air transportation system.

6. **Investors Would be Egregiously and Unfairly Injured and Aggrieved.** A ruling that the lease agreement constitutes unsecured pre-petition debt would violate the legal rights and remedies of bondholders and cause substantial investment loss: (i) lease-backed special facility debt would be viewed as substantially riskier investment; (ii) the value of all lease-backed special facility debt would precipitously decline; and (iii) the increased risk would reduce the marketability and liquidity of these securities.
  
7. **Likely Spillover Effects of Lease Recharacterization Extremely Disruptive to the Entire Municipal Marketplace.** The adverse consequences that derive from an unfavorable ruling on the UAL petition are not limited to the roughly \$1.7 billion of outstanding UAL Special Facility Debt or even to the airline industry as a whole. In addition to municipal airports, because lease-backed structures are frequently employed to comply with statutory restrictions governing the issuance of municipal debt, many other issuers in the municipal market rely upon lease-type financing structures to fund a wide variety of capital projects. Other credit sectors where lease backed security and payment structures are used include: (i) industrial revenue bonds; (ii) project financings; (iii) multifamily housing bonds; (iii) transportation projects; (iv) equipment financings; and (v) general governmental purpose bonds. If the terms of the lease agreement are not upheld by the Court, this would potentially call into question the enforceability of identical provisions incorporated in billions of dollars of municipal transactions and prove extremely disruptive to the entire market.

## Conclusion

UAL's motion to recharacterize lease agreements as loans should be denied. UAL's argument that facility leases constitute "disguised financings" is extremely flawed on several grounds. The lease agreements vest UAL only with the limited rights of use and occupancy, not fee simple ownership of the premises which is explicitly retained by the issuer. UAL acquires no equity interest or purchase option in the facilities either during the lease term or upon its stated expiration. The fact that the parties intended to enter a lease agreement rather than a loan financing is also evidenced by numerous provisions limiting the rights of the lessee to those of a tenant. Aside from these legal considerations, there are other compelling reasons to deny UAL's petition. The disclosure documents fail to provide investors with accurate and complete information about the material terms of the lease agreements, provide factual information that supports a single inescapable conclusion that the facility lease agreements are true leases and generally fail to alert investors about the possibility that the underlying agreements are subject to the risk of being recharacterized by a bankruptcy court as unsecured loans. As a matter of public policy, moreover, the Court should not allow the lease agreements to be recharacterized for

several reasons: (i) based upon legal precedent and accepted industry practice and custom, the notion that lease agreements are enforceable contracts to be accorded the protection and sanctity of the law are deeply engrained in the municipal marketplace; (ii) investors in special facility lease transactions purchased these securities with the expectation that if United Airlines ever filed a bankruptcy petition, Section 365 of the Bankruptcy Code would apply to facilitate ongoing payment of lease rental payments so long as UAL remained in possession of the premises; (iii) if the UAL agreements are recharacterized as loans, given the precarious financial condition of other network carriers, this could set off a chain reaction leading to wholesale repudiation of all airline special facility debt; (iv) recharacterization would cause bondholders to absorb staggering investment losses and would likely preclude the future use of special facility debt to finance capital improvements to the national air transportation system; and (v) if the terms of the lease agreement are not upheld, this would potentially call into question the enforceability of identical provisions incorporated in billions of dollars of municipal security transactions in other credit sectors and prove extremely disruptive to the entire municipal market.