

**United States Bankruptcy Court
Northern District of Illinois
Eastern Division**

Transmittal Sheet for Opinions for Posting

Will this opinion be Published? **NO**

Bankruptcy Caption: **In re: UAL Corporation, et al.**

Bankruptcy No. **02 B 48191**

Date of Issuance: **11/21/2005**

Judge: **Wedoff**

Appearance of Counsel:

Attorneys for UAL Corporation: **James H.M. Sprayregen, Marc Kieselstein, David R. Seligman, James J. Mazza, Jr., Kirkland & Ellis LLP, Chicago, IL**

Attorneys for Official Committee of Unsecured Creditors: **Fruman Jacobson, Sonnenschein Nath & Rosenthal LLP, Chicago, IL, Carole Neville, Mark A. Fink, Sonnenschein Nath & Rosenthal LLP, New York, NY**

Attorneys for U.S. Bank National Association as Trustee: **James Spiotto, Ann Acker, Franklin H. Top, III, Chapman and Cutler, LLP, Chicago, IL, Richard Hiersteiner, Jeanne P. Darcey, Palmer & Dodge LLP, Boston, MA**

**UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION**

In re:) **Chapter 11**
)
 UAL Corporation, et al.,) **Case No. 02 B 48191**
)
 Debtors.)
)
 _____)

AMENDED MEMORANDUM OF DECISION

These Chapter 11 cases are before the court on the motion of U.S. Bank National Association (1) for the allowance of an administrative expense pursuant to §§ 365(d)(10) and 503(b) of the Bankruptcy Code (Title 11, U.S.C.) and (2) for an award of adequate protection pursuant to § 363(e) of the Code. The Bank’s motion is based on the use by one of the debtors, United Air Lines, Inc. (“United”), of aircraft subject to a lease that is administered by the Bank as trustee. As discussed below, (1) the Bank’s administrative claim for United’s use of the aircraft is defined by agreements that United and the Bank entered into after United’s bankruptcy filing; (2) these agreements also settled any claim of the Bank for adequate protection in connection with the aircraft; (3) there are facts in dispute that require an evidentiary hearing to determine the extent of the Bank’s administrative claim for breach of the maintenance and return provisions of the agreements; and (4) United is entitled to reduce the Bank’s administrative claim by payments that it made under other agreements with Bank continuing United’s right to maintain possession of the aircraft.

Jurisdiction

The resolution of claims against a debtor’s estate is a core bankruptcy proceeding, which can be finally adjudicated by a bankruptcy judge upon reference from the district court.

28 U.S.C. § 157(b)(2)(B). These cases were referred to this court pursuant to Internal Operating Procedure 15(a) of the District Court for the Northern District of Illinois.

Factual Background

The facts underlying the Bank's motion are not disputed. The aircraft involved in the motion (two planes identified as N316UA and N317UA) were part of United's fleet on December 9, 2002, when United and twenty-seven related corporations filed the voluntary Chapter 11 cases now before the court. United had possession of the aircraft pursuant to financing arrangements (the "Aircraft Agreements") that included leases of the aircraft. These leases, in turn, were collateral for loans made by trusts for which the Bank is trustee. Under the Aircraft Agreements, the Bank had the right to receive lease payments on behalf of the trust and the power to negotiate new financing terms with United. On February 6, 2003, 59 days after the bankruptcy filing, United and the Bank entered into a "Stipulation and Order Approving Section 1110(b) Extension" (an "1110(b) Stipulation") with respect to each of the aircraft. The 1110(b) Stipulations extended the time during which United could maintain possession of the aircraft. Without the stipulations, the automatic stay imposed by § 362(a) of the Bankruptcy Code would have terminated on February 7, 60 days after the bankruptcy filings, pursuant to § 1110(a)(2)(A) of the Code, and the Bank could have demanded return of the aircraft unless United agreed to perform all of its obligations under the Aircraft Agreements.

Originally, the stipulations extended the automatic stay for two months, to April 8, 2003, but the stipulations were renewed repeatedly. The final extension terminated on July 26, 2004. The stipulations required United to make monthly payments of \$65,000 per aircraft "credited against [United's] payment obligations under the Aircraft Agreements." 1110(b) Stipulations, ¶ 6. By the time stipulations expired, United had paid the Bank a total of \$2.34 million for the use of the two aircraft (i.e., 18 monthly payments of \$130,000). The stipula-

tions preserved the right of the Bank to seek both full payment under the Aircraft Agreements and adequate protection. *Id.*, ¶ 9.

On August 15, 2003, while the 1110(b) Stipulations were in effect, United and the Bank entered into “Restructuring Term Sheets” for each of the aircraft (the “Term Sheets”). The Term Sheets were the subject of a motion for court approval under § 363 of the Bankruptcy Code (Docket No. 3543), and were approved by the court, after notice and hearing, in an order entered on August 29, 2003 (Docket No. 3830). In these Term Sheets, United and the Bank agreed to a refinancing of the two aircraft, in the form of new leases, and provided substantial detail regarding the terms of the new leases, including monthly lease payments of \$85,000 for each of the aircraft and provisions for maintenance and return of the aircraft by United. Term Sheet at 4, “Lease Rentals”; 5-6, “Maintenance of Aircraft”; 13, “Return Conditions.”

The Term Sheets also provided the Bank with an administrative claim for United’s use of the aircraft during the period before the new leases would commence. Like the lease rental payments, the administrative claim was in the amount of \$85,000 per month, prorated for partial months, and was “in full satisfaction of all administrative expense claims for the use of the Aircraft” from the commencement of the bankruptcy cases on December 9, 2002, until the commencement of the anticipated new leases. *Id.* at 3-4, “Administrative Claim for Use of Aircraft.” However, the Term Sheets also addressed the possibility that no new leases would actually be entered into, providing that “if no Lease is ever entered into, the Administrative Claim shall be for the period United uses the Aircraft after December 9, 2002.” *Id.* Moreover, if the new leases were entered into, the Term Sheets provided that United could terminate them prior to substantial confirmation of a Chapter 11 plan if, “in the exercise of its business judgment, [United] determine[d] that the Aircraft is not necessary for the implementation of its business plan,” and that, in the event of such a termination, the lessor’s

rental damages would be “limited to a claim for unpaid rent for the period during which United used the Aircraft at the Lease Rental.” *Id.* at 1-2, “Termination at Lessee’s Option during Chapter 11.”

Anticipating prompt execution of the new leases, the Term Sheets initially provided that they would terminate no later than October 8, 2003. *Id.* at 13, “Extension of 60-day Section 1110 Period.” However, the parties agreed to extend the date for entry into new leases until July 26, 2004—coextensive with the 1110(b) Stipulations.

No new lease was ever entered into with respect to the two aircraft, and, on September 17, 2004, United rejected the old leases on the aircraft and returned the aircraft to the Bank. The Bank contends that, at the time of the return, the aircraft suffered from unperformed maintenance.

On October 7, 2005, the Bank filed the pending motion seeking allowance of an administrative expense and adequate protection in connection with United’s use of the aircraft. Both United and the Official Committee of Unsecured Creditors oppose it. At the initial hearing on the motion, the court determined that resolution of contested legal questions would expedite a final decision on the motion.

Discussion

1. The extent of the Bank’s administrative claim. The Bank is entitled to an administrative claim for the use of the aircraft at issue here, pursuant to the Term Sheets, but not otherwise.

Before the Term Sheets were negotiated, the Bank had a claim for an administrative expense award based on United’s use of the aircraft, but the claim was in dispute. The Bank could argue that it was entitled both to lease payments as prescribed by the prepetition leases from 60 days after the filing of the case until the time of rejection, under § 365(d)(10), and to damages for any failure of United to maintain or return the aircraft in compliance with those

leases. In fact, the Bank has made such arguments in this motion. At the same time, United could have argued (as it does here) that the Bank was entitled to no more than fair market value for the use of the aircraft under the “equities of the case” provision of § 362(d)(10) of the Code, or (as the Creditors’ Committee now argues) that the prepetition leases should be re-characterized as financing agreements, so that no use payments are appropriate. *See United Airlines, Inc. v. HSBC Bank U.S.A., N.A.*, 416 F.3d 609 (7th Cir. 2005) (affirming such a re-characterization of nominal real property leases). Indeed, all of these arguments have been made in connection with other administrative claims made earlier in these cases and the court has issued preliminary rulings with respect to them.

None of the earlier arguments were ever finally resolved, however, because the underlying disputes were settled. So was this one. In seeking approval of the Term Sheets for the aircraft involved in this motion, United pointed out that it was seeking authorization to pay a compromised administrative claim.

[T]he Term Sheets provide that administrative claims arising from United’s use and possession of the Aircraft Equipment . . . will be liquidated and paid United . . . requests explicit authority for its performance of these provisions pursuant to section 363(b) of the Bankruptcy Code and Bankruptcy Rule 9019.

Under Section 363(b) of the Bankruptcy Code and Bankruptcy Rule 9019, a bankruptcy court should approve a proposed compromise if it is fair and equitable and in the best interests of the estate.

Settling the administrative claims arising from United’s use and possession of the Aircraft Equipment is in the best interest of the estate. The bankruptcy estate would likely incur a great deal of time and expense in litigating such potential claims, and United would have no guaranty of success. . . . Accordingly, by settling and compromising these claims in accordance with the terms and conditions of the Term Sheets, United will avoid these unnecessary costs and delays.

Motion, Docket No. 3543, ¶¶25-27.

As noted above, the Term Sheets did in fact settle all administrative claims of the Bank in connection with United’s use of the aircraft, giving the Bank a claim of “\$85,000 per month (prorated for partial months) . . . for the period United uses the Aircraft after December 9,

2002,” and providing that this claim is “in full satisfaction of all administrative expense claims (including, without limitation, claims under Sections 361, 363, 365, 503 and 507 of the Bankruptcy Code) for the use of the Aircraft.” Term Sheets at 3-4, Administrative Claim for Use of Aircraft, Lease Rentals. Upon the court’s approval of the Term Sheets, these provisions became binding on both United and the Bank, pursuant to § 363(b) of the Bankruptcy Code.

The Bank makes two arguments for not treating the Term Sheets as definitive on this point. The first is based on a provision that in the Term Sheets establishing a “Term Sheet Termination Date.” The Bank contends that once this termination date occurred, the Term Sheets “expired” so that the settlement of administrative claims contained in the Term Sheets is “without any force or effect.” Motion, ¶ 20. However, the Term Sheets do not provide for nullification of the administrative claim settlement upon the occurrence of the Term Sheet Termination Date. To the contrary, the only substantive provision of the Term Sheets employing the Term Sheet Termination Date states in its entirety: “Lessee [United] agrees not to reject the underlying existing lease arrangements respecting the Aircraft prior to 12:01 a.m. CST on the Term Sheet Termination Date.” Term Sheets, p. 15, Rights Until Term Sheet Termination Date. Moreover, because the administrative claim settlement was expressly effective even if no lease was ever entered into, the administrative claim settlement was necessarily effective after the Term Sheet Termination Date.

The Bank’s other argument is a that United breached a duty of good faith and fair dealing implicit in the Term Sheets by not entering into the contemplated new leases. Illinois law, which the Term Sheets provide is governing, does imply such a duty in every contract, but this implied duty, as the explained in the decision cited by the Bank, is principally an interpretative aid for ambiguous contracts.

The obligation of good faith and fair dealing is essentially used to determine the intent of the parties where a contract is susceptible to two conflicting constructions. Problems involving the obligation of good faith and fair dealing generally arise where one party to a contract is given broad discretion in performance.

The covenant of good faith requires that a party vested with contractual discretion exercise that discretion reasonably, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectation of the parties. Parties to a contract, however, are entitled to enforce the terms of the contract to the letter and an implied covenant of good faith cannot overrule or modify the express terms of a contract.

Northern Trust Co. v. VIII S. Mich. Assocs., 657 N.E.2d 1095, 1104 (Ill. App. Ct. 1995) (citations omitted).

There is no ambiguity in the Term Sheets that would be elucidated by the obligation of good faith and fair dealing. The parties expressly provided for the possibility that no new leases would ever be executed, and even if new leases were executed, United was given the right to terminate them, without penalty, at any time before the effective date of a plan of reorganization. Thus, United was within its rights under the Term Sheets to decline to enter into new leases, and the implied duty of good faith cannot change these express provisions on which United relies.

Giving effect to the court-approved settlement of the Bank's administrative claim for use of the aircraft, prescribed by the Term Sheets, results in a total administrative claim of \$3,615,333.33:

21 months @ \$85,000 per month (December 9, 2002 to September 9, 2004)	\$1,785,000.00
8 days @ \$2,833.33 (1/30th of \$85,000) per day (September 9 to September 17, 2004)	+ <u>22,666.66</u>
	1,807,666.67
	<u> x 2</u>
	<u>\$3,615,333.33</u>

2. *Additional claim for adequate protection.* Under § 363(e) of the Bankruptcy Code, a party with an interest in property of a debtor's estate is entitled to an award of adequate protection, upon its request, to protect against a decline in the value of that interest during a period in which the party is precluded by the automatic stay from asserting its non-bankruptcy remedies against the estate property. See *United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 370 (1988) (“[T]he right of a secured creditor to have the security

applied in payment of the debt upon completion of the reorganization . . . is not adequately protected if the security is depreciating *during the term of the stay*,” and so the creditor is entitled “to cash payments or additional security in the amount of the decline.”) (emphasis added). The types of acceptable adequate protection are defined in § 361 of the Code.

Like a secured creditor, a personal property lessor may demand adequate protection under § 363(e). The *Timbers* rationale suggests that if leased property is declining in value during a period in which the automatic stay prevents repossession of the property, the decline in value should be offset by lease payments or other forms of adequate protection at least up to the amount of rent called for by the lease. However, it would not appear appropriate to award a lessor adequate protection in an amount greater than the prescribed lease payments. See *In re Palace Quality Services Industries, Inc.*, 283 B.R. 868, 882 n.13 (E.D. Mich. 2002) (“[A] lessor cannot compel the trustee under Section 363 to pay more than the benefit of the bargain in the event that the lessor miscalculated in setting the lease payment at less than the rate of depreciation associated with the leased personalty.”).

With this understanding, it appears that before the Term Sheets became effective, the Bank may have had some claim for adequate protection. For the first 60 days of bankruptcy administration, the automatic stay prevented the Bank from repossessing the aircraft, and it is not clear that the United made any payment during that time for the use of the aircraft. Thus, any decline in the value of the aircraft would have been uncompensated. Following this initial 60 day period, however, pursuant to § 1110(a) and (c) of the Code, the Bank had the right to immediate surrender of the aircraft, in the absence of a cure by United of all defaults and an agreement to comply with the terms of the prepetition leases. Thus, after the 60-day period, either United would have had to provide full lease payments and compliance with all maintenance duties (arising both before and after the bankruptcy filing) or the automatic stay would no longer prevent repossession. In either situation, the rationale for adequate protection

would not exist. Thus, the Bank's claim for adequate protection would have been limited to depreciation during the initial 60-day period.

However, with the execution of the Term Sheets, this adequate protection claim was also settled. Under the Term Sheets, United agreed to pay the Bank \$85,000 per month for each aircraft, retroactive to the commencement of the cases, in full satisfaction of any claims for administrative expenses arising under (among other named sections of the Bankruptcy Code) "Sections 361 [and] 363." Section 361 deals only with adequate protection, and § 363(e), as noted above, is the provision of the Code that allows a lessor of personal property to seek adequate protection.¹ Thus, the \$85,000 monthly payments (combined with the maintenance requirements) provided for by the Term Sheets were agreed by the parties to satisfy any claim that the Bank had for adequate protection.

3. *Additional administrative claim for breach of maintenance and return requirements.* Apart from an administrative claim for United's use of the aircraft involved in the pending motion, the Bank may also have a claim for failure to maintain and return the aircraft in compliance with the requirements of the Term Sheets. The parties have not addressed the extent of any such claim, and, to the extent that it is in dispute, its determination would require an evidentiary hearing.

4. *Accounting for payments made under the 1110(b) Stipulations.* The final disputed legal issue raised by the Bank's motion is whether the Bank's administrative claim under the Term Sheets should be reduced by the payments United made under the 1110(b) Stipulations.

¹ It might be argued that a claim for adequate protection is not an administrative expense claim, since § 361(3) prohibits the use of administrative expense allowances as adequate protection. This prohibition, however, is only against the prospective use of an administrative expense allowance to provide adequate protection. In order to redress a failure of adequate protection, the court is specifically authorized under § 507(b) to award an allowance of an administrative expense. See *In re Carpet Center Leasing Co., Inc.*, 991 F.2d 682, 688 (11th Cir. 1993) (a § 507(b) "administrative expense claim is based on the diminution in the value of the collateral by reason of the automatic 362 stay"). Claims under § 507 were also explicitly included in the Term Sheets' settlement of the Bank's administrative claims.

The Term Sheets do not address this question directly, but, as noted above, they do state that the \$85,000 monthly payments they require of United for “in full satisfaction of all administrative expense claims for the use of the Aircraft.” Thus, if the payments made by United under the 1110(b) Stipulations are for use of the aircraft, they must be credited against the payment obligation of Term Sheets.

In fact, payments under the 1110(b) Stipulations were for the use of the aircraft. At the time these stipulations were entered into, the only agreements providing the Bank with payments for the use of the aircraft were the prepetition leases. The 1110(b) Stipulations preserved the right of the Bank to claim the full amount due under these leases, and treated the payments required of United as credits against such claims:

United will pay to the Aircraft Creditors . . . the amounts set forth on Exhibit B hereto [\$65,000 per month] on the dates set forth therein. Such payments shall be credited against United’s payment obligations under the Aircraft Agreements and will be made in the form and manner provided in the Aircraft Agreements and shall be a permanent cash payment made in accordance therewith By accepting these payments the Aircraft Creditors do not waive any right to receive the full amounts due under the Aircraft Agreements

1110(b) Stipulations, ¶ 6.

The impact of this provision was that the \$65,000 monthly payments required by the 1110(b) Stipulations were part payment of the Bank’s claim for United’s use of the aircraft under the prepetition lease, and that the Bank retained the right to seek additional payment for use of the aircraft. Ultimately, the Term Sheet was substituted for the prepetition lease in establishing the amount due the Bank for United’s use of the aircraft, and it did indeed require additional payment. However, the payments made under the 1110(b) Stipulations are still required to be “credited against” this additional payment obligation.

The Bank seeks to avoid this conclusion by arguing that the \$65,000 payments under the 1110(b) Stipulations were not for United’s use of the aircraft but were “additional payments for a monthly maintenance so that funds would be available to at least partially offset

maintenance costs if not performed by United during its term of use” and thus that “[t]hese Section 1110(b) payments were in addition to payments required for ‘rent.’” Motion at 18. This contention is supported by no citation to the 1110(b) Stipulations and is directly contrary to the provision quoted above. The payments made under the 1110(b) Stipulations are expressly identified as credits against the rent due under the prepetition leases; there is nothing in the stipulations linking the payments to any maintenance fund; and the stipulations contain a requirement separate from the payment obligation that United “maintain and insure the Aircraft Equipment in compliance with the Aircraft Agreements and . . . cooperate with respect to inspections of the Aircraft Equipment.” 1110(b) Stipulations at ¶ 4(c). Payments under the 1110(b) Stipulations were therefore for United’s use of the aircraft, not a maintenance fund, and United is entitled to credit these payments against the amounts due under the Term Sheets for use of the aircraft.

Conclusion

For the reasons stated above, the Bank has a \$3,615,333.33 administrative claim for the United use of the aircraft, which claim must be reduced by the \$2.34 million already paid by United on account of that use, leaving a claim of \$1,275,333.33. That amount, together with any damages shown by the Bank to have resulted from a breach by United of the maintenance and return provisions of the Term Sheets will be the allowed amount of the Bank’s administrative claim.

Dated: November 21, 2005

Eugene R. Wedoff
United States Bankruptcy Court