

Alert

Seventh Circuit Holds that Bankruptcy Court Improperly Reduced Oversecured Lenders' Claim

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The U.S. Court of Appeals for the Seventh Circuit held on May 5, 2009, that a group of secured lenders were fully secured and “entitled to a full recovery” from the debtor despite the bankruptcy court’s improper valuation of the collateral (improved airport terminal space) securing the lenders’ underlying \$60 million loan. *In re United Airlines, Inc.*, ___ F.3d ___, 2009 U.S. App. LEXIS 9648 (7th Cir. 5/5/09) (Easterbrook, Ch. J.). The lower courts had valued the lenders’ collateral at \$35 million, leaving them with a \$25 million unsecured claim. According to the Seventh Circuit, the bankruptcy and district courts had not only ignored critical evidence showing comparable terminal space with a higher value, but the bankruptcy court had also used an improper discount rate when valuing the space rentals over the term of the loan. In the court’s words, “[r]eal prices are much more informative than lawyers’ talk.” *Id.* at 13.

Facts

The debtor airline had borrowed \$60 million for improvements to its 345,167 sq. ft. space at Los Angeles International Airport (“LAX”). The debtor had “Lease[d] rather than own[ed] space at airports.” *Id.*, at *2. Because “there is no liquid market for . . . improved space at airports,” valuation of the lenders’ collateral, reasoned the court, was not “straightforward.” *Id.*

The Lower Courts’ Faulty Valuation

The bankruptcy court valued the debtor’s improved space subject to the lenders’ lien at “an annual value of \$17 per square foot . . . as of 2004.” *Id.* It then “added up the imputed rentals [with projected increases] through 2021 (when the loan comes due), and discounted the result at 10% per annum.” *Id.*, at *2-*3. Reaching “a present value of roughly \$35 million for the lenders’ security,” the bankruptcy court “treated [\$25 million] as unsecured debt and [wrote it] down according to the [previously confirmed] plan of reorganization,” and the “district judge affirmed.” *Id.*, at *3.

Finding The Correct Annual Rental Rate

The bankruptcy court mistakenly found “that \$17 per square foot per year is the market for terminal space” at LAX “because that is what . . . the airport charges to willing buyers (the airlines).” *Id.*, at *4. The \$17 per square foot rental “is a price for unimproved terminal space,” however, and was inappropriate. *Id.*, at *5. “A price for unimproved space does not measure the value of the collateral,” reasoned the Seventh Circuit, for the lenders’ “security is in the *improved* space.” *Id.*, at *6 (emphasis in original text). Indeed, if the lenders “foreclosed and took over the space,” they “could rent the gates to” another airline “at more than \$17 a square foot—at perhaps four times that much, to go by prices at the airport’s one terminal that leases fully built-out gates.” *Id.* The debtor had originally borrowed \$75 million from the lenders to make improvements on the space here, and would not have done so “unless it increased the space’s value by at least that much Any valuation method that treats improvements as worthless can’t be appropriate.” *Id.*, at *7. In short, the bankruptcy court had unjustifiably disregarded “the fact that air carriers willingly pay \$63 per square foot for space at [LAX], the only estimate in the record of improved space’s going price.” *Id.* at 11. Because “[a]ny

potential rental price higher than \$30 would make the collateral worth at least \$60 million, and thus make the loan fully secured, even with the [“bankruptcy court’s improper] 10% discount rate,” the lenders were held “entitled to collect 100 [cents] on the dollar , plus interest.” *Id.*, at *11-12.

Finding The Correct Discount Rate

Holding “that the 10% discount rate is too high,” the Court of Appeals found that “the bankruptcy judge [had merely] added the two estimates” proffered by the parties’ opposing experts, “and divided by two.” *Id.*, at *12. Instead of splitting “the difference between the parties,” the bankruptcy judge “should choose the *right* discount rate. . . .” *Id.* The fact that LAX “is operating at capacity, and can raise money at 8% without giving security, [was] all [the Seventh Circuit] need[ed] to know to conclude that the discount rate cannot exceed 8%.” *Id.*, at *13. “With the discount rate at 8%,” the lenders would be “fully secured” even if the space were rented at “roughly \$23 per square foot.” *Id.*, *14. Improved space at LAX, however, “fetches almost three times the price” needed to make the lenders’ loans “fully secured,” entitling them “to a full recovery.” *Id.*

Comments

1. A Trial Court Cannot Ignore Material Facts. The Court of Appeals had no trouble in reversing the bankruptcy judge’s fact finding as to annual rental rate. When, as here, a lower court disregards material evidence in the record to reach a contrary conclusion, there is clear error. *United States v. U.S. Gypsum Co.*, 333 US 364, 394-96 (1948) (finding clearly erroneous “when although there is evidence to support it, the reviewing court on the *entire evidence* is left with the definite and firm conviction that a mistake has been committed.... Where...testimony is in conflict with contemporaneous documents we can give it little weight.”); *Jiminez v. Mary Washington College*, 57 F.3d 369, 384 (4th Cir. 1995) (appellate court “left with the definite conviction that the factual findings of the district court [were] clearly erroneous. . . [because it] ignored substantial evidence or failed to evaluate substantial contrary evidence in making its findings of fact.”); *Weissman v. Freeman*, 868 F.2d 1313, 1322 (2d Cir. 1989) (district court’s decision clearly erroneous because it “implausibly overlooked” and “failed to give detailed consideration to” key evidence).

2. A Trial Court Cannot Merely “Split the Difference.” Secured lenders, like other parties, are entitled to reasoned judicial findings based on facts in the record, not guesses. Again, the Seventh Circuit easily rejected the bankruptcy court’s superficial splitting of “the difference between the parties.” 2009 U.S. App. LEXIS 9648, at *12. “An arbitrator might choose such a method, and perhaps a jury would do so behind closed doors, but a judge should choose the *right* discount rate. . .” *Id.*, at 12.

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