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# From the Bankruptcy Courts

*Benjamin Weintraub\* and Alan N. Resnick\*\**

## **Trust Created to Facilitate Secured Financing Held Ineligible for Bankruptcy Relief**

In a divided decision that should be of interest to those involved in the structuring of secured financing transactions, the Court of Appeals for the Second Circuit held that a trust created in connection with the sale and leaseback of a portion of the fleet of Eastern Air Lines is not a "business trust" and, therefore, is not eligible for bankruptcy relief.<sup>1</sup>

Eastern Air Lines sought to raise \$500 million in financing using a portion of its aircraft fleet as collateral. The mechanism used for the financing transaction involved the creation of a trust pursuant to the "Secured Equipment Indenture and Lease Agreement Between First Fidelity Bank, Indenture Trustee and Eastern Air Lines, Inc." The trust

sold to investors \$500 million in "trust certificates," used the proceeds of the sale of the certificates to purchase a portion of Eastern's fleet, and leased the fleet back to Eastern in exchange for Eastern's agreement to make rental payments equal to the amount of principal, premium, and interest on the certificates. It was undisputed that the sale and leaseback transaction between Eastern and the trust was a secured financing transaction, rather than a true sale and lease.

The trust certificates were sold in three series: a first-priority \$200 million series due in 1993, a second-priority \$200 million series due in 1996, and a third-priority \$100 million series due in 2001. Although the trust had one trustee, called the "Collateral Trustee," who managed the affairs of the trust, each series of certificates was represented by its own "Series Trustee." The Collateral Trustee had the responsibility of collecting the lease payments from Eastern Air Lines and distributing them to certificateholders in accordance with the priorities set forth in the indenture. Any rental payments in excess of the amounts due under the indenture would have to be returned to Eastern. Upon payment in full by Eastern, title to the collateral would be

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<sup>1</sup> In re Secured Equip. Trust of Eastern Air Lines, Inc. (Shawmut Bank Conn., et al. v. First Fidelity Bank, et al.), 38 F.3d 86 (1994).

reconveyed to Eastern and the trust would be dissolved. The indenture gave the Collateral Trustee the power, upon a default by Eastern, to take possession of the collateral and to hold, sell, keep, or lease its components in order to enforce the indenture.

After Eastern filed a chapter 11 petition in 1989, it stopped making rental payments to the trust. Each of the three Series Trustees filed proofs of claim in Eastern's bankruptcy case for the principal, premiums, interest, fees, and expenses owed to the holders of the certificates. In 1991, the Collateral Trustee and Eastern's chapter 11 trustee entered into a stipulation that resulted in certain aircraft being returned by Eastern to the trust and the turn-over to the trust of over \$230 million in proceeds from Eastern's sale and lease of collateral.

Pursuant to its powers under the indenture, after Eastern's default, the Collateral Trustee began to actively manage, maintain, market, lease, and sell the equipment entrusted to it. In connection with these functions, the Collateral Trustee hired lawyers, accountants, and an aviation consultant to assist in the process of liquidating the collateral, a process that was estimated to take several years to complete.

### **Involuntary Petition Filed**

In 1991, three holders of trust certificates—which certificates equaled \$54.2 million in aggregate principal amount—filed an involun-

tary chapter 11 petition against the trust in the District of New Jersey. The Resolution Trust Corporation, which held \$35 million in certificates, subsequently joined in the petition. The Collateral Trustee moved to dismiss the case or, alternatively, to have it transferred to the Southern District of New York. The case was transferred to the Southern District, where the Eastern Air Lines bankruptcy case was pending, and the bankruptcy court then granted the motion to dismiss the case. The bankruptcy court held, and the district court affirmed, that the trust was not a "business trust" and, therefore, was not eligible for relief under the Bankruptcy Code.

The Bankruptcy Code makes an important distinction between "business trusts" and other types of trusts. Under the Code, only a "person" is eligible for bankruptcy relief. Section 109(a) provides that only a "*person* that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title." In addition, Section 303(a) provides that only a "person" may be the subject of an involuntary petition. The term "person" is defined in Section 101 of the Code to include an "individual, partnership, and corporation. . . ." Although one might conclude from these sections alone that a trust is not eligible for bankruptcy relief, it would be a mistake to stop examining the definitions in the Code. The term "corporation" is defined in

Section 101 to include a "business trust." Unfortunately, the Code does not include a definition of "business trust."

The sole issue presented to the Second Circuit was whether the trust is a "business trust" within the meaning of the Bankruptcy Code. "Notably, we have never before had to expressly address the definition of 'business trust' under the Bankruptcy Code. Furthermore, although many other courts have been called on to make this type of determination, none have been presented with a trust that was created in order to secure the payment of certificates issued in connection with a secured financing. As such, we are faced with an issue of first impression for this and any appellate court."<sup>2</sup>

The court of appeals looked to the methodology used by other courts faced with the question of whether a certain trust is a "business trust." Since a business trust is included in the definition of "corporation," it is not surprising that courts have looked to see whether the trust in question had the attributes of a corporation. "Clearly, most courts agree that a basic distinction between a business trust and other trusts is that business trusts are created for the purpose of carrying on some kind of business, whereas the purpose of a non-business trust is to protect and preserve the res."<sup>3</sup> However, the Second Circuit also noted that, while a trust must engage

in business-like activities to be a business trust, "such activity, without more, does not necessarily demonstrate that a trust is a business trust."<sup>4</sup> Except for these few general guidelines, the decisions are hopelessly divided and "each decision is based on a very fact specific analysis of the trust at issue."<sup>5</sup>

The petitioning creditors, who had the burden of establishing that the trust was eligible for bankruptcy relief, argued to the bankruptcy court that the trust's activities demonstrate that it is a business trust. In particular, they argued that, since Eastern filed its bankruptcy petition, the Collateral Trustee has carried on the business of leasing and selling the equipment, including hiring accountants, attorneys, and marketing personnel to assist in those endeavors. The bankruptcy court did not find these arguments persuasive, and held that the trust in this case is not a business trust because it was established only to "secure the payment of the Secured Equipment Certificates,"<sup>6</sup> rather than to generate a profit or to liquidate the final affairs of a company originally established to generate a profit.

#### **Absence of Profit-Generating Purpose**

On appeal to the Second Circuit, which reviewed the lower courts' definition of "business trust" de

<sup>2</sup> 38 F.3d at 88-89.

<sup>3</sup> 38 F.3d at 89.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

novo, the petitioning creditors argued that the bankruptcy court was wrong in requiring as a condition to being a business trust that the trust have a profit-generating purpose. They cited several decisions in which courts have found a trust to be a business trust despite the absence of a profit motive, including one decision in which a self-funded employee benefit plan trust that provided and maintained health benefits for employees of member stores was held to be a business trust even though it did not operate to generate profits.<sup>7</sup> Cases that were factually similar, but where the courts have concluded that such trusts were not business trusts, were cited by the Collateral Trustee.<sup>8</sup> The Second Circuit did not find it necessary to resolve this split of authority, because it did not read the bankruptcy court's decision as foreclosing the possibility that trusts not established to create a profit may nonetheless be business trusts. "We interpret the [bankruptcy] court's reference to trusts that seek profits or carry on the final affairs of a company as merely examples of what the court also refers to as trusts that 'transact

business for the benefit of investors.' "<sup>9</sup>

Although it stopped short of holding that a profit-generating purpose is a necessary element of a business trust, the Second Circuit emphasized that many courts have found the presence or absence of a profit motive influential in their determination as to whether a trust is eligible for bankruptcy relief. "As most corporations are established to generate a profit, we too find this factor relevant to our determination of whether the Trust is a business trust. We do not, however, foreclose the possibility that a Trust that was not specifically established to generate a profit may still be considered a business trust."<sup>10</sup>

Applying these legal principles to the case at hand, the Second Circuit concluded that the trust was not established to generate a profit.

"Assuming *arguendo* that the interest the certificateholders are entitled to constitutes profit . . . the Trust was not established to *generate* such interest. Rather, it was established merely to secure the repayment of the certificateholders' loans to Eastern. As such, its purpose was to *preserve* the interest that the certificateholders had already been guaranteed, not to generate it. Notably, any payments in excess of amounts due under the Indenture were to be returned to Eastern."<sup>11</sup>

The Second Circuit also concluded that, aside from the absence of

<sup>7</sup> In re Affiliated Food Stores, Inc. Group Benefit Trust, 134 B.R. 215 (Bankr. N.D. Tex. 1991).

<sup>8</sup> The Collateral Trustee cited In re Consol. Welfare Fund "ERISA" Litig., 798 F. Supp. 125 (S.D.N.Y. 1992); In re Westchester County Civil Serv. Employees Assoc., Inc. Benefit Fund, 111 B.R. 451 (Bankr. S.D.N.Y. 1990); and In re Cahill Assocs. Pension Plan, 15 B.R. 639 (Bankr. E.D. Pa. 1981).

<sup>9</sup> 38 F.3d at 90.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

a profit motive, the trust was not created to "transact business" as that term is commonly construed. The trust was not created to run a business, but was established only to serve as a vehicle to facilitate secured financing. Creation of the trust and placing title to the collateral pool in one entity "enabled numerous lenders to receive the benefit of a security interest without the need for multiple security agreements and filings, which would drastically increase transaction costs."<sup>12</sup> Any business activities that the trust is engaged in were incidental to the trust's sole responsibility of protecting the certificateholder's security interest. Moreover, the court of appeals commented that its inquiry was based on the totality of the circumstances and the trust documents, not solely on whether the trust engages in a business.

The Second Circuit also found unpersuasive the argument that, by denying the petitioning creditors relief under the Bankruptcy Code, the court would be depriving them of any forum to adjudicate their claims. First, the court questioned whether the availability of another forum should be given any weight in a determination of whether a trust is a business trust. Second, the petitioners are not left entirely without a forum. "Although petitioners may have no forum in which to seek redress from the Trust for a decline in the value of the Collateral Pool,

because the petitioners are actually secured creditors of Eastern, their deficiency claims can be dealt with in Eastern's bankruptcy."<sup>13</sup> The court noted that each Series Trustee had filed in the Eastern case a proof of claim on behalf of the certificateholders it represents. The petitioners also could resort to state or federal court to assert any claims regarding the management of, or distributions made by, the trust.

On the basis of this reasoning, the Second Circuit held, by a 2-1 vote, that the trust was not a business trust and, therefore, was not eligible for relief under the Bankruptcy Code.

### The Dissent

In a dissenting opinion, Judge Kearse argued that the trust was a business trust and that the case should not have been dismissed.

Judge Kearse emphasized that the certificateholders expected to earn a profitable return on their investments and that the Collateral Trustee had the power to, and actively did, manage, lease, and sell the assets of the trust. As of January 1991, the Collateral Trustee had taken possession of, engaged in a marketing program for, and arranged for the maintenance, repair, storage, and insurance of, 67 commercial jet aircraft and 165 engines. It was still managing a fleet of 47 aircraft two years later. "In my view, the Trustee was operating a business, and the Trust would be a business trust under New York law,

<sup>12</sup> 38 F.3d at 90.

<sup>13</sup> *Id.* at 91.

which defines such an entity as 'any association operating a business under a written instrument or declaration of trust, the beneficial interest under which is divided into shares represented by certificates.' <sup>14</sup>

The dissenting opinion also referred to legislative history of the Bankruptcy Code for guidance. The former Bankruptcy Act defined "corporation" to include "any business conducted by a trustee or trustees wherein beneficial interest or ownership is evidenced by certificate or other written instrument." <sup>15</sup> When the Bankruptcy Code was enacted in 1978, this language was replaced with "business trust" and the House and Senate Judiciary Committee Reports on the Code indicated that "[t]he definition of 'corporation' . . . is similar to the definition in current law, section 1(8)." <sup>16</sup> Judge Kearsé concluded from this legislative history that the term "business trust" was intended to include the type of trust described in the definition of "corporation" in the former Act, and that the trust in this case fits that definition.

Judge Kearsé also disagreed with the majority's view that the trust was created merely for the preservation of assets. "The Trust was a vehicle through which financial in-

stitutions that agreed to make collateralized loans to Eastern agreed to have the money transferred and the aircraft collateral held, and it is plain from the indenture documents that neither the loans nor the interest payable to the certificateholders existed independent of the Trust. The Trust was established in order to enter into the purchase-and-leaseback transactions that would generate the rental income that created the certificateholders' profits." <sup>17</sup>

The dissent also emphasized that the trust was "no eleemosynary entity," <sup>18</sup> even though excess profits generated by the sale-leaseback would be payable to Eastern. Judge Kearsé criticized the majority for putting too much weight on the fact that the return for investors was contractually limited. "I fail to see why the agreed profit limitation should remove the Trust from the Code definition of corporation." <sup>19</sup>

### **Ramifications of the Court's Decision for Asset Securitization Transactions**

In recent years, we have seen the growth of the use of asset-backed securities as a vehicle to raise cash for companies that have substantial receivables or other income-generating assets. Although transactions involving asset-backed securities are not all the same and may have different features, typically, receiv-

<sup>14</sup> 38 F.3d at 92. Judge Kearsé cited N. Y. General Associations Law § 2.2. as the applicable authority under New York law.

<sup>15</sup> 11 U.S.C. § 1(8) (1976), repealed by the Bankruptcy Reform Act of 1978.

<sup>16</sup> 38 F.3d at 92. The court cited S. Rep. No. 989, 95th Cong., 2d Sess. 22 (1978); H.R. Rep. No. 595, 95th Cong., 2d Sess. 309 (1978).

<sup>17</sup> 38 F.3d at 93.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

ables or other income producing assets are sold to a newly created special-purpose entity that issues notes or other securities to raise the cash needed to buy the assets. The cash flow from the assets is used to pay the notes or other debt securities. The securities issued by the special-purpose entity often receive a higher credit rating than would similar securities issued by the operating company, because the debt securities are evaluated on the basis of the particular asset pool, rather than on the creditworthiness of the operating company. These transactions are usually structured as a "true sale" of assets to the special-purpose entity without recourse to the selling company, rather than as a secured loan to the company, to minimize the risk that the bankruptcy of the company will interrupt and otherwise affect the collection of receivables and cash flow to the investors. Finally, lawyers who structure these transactions attempt to make the special-purpose entity as "bankruptcy remote" as possible so as to reduce the likelihood that the entity will itself be the subject of a bankruptcy petition. This is often attempted using such strategies as requiring independent directors who must consent to any bankruptcy petition, placing restrictions on the debt that the entity may incur, and taking certain steps to minimize the risk of substantive consolidation of the special purpose entity and the company.

One can only speculate as to whether the Second Circuit's deci-

sion that the secured equipment trust in the Eastern Air Lines matter is ineligible for bankruptcy relief will tempt lawyers to use trusts instead of corporations as the special-purpose entity in asset-backed securitization financing. A careful reading of the court's opinion reveals several indications that the holding may not apply to typical asset-securitization financing. First, the court emphasized that a determination of whether a trust is a business trust for bankruptcy eligibility purposes depends on the particular facts of the case. "Ultimately, each decision is based on a very fact specific analysis of the trust at issue."<sup>20</sup> Second, in determining that the trust was not created to generate a profit, the court emphasized that the sole purpose of the trust was to preserve the interest payments that the certificateholders had already been guaranteed: "Notably, any payments in excess of amounts due under the Indenture were to be returned to Eastern."<sup>21</sup> In contrast, the transfer of assets to a special-purpose entity in an asset-securitization financing transaction is often designed to be construed as a "true sale" without leaving the operating company with a financial interest in the cash flow from the transferred assets. Third, the court pointed out—apparently because it found it relevant—that it was undisputed that the sale-leaseback transaction in that case was merely a secured loan to East-

<sup>20</sup> 38 F.3d at 89.

<sup>21</sup> *Id.* at 90.



ern. Again, typical asset-securitization transactions are structured as true sales to minimize the risk of being characterized as secured loans to the operating company.

These warnings, and the inherent risk in relying on a 2-1 decision of the only circuit court to face the issue, should leave lawyers in sub-

stantial doubt as to whether a trust used as a special-purpose entity in a typical asset-securitization financing transaction will be ineligible for bankruptcy relief. In any event, lawyers should carefully consider the features of the particular transaction before speculating as to whether any trust is a "business trust" under the Bankruptcy Code.