# Independence Air

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independence air

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## Introduction

Part I of this paper deals primarily with ACA. This section focuses on ACA's business model and the company as a predecessor of Independence Air. Part II examines the transition from ACA to Independence Air and explores the challenges faced during the transition. Part III focalizes on Independence Air as a new and distinct entity. Finally, Part IV explores Independence Air's Chapter 11 filing and its ongoing aftermath.

## I. Before Independence Air

Before Independence Air was Independence Air, the company operated as a regional airline carrier primarily servicing United Airlines and Delta customers. The airline was Atlantic Coast Airlines ("ACA" or the "company") which was the primary subsidiary of Atlantic Coast Airlines Holdings, Inc., a Delaware corporation ("ACAI").[1] ACA had service contracts with both United Airlines and Delta which allowed ACA to use the flight designator codes for each airline.[2] Thus, ACA flights were designated as either a United Airline flight or a Delta flight in the major airline computer reservation systems. Therefore, ACA did not need a brand identity recognizable to the ordinary passenger because in essence they were an outsourced function of United Airlines and Delta. Although the company did not incur the full risk of an independent airline, the company was almost completely dependent upon the marketing of United Airlines and Delta. Therefore, if United Airlines or Delta suffered losses, so did ACA. Typically,

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[1] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 53 (2004).

[2] Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 37 (2003).

ACA recognized approximately 80% of its revenues from United Airlines regional flights and approximately 20% of its revenues from Delta regional flights.[3]

This was a profitable business for ACA which serviced 85 destinations in 30 states within the Eastern and Midwestern United States and Canada. In fact, ACA did quite well for over a decade. For instance, the company had significant net income from 1997 through 2001. In addition, the company had continual increases in total assets and retained earnings from 1997 through 2001. The company had:

| **Fiscal Year (in millions)** | (1997)[4] | (1998)[5] | (1999)[6] | (2000)[7] | (2001)[8] |
|---|---|---|---|---|---|
| **Operating Revenues** | $202,540 | $285,243 | $342,079 | $442,695 | $583,416 |
| **Operating Expenses** | $176,501 | $237,249 | $298,073 | $428,439 | $539,222 |
| **Operating Income** | $ 26,039 | $ 47,994 | $ 44,006 | $ 14,256 | $ 44,194 |
| **Net Income** | $ 14,500 | $ 30,412 | $ 28,268 | $ 15,155 | $ 34,322 |
| **Total Assets** | $148,992 | $227,626 | $293,753 | $382,700 | $452,425 |
| **Retained Earnings** | $ 11,403 | $ 41,815 | $ 70,083 | $ 85,238 | $119,560 |

Based on these reported earnings only, the company seemed to be a great investment. Even more impressive was the company's utilization of cash flows for years 1996 through 2001.

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[3] Atlantic Coast Airlines Holdings, Inc., 2001 Summary Annual Report 36 (2002); Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 38 (2003).

[4] Atlantic Coast Airlines Holdings, Inc., 1998 Summary Annual Report, Financial Statements 1-3 (1999).

[5] *Id.*

[6] Atlantic Coast Airlines Holdings, Inc., 1999 Summary Annual Report, Financial Statements 1-2 (2000).

[7] Atlantic Coast Airlines Holdings, Inc., 2000 Summary Annual Report 19-20 (2001).

[8] Atlantic Coast Airlines Holdings, Inc., 2001 Summary Annual Report 28-29 (2002).

| Fiscal Year (in millions) | (1997)[9] | (1998)[10] | (1999)[11] | (2000)[12] | (2001)[13] |
|---|---|---|---|---|---|
| Net Income | $ 14,500 | $ 30,412 | $ 28,268 | $ 15,155 | $ 34,322 |
| Net cash provided by/(used) in operating activities | $21,260 | $39,730 | $49,850 | $93,929 | $ 88,045 |
| Net cash provided by/(used) in investing activities | ($55,189) | ($39,737) | ($89,812) | ($43,841) | ($ 5,704) |
| Net cash provided by/(used) in financing activities | $51,626 | $25,252 | $15,227 | ($3,868) | $ 5,211 |

The company's cash flows show a steady increase of using cash provided by operating activities for investment activities while at the same time a steady decrease on the reliance of cash provided by financing activities. However, financial statements are only a reflection of past experience and do not adequately predict the future. Furthermore, ACA carried several risks which were not disclosed on its financial statements. Looking closer at its operations, ACA had contracts in several areas which carried significant risk. A closer look at these contracts helps illuminate ACA's change of business model and name to Independence Air. It also shows how one could easily predict Independence Air's bankruptcy.

**United Airlines/Delta Service Agreements**

ACA's relationship with United Airlines was defined in the United Express Agreements ("UA Agreements").[14] The UA Agreements allowed ACA to use United

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[9] Atlantic Coast Airlines Holdings, Inc., 1998 Summary Annual Report, Financial Statements 5-7 (1999).

[10] *Id.*

[11] Atlantic Coast Airlines Holdings, Inc., 1999 Summary Annual Report, Financial Statements 4-5 (2000).

[12] Atlantic Coast Airlines Holdings, Inc., 2000 Summary Annual Report 22 (2001).

[13] Atlantic Coast Airlines Holdings, Inc., 2001 Summary Annual Report 31 (2002).

[14] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 36 (2004).

Airlines' flight designator code "UA" for identification of ACA flights and fare in major airline computer reservation systems.[15] Further, the UA Agreements permitted ACA to utilize United Express logos, paint schemes used by United Express on the exterior of designated ACA aircraft, and uniforms similar to those of United Express employees.[16] Before 2000, the UA Agreements called for ACA to receive revenue on a prorated fare basis.[17] Thus, ACA received revenues from each flight based on flight capacity. However, in November 2002, the UA Agreements were restated so that ACA would recognize revenue on a fee-per departure basis.[18] Accordingly, ACA was obligated to maintain certain flight schedules and United Airlines was obligated to pay ACA an agreed upon price for each successful departure regardless of the number of passengers.

Therefore, ACA assumed the risk related to successful flight completion and United Airlines assumed the risks associated with flight scheduling, marketing, and sales.[19] The restated UA Agreements gave ACA authority to utilize 128 regional jets in the United Airlines regional operations. In addition, ACA received the following services from United Airlines without any additional cost:

> customer reservations, customer service, pricing, scheduling, revenue accounting, revenue management, frequent flyer administration, advertising, provision of ground support services at most of the airports served by both United [Airlines] and ACA, provision of ticket handling

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[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

> services at United [Airlines'] ticketing locations, and provision of airport signage at airports where both ACA and United [Airlines] operate.[20]

The UA Agreements allowed United Airlines to enter into additional agreements with other regional carriers to serve routes that were serviced by ACA; however, United Airlines had the option to terminate the UA Agreements if ACAI or ACA entered into similar type contracts with carriers other than Delta without United Airlines' prior written consent.[21] Furthermore, the UA Agreements limited ACAI and ACA's ability to merge with other entities or dispose of certain assets or certain aircraft without offering United Airlines a first right of refusal to acquire the company or asset.[22] In addition, the UA Agreement provided that United Airlines had the right to terminate the agreement if ACA or ACAI were to merge with, be acquired by, or become controlled by another airline.[23] In the event that ACA breaches certain provisions of the UA Agreement or fails to meet specified performance standards, then United Airlines had the right to assume ACA's ownership or leasehold interest in certain aircraft designated under the agreement.[24]

ACA had a similar contractual relationship with Delta as designated in the Delta Connection Agreement ("DL Agreement").[25] ACA and Delta entered into the ten year contract in 1999.[26] The DL Agreement provided that ACA was to operate certain flight schedules as designated by Delta and ACA was to receive an agreed fee for each hour of

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[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 37 (2003).

[26] *Id.*

flight service regardless of passenger load.[27] In addition, ACA was entitled to incentive pay for meeting optimal performance standards.[28] Therefore, ACA assumed the risks of performing the flight schedules while Delta assumed the risks associated with scheduling, marketing, and selling seats to passengers.[29] Because ACA was operating Delta Connection flights, ACA was allowed the use of Delta's flight designator code "DL" for identification of its fares and flights in global distribution systems, such as Delta's "Deltamatic" reservation system.[30] ACA also used Delta Connection logos, Delta paint schemes for the exterior of the related ACA aircraft, and uniforms similar to those of Delta employees for ACA personnel operating the outsourced Delta Connection flights.[31] In turn, Delta provided numerous support services to ACA free of charge, such as:

> Customer reservations, customer service, ground handling, station operations, a maintenance hangar facility in Cincinnati, pricing, scheduling, revenue accounting, revenue management, frequent flyer administration, advertising, and other passenger, aircraft and traffic servicing functions in connection with the ACA operation.[32]

Thus, ACA was truly an outsourced carrier function for Delta as part of Delta Connection Services. Without additional infrastructure, ACA could not independently compete with Delta for passenger revenues.

Except in the case that the UA Agreements were terminated, ACA was obligated to acquire Delta's approval if ACA elected to enter into a similar arrangement with any

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[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

other airline where ACA would be using that airline's fight designation codes or operating flights on behalf of that airline.[33] Further, ACA was obligated to offer Delta a first right of refusal on aircraft subject to the DL Agreement before ACA could dispose of those aircraft.[34] On the other hand, Delta was not restricted from entering into agreements with other airlines to service routes flown by ACA for Delta Connection.[35]

Finally, Delta had the option of terminating the DL Agreement with or without cause. The DL Agreement denoted certain performance standards which ACA's failure to meet would create cause for Delta's termination of the agreement.[36] Further, Delta had the option of extending or terminating the DL Agreement if, among other things, ACA were to merge or sell its assets to another entity or if ACA was acquired by another entity or if any person accumulated a certain percentage of ACA's stock.[37] However, Delta could also terminate the contract without cause provided that it gave ACA proper notice 180 days before such termination.[38] Nonetheless, if Delta were to terminate the DL Agreement without cause, then ACA had the right to require Delta to assume aircraft obligations for aircraft dedicated to the Delta Connection flights under the agreement.[39] In sum, the DL Agreement put significant constraints on ACA's operational decision making.

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[33] *Id.*

[34] *Id.* at 38.

[35] *Id.*

[36] *Id.* at 37.

[37] *Id.* at 38.

[38] *Id.* at 37.

[39] *Id.*

**Employee Union Contracts**

ACA had three major employee groups which were subject to collective bargaining agreements. The ACA pilots were represented by the Airline Pilots Association ("ALPA").[40] The ACA flight attendants were represented by the Association of Flight Attendants-Communication Workers of America ("AFA-CWA").[41] The ACA aviation maintenance technicians and ground service equipment mechanics were represented by the Aircraft Mechanics Fraternal Association ("AMFA").[42] At various times, other labor groups would seek to unionize other ACA employee groups but were unsuccessful. For instance, ACA was informed by the National Mediation Board that the Transportation Workers Union and the International Association of Machinists and Aerospace Workers attempted to organize ACA employees, but both of those organizations did not receive sufficient interest from ACA employees.[43]

Before ACA became Independence Air, ACA sought to amend each collective bargaining agreement. During 2003, ACA and its pilots, along with ALPA, agreed to revise its 2001 collective bargaining agreement.[44] The main goal of this revision was to establish pay rates and work-rules for pilots that were similar to low-fare independent carriers.[45] The revisions to the agreement were conditioned upon ACA achieving

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[40] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 57 (2004).

[41] *Id.*

[42] *Id.*

[43] *Id.* at 56-57.

[44] *Id.* at 56.

[45] *Id.*

"certain milestones in the implementation of Independence Air."[46] If these conditions were not met, then the 2001 collective bargaining terms would continue to be applicable.[47] During 2002, ACA's collective bargaining agreements with both AMFA and AFA-CWA became amendable; however, at the end of 2003 these contracts had yet to be fully negotiated or finalized.[48] In addition, ACA and the AMFA had agreed to mediation under the Railway Labor Act to facilitate the negotiation process.[49] For the duration of the negotiations and mediations, ACA was obligated to meet the wage rates and benefit terms designated under amendable collective bargaining agreements for its flight attendants, aviation maintenance technicians, and ground service equipment mechanics.[50]

**Aircraft Related Contracts**

As a regional air carrier, ACA entered into many purchase agreements and leases for aircraft as well as maintenance contracts for its aircraft. At the end of each fiscal year, ACA would have several aircraft on order or held options for the purchase of additional aircraft. For instance, ACA had the following firm orders:

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[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.* at 57.

| Fiscal Year | Vendor | Ordered | Optioned |
|---|---|---|---|
| (1998)[51] | Bombardier, Inc. | 29-RJs | 27-RJs |
| (1999)[52] | Bombardier, Inc. | 42-CRJs | 27-CRJs |
| | Fairchild Aerospace Corporation | 25-328JET | 85-328JET |
| (2000)[53] | Bombardier, Inc. | 58-CRJs | 80-CRJs |
| | Fairchild Aerospace Corporation | 48-328JET | 83-328JET |
| (2001)[54] | Bombardier, Inc. | 39-CRJs | 80-CRJs |
| | Fairchild Aerospace Corporation | 36-328JET | 81-328JET |
| (2002)[55] | Bombardier, Inc. | 47-CRJs | 80-CRJs |
| (2003)[56] | Bombardier, Inc. | 34-CRJs | 80-CRJs |

When ACA entered into such firm orders, it created an obligation for ACA to purchase and finance the ordered aircraft.[57] ACA generally financed aircraft purchases through "leverage lease structures involving investments by institutional or industrial investors who provide debt and equity capital to finance the Company's aircraft."[58] Thus, ACA

[51] Atlantic Coast Airlines Holdings, Inc., 1998 Summary Annual Report, Notes to the Consolidated Financial Statements 17 (1999).

[52] Atlantic Coast Airlines Holdings, Inc., 1999 Summary Annual Report, Notes to the Consolidated Financial Statements 17 (2000).

[53] Atlantic Coast Airlines Holdings, Inc., 2000 Summary Annual Report 39 (2001).

[54] Atlantic Coast Airlines Holdings, Inc., 2001 Summary Annual Report 50 (2002).

[55] Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 39 (2003).

[56] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 69 (2004).

[57] Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 57 (2003).

[58] *Id.* at 53.

would finance its aircraft purchases by borrowing funds collateralized by the aircraft. In addition, these institutional or industrial investors would typically take a 20% equity investment in the aircraft as part of the financing arrangement with ACA.[59]

Further, ACA executed long-term maintenance contracts with engine manufacturers and other service providers for repair and overhaul of its aircraft engines, avionic components, airframe and landing gear.[60] These contracts call for escalating rates for maintenance costs.[61] ACA experienced difficulties with its seven-year engine services agreement with GE Engine Services ("GE") which was entered into in 2000.[62] Basically, the escalating rate increases under the maintenance contract were based on projected hours flown; however, the actual flight hours of the aircraft were much lower than the estimates.[63] Thus, ACA was paying a higher rate for maintenance costs with GE as compared to the market rate with other service providers.

In 2002, Fairchild Dornier GmbH ("Fairchild") began formal insolvency proceedings in Germany.[64] ACA ordered and operated Fairchild aircraft.[65] When Fairchild entered into bankruptcy, the likelihood of ACA receiving its ordered aircraft decreased significantly even though ACA had already given Fairchild deposits of $1.2

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[59] *Id.*

[60] *Id.* at 42.

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 55 (2004).

[65] *Id.*

million for the undelivered aircraft.[66] ACA $1.2 million deposit became part of Fairchild's bankruptcy estate and most likely out of the reach of ACA.[67] Further, the reduced availability of spare parts and the reliance on third party service for the Fairchild aircraft caused unexpected increases in maintenance costs.[68] Moreover, the engines in the ACA-owned Fairchild aircraft were problematic and caused unscheduled maintenance events.[69]

These unscheduled maintenance events caused ACA to cancel some of its scheduled flights for Delta.[70] Under the DL Agreement, Delta could terminate the agreement based on cause if ACA failed to meet certain performance standards. In 2004, (after the launch of Independence Air) Delta terminated the DL Agreement with 180 days' notice and without cause.[71] Thus, ACA turned over all aircraft designated under the DL Agreement and Delta assumed all outstanding lease obligations for those aircraft.[72]

**Economic and Outside Impacts**

On September 11, 2001, the United States suffered a horrific terrorist attack where planes were purposely crashed into the World Trade Towers and the Pentagon. After the attack, U.S. flights were temporarily suspended for safety concerns. Several

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[66] *Id.* at 58.

[67] *Id.* at 89.

[68] *Id.* at 55.

[69] *Id.*

[70] *Id.*

[71] FLYi, Inc., 2004 Summary Annual Report 60 (2005).

[72] *Id.*

months after reopening U.S. airports, the airline industry experienced a significant reduction in ticket sales as compared to previous years.[73] In fact, the U.S. airline industry was reportedly less than robust before the attacks because of "rising debt ratios and falling returns on investment."[74] In 2002, airline passenger traffic remained below normal even with US airlines receiving government support.[75]

The slowing US economy is also to blame for lower passenger travel. Before the terrorist attacks, the US was experiencing a declining economy and many businesses began cutting back on business travel.[76] Furthermore, the increased reliance on media to facilitate long-distance communications also offered many business alternatives to airline travel.[77] Other reported effects of the downturn in passenger travel included the U.S. invasion of Iraq and the health epidemic SARS.[78] Even though ACA is just a regional carrier, its financial health was completely dependent upon United Airlines and Delta. As we have already discussed, ACA would lose its revenue stream from Delta.[79] However, the biggest impact on ACA's decision to become Independence Air would result from United Airlines bankruptcy.

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[73] *Americans slowly returning to fly*, by Mike Alhers posted on CNN, January 18, 2002.

[74] Economic Costs to the United States Stemming From the 9/11 Attacks, Strategic Insights, Volume I, Issue 6 (August 2002) by Robert Looney available at http://www.ccc.nps.navy.mil/si/aug02/homeland.asp.

[75] *Id.*

[76] Business Air Travel Losing Ground, by Kathleen Koch posted on CNN at March 25, 2002.

[77] *Id.*

[78] *Id.*

[79] It is very likely that Delta took the opportunity to terminate the DL Agreement and claim aircraft under the DL Agreement so that Delta could compete with Independence Air and effectively "squeeze" that competition out of the market.

## II. <u>Transition to Independence Air</u>

### United Airlines Bankruptcy

In December 2002, UAL, Inc. and its subsidiaries, including United Airlines, filed for Chapter 11 protection under the United States Bankruptcy Code.[80] At the first day of filing proceedings, United was granted permission to continue to honor the UA Agreements while in bankruptcy.[81] However, United was not under an obligation to do so.[82] Under the Bankruptcy Code, United had the right to assume or reject the UA Agreement since its status as an executory contract was not debated.[83] If United were to reject the UA Agreement, then ACA realized that it would lose approximately 80% of its revenue stream.[84] As of the date of the bankruptcy filing, United owed ACA approximately $8 million for unpaid pre-petition obligations resulting from United Express services.[85] After a year, United had still not assumed or rejected the UA Agreements.[86] It was clear that ACA needed a new game plan because its current business model was at the mercy of the Bankruptcy Court. ACA management reported

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[80] Micheline Maynard, *United and Atlantic Coast Agree to a Split*, N.Y. Times, April 6, 2004.

[81] Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 12 (2003).

[82] *Id.*

[83] 11 U.S.C. §365(a). The term "executory contract" is not defined in the Bankruptcy Code; however, many courts have accepted the "Countryman definition" which holds:

> [A] contract under which the obligation of both the bankrupt and the other party to the contract is so far clearly unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.

Countryman, *Executory Contracts in Bankruptcy: Part I.*, 57 MINN. L. REV. 439, 469 (1973).

[84] Atlantic Coast Airlines Holdings, Inc., 2001 Summary Annual Report 36 (2002); Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 38 (2003).

[85] Atlantic Coast Airline Holdings, Inc., 2002 Summary Annual Report 12 (2003).

[86] Atlantic Coast Airline Holdings, Inc., 2003 Summary Annual Report 11 (2004).

that they feared that United Airlines would use the bankruptcy process to terminate the UA Agreement and then force ACA to accept lower fees.[87] In 2004, ACA and United Airlines agreed to sever the UA Agreements subject to approval of the bankruptcy court.[88]

**Mesa Hostile Takeover Attempt**

Mesa Airlines ("Mesa") is a regional carrier which operates independently and under code sharing agreements with several major airlines, such as United and Delta. Currently, Mesa operates 182 airplanes within 165 cities in 45 states.[89] After United Airlines entered into bankruptcy but before the formal emergence of Independence Air, Mesa attempted a hostile takeover bid for ACA.[90] Mesa proposed to merge with ACA and to replace all existing board members of ACA.[91] In the meantime, Mesa had received a non-binding memorandum of understanding from United Airlines which stated that if Mesa's takeover of ACA were successful then United Airlines would use Mesa-owned ACA as its regional carrier.[92] United Airlines abandoned its agreement with Mesa five days after a federal judge issued an injunction against Mesa from continuing with its

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[87] Micheline Maynard, *United Ends Its Takeover Support for Mesa Air*, N.Y. Times, December 23, 2003, at C2.

[88] Micheline Maynard, *United and Atlantic Coast Agree to a Split*, N.Y. Times, April 6, 2004, at C2.

[89] Corporate Profile, http://phx.corporate-ir.net/phoenix.zhtml?c=78947&p=irol-irhome (last visited on April 9, 2006).

[90] Micheline Maynard, *U.S. Begins Investigation of Airlines*, N.Y. Times, December 19, 2003, at C1.

[91] Press Release, Mesa Air Group, *Mesa Air Group Proposes Atlantic Coast Board Slate Committed to Act in Shareholders' Interests; Intends to Commence Exchange Offer for ACA Shares,* (Oct. 14, 2003) at http://phx.corporate-ir.net/phoenix.zhtml?c=78947&p=irol-newsArticle&ID=458539&highlight= (last visited on April 9, 2006).

[92] Micheline Maynard, *United Ends Its Takeover Support for Mesa Air*, N.Y. Times, December 23, 2003, at C2.

hostile takeover bid for ACA and after the Justice Department opened an antitrust investigation concerning United Airlines' role in the unsolicited offer by Mesa for ACA.[93] Subsequently, ACA was contacted by the Justice Department regarding investigations against both United Airlines and Mesa for possible violations of Section 1 of the Sherman Act and Section 7 of the Clayton Act in connection with the hostile takeover bid.[94]

## III. Independence Air

### Independence Air Business Model

Obviously, ACA management could see that it was in a bind. ACA was almost completely dependent upon United Airlines for revenues.[95] United had entered bankruptcy in 2002 and continued to push back emergence from bankruptcy protection in 2003 because of significant losses totaling $2.3 billion despite deep cost-cutting and contract concessions.[96] One part of United Airlines emergence plan from bankruptcy involved settling disputes with ACA.[97] ACA and United Airlines had been negotiating the terms of the UA Agreements; however, ACA feared that United Airlines would use the bankruptcy process to force ACA into unprofitable contracts.[98] In July 2003, ACA

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[93] Micheline Maynard, *United Ends Its Takeover Support for Mesa Air*, N.Y. Times, December 23, 2003, at C2.

[94] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 73 (2004).

[95] Atlantic Coast Airlines Holdings, Inc., 2001 Summary Annual Report 36 (2002); Atlantic Coast Airlines Holdings, Inc., 2002 Summary Annual Report 38 (2003).

[96] Micheline Maynard, *United is Said to Push Bank Its Timetable on Chapter 11*, N.Y. Times, March 18, 2004, at C1.

[97] Micheline Maynard, United *Ends Its Takeover Support for Mesa Air*, N.Y. Times, December 23, 2003, at C2.

[98] *Id.*

announce its decision to organize as an independent low-fare airline operating under the name of Independence Air.[99]

Shortly thereafter, ACA would be subject to the hostile takeover attempt by Mesa as previously discussed.[100] In addition, United Airlines began a low-fare airline named "Ted" in February 2003.[101] Ted was scheduled to serve flights out of Washington Dulles International Airport ("Washington Dulles") by the end of 2004.[102] Interestingly, Washington Dulles was the only hub of Independence Air.[103] It seems clear that United Airlines was not happy with the prospect of competing with Independence Air. Nevertheless, ACA management took the gamble of beginning a new independent airline in what it admitted was "the worst possible time in history to begin a new airline."[104]

To begin with, the former ACAI renamed itself as FLYi, Inc., and changed the name of its primary subsidiary to Independence Air which served as the low-fare air carrier.[105] Operations under Independence Air began June 16, 2004 at its Washington Dulles hub.[106] Independence Air's strategy was to stimulate demand for air travel to and from its Washington Dulles hub and to provide "reliable and easy to use air transportation

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[99] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 6 (2004).

[100] Micheline Maynard, *United Ends Its Takeover Support for Mesa Air*, N.Y. Times, December 23, 2003, at C2.

[101] Micheline Maynard, *Player Named Ted Joins The Low-Fare Airlines*, N.Y. Times, December 21, 2003, at 5-3.

[102] *Id.*

[103] FLYi, Inc., 2004 Summary Annual Report 4 (2005).

[104] *Id.*

[105] *Id.*

[106] *Id.*

with excellent customer service...[by] achieving simplicity in operations, high employee and asset productivity and low overhead, [so as] to offer low[er] fares."[107] Simply put, Independence Air hoped to provide the lowest fares in the Washington Dulles market while still remaining profitable. The success of the company was precariously dependent upon its (1) implementation of new infrastructure; (2) ability to reduce costs; (3) actual market demand for air travel to and from Washington Dulles; (4) ability to compete with other airlines; (5) no changes or only favorable regulatory changes in the airline industry; and (6) ability to generate or obtain adequate cash flows.

First, Independence Air had to secure the appropriate infrastructure needed to operate an independent airline.[108] ACA had been a regional carrier operating for the benefit of United Airlines and Delta. As such, ACA had received services, free of charge, from both airlines. Now, Independence Air had to implement these structures and with very little lead time at that. For instance, Independence Air had to establish a brand and logo which would be recognizable to the traveling public.[109] It had to identify market demand for schedule times and route planning.[110] Furthermore, it had to coordinate means for passengers to book reservations, check flight information, and print boarding passes.[111]

Second, Independence Air had to identify expenses which it could reduce or eliminate. One of the primary ways Independence Air proposed to reduce costs was to

[107] *Id.*

[108] *Id.* at 10-11.

[109] *Id.*

[110] *Id.* at 11.

[111] *Id.*

maintain a high aircraft utilization rate.[112] Thus, the company would schedule flights to meet customer demand but also ensure the highest passenger load to reduce operational costs, such as employees, fuel, and maintenance on aircraft.[113] However, aircraft utilization rate includes many factors which an airline cannot control. For instance, aircraft utilization is reduced by air traffic and airport congestion, inclement weather, security requirements, crew availability, and unscheduled maintenance.[114] Further, Independence Air continued negotiations and mediations with employee unions AMFA and AFA-CWA to lower wages and benefits.[115] Independence noted the significance of its failure to reduce overall costs. In fact, the company reported:

> The economic downturn reduced demand for air travel and the success of low-fare carriers has resulted in increased emphasis in the airline industry on controlling and reducing expenses. In this environment, if we are unable to align our costs with our business plan or to control and reduce our costs in general, we may not be able to effectively compete against other regional carriers or low-fare carriers to maintain or expand our existing operations and carry out our business plan.[116]

Furthermore, Independence Air incurred new expenses related to infrastructure and new aircraft.[117] This would prove to put a significant strain on the company's cash flows.

Third, Independence Air put all of its beans in one hub. The airline was flying out of Washington Dulles only and servicing 50 other cities. The company reported that they had chosen Washington Dulles because it was the "fifth largest market in the United

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[112] *Id.* at 23.

[113] *Id.*

[114] *Id.*

[115] *Id.* at 25.

[116] *Id.*

[117] *Id.* at 11-22.

States… [for] local traffic" and that the Washington, D.C. region was rated as having households with the highest disposable income in the United States.[118] However, the company also admitted that its largest competitor at Washington Dulles was United Airlines operating its United Express operation for premium fare passengers.[119]

Fourth, Independence Air would have to compete with established airlines and with new low-fare carriers. As previously mentioned, United Airlines had already planned on launching a discount carrier named "Ted" from Washington Dulles.[120] Ironically, Ted's projected fares were 15% higher than fares charged by other low-fare carriers on the same routes.[121] Naturally, a huge hurdle to launching a new airline is winning customer trust. It can be assumed that many airline travelers want to see a new airline establish consistency and reliability before using that airline. Therefore, Independence Air would have to overcome initial customer hesitation which cannot always be compensated for by offering a lower fare.

Fifth, Independence Air had to assume that it would experience no detrimental regulatory changes and that it would continue to obtain adequate cash flows. Independence Air was subject to the Department of Transportation ("DOT") as well as the Federal Aviation Administration ("FAA"). Among many other duties, the DOT determines a carrier's fitness, willingness and capacity to provide air transportation. In addition, the DOT issued to ACA a certificate of public convenience and necessity which

[118] *Id.* at 10.

[119] *Id.*

[120] Micheline Maynard, *Player Named Ted Joins the Low-Fare Airlines*, N.Y. Times, at 5-3.

[121] *Id.*

authorizes the airline to conduct scheduled and charter air transportation.[122] The FAA comprehensively regulates air carriers' safety-associated activities. Any unfavorable changes in the DOT or FAA regulations could have crippled Independence Air's operations.

Finally, Independence Air would have to find a steady source of cash flows whether through revenues or investors. Because Independence Air ended its contractual obligations under the UA Agreement and the DL Agreement, it no longer had secure sources of revenues. Further, Independence Air was dependent upon outside equity and debt financing for purchasing new planes as previously discussed. All companies dependent upon cash flows and this business model are no different.

In sum, the choice to become Independence Air was the only real option for ACA management to retain control over the company's assets. If ACA were to enter into another contract with United Airlines, then most likely ACA would incur dwindling profit margins. Most companies want to maximize the value of their assets to reward management and owners. Certainly, ACA was no different, especially considering the exceptional capitalization of the company in the past and the company's generous profit sharing plan.[123] Undoubtedly, United Airlines wanted to cut out "the middle man." If United were able to control ACA assets, then United could experience higher profits by eliminating theses subsidies to ACA management and owners. More dramatically, if ACA were to merge with another company, like Mesa, then ACA management would

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[122] Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 15 (2004).

[123] "Profit sharing compensation, which is based on attainment of certain performance and financial goals, was approximately $6.3 million, $10.3 million, and $1.1 million in 2001, 2002 and 2003, respectively." Atlantic Coast Airlines Holdings, Inc., 2003 Summary Annual Report 67 (2004).

probably be completely replaced. Therefore, the safest bet for ACA management was to launch Independence Air even though to do so was launching an independent airline during "the worst possible time in history to begin a new airline."[124]

**Independence Air's Pre-Bankruptcy Financial Restructuring**

As Independence Air began operations, its available cash flows began to tighten due to the need for new infrastructure, the delayed payment of receivables due to the United Airlines bankruptcy, and significantly lower revenues. Independence Air sought to address its liquidity through financial restructuring. Much of this restructuring involved making amendments to purchase agreements with various airline manufacturers; however, Independence Air would also authorize and issue a significant amount of debt securities.

First, Independence Air amended its purchase agreement with Airbus's wholly owned affiliate AVSA S.A.R.L. ("AVSA") for the purchase of 16 Airbus A319 aircraft.[125] The amendment pushed back the delivery dates for these aircraft and in turn delayed pre-delivery payments required under the purchase agreement.[126] However, the terms of the amendment did not affect the delivery dates for aircraft which Independence Air had leased from AVSA.[127]

Second, Independence Air amended its purchase agreement with Bombardier in order to access approximately $38.8 million on deposit with Bombardier for aircraft

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[124] Flyi, Inc., 2004 Summary Annual Report, Letter to the Shareholders (2005).

[125] FLYi, Inc., 2004 Summary Annual Report 5 (2005).

[126] *Id.*

[127] *Id.*

purchase orders.[128] Under the amended agreement, Independence was allowed to apply the bulk of this accessed deposit amount to aircraft delivered in 2003 from an affiliate of Bombardier.[129] In addition, Independence Air sold four aircraft previously purchased from Bombardier, as well as an engine, which it owned free and clear of any liens.[130] Even after this amendment, Independence Air had approximately $3.4 million remaining on deposit with Bombardier for the future delivery of 34 aircraft.[131] Interestingly enough, Standard & Poor's reported in 2005 that Bombardier would reduce production of its aircraft suited for regional service because of an oversupply in the market.[132]

Third, Independence Air entered into a series of agreements with GE Commercial Aviation Services, Inc. and some of its affiliates (collectively, "GECAS") relating to the leveraged leases of several aircraft.[133] These agreements provided for lower rents and early termination of the leases so that outstanding accrued interest due on the agreements was reduced.[134] The early termination of these leases also lowered the costs of training, spare parts, and other services which were related to these leases.[135] The total savings related to these amendments was estimated to be $37.5 million.[136] These agreements

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[128] *Id.*

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] Betsy Snyder, *FLY INC.*, Standard & Poor's 2005 Defaults in Profile.

[133] *Id.*

[134] *Id.* at 6.

[135] *Id.*

[136] *Id.*

were subject to another "Milestone" agreement which gave GECAS the option to reject the amended terms if certain financial milestones were not meet.[137] Such milestones were measured by Independence Air's unrestricted cash balances and its earnings before interest, tax, depreciation, amortization, and aircraft rents as a percentage of passenger revenues.[138]

Fourth, Independence Air amended the operative leases of loan agreements for over 52 aircraft as of early 2005.[139] These agreements were restructured from semi-annual payments to monthly payments and deferred approximately a total of $70 million in rent or loan payments due in 2005, 2006, and 2007.[140] In consideration for the amendments to these operative lease and loan agreements, Independence Air, through its parent company Flyi, Inc., issued a total of 2,035,000 additional shares of FLYi common stock.[141]

Fifth, Independence Air entered into a series of agreements for the early termination of 21 leases for the 30 Jetstream 41 ("J41") turboprop aircraft.[142] These J41s were previously retired from Independence Air's fleet and were not being used in operations.[143] Independence Air entered a claim agreement with BAE Systems (Operations), Limited and its affiliates ("BAE") which had provided support to 10 lessors

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[137] *Id.*

[138] *Id.*

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.*

of the J41 aircraft.[144] This agreement provided that BAE would not pursue claims against Independence Air for the consideration of (1) a cash payment of $2 million; (2) the issuance of a $3.5 million promissory note bearing interest at 6.75%; (3) a $5 million non-interest bearing note convertible into one million shares of the FLYi common stock; and (4) and agreement by Independence Air to return to BAE all of the remaining J41 spare engines, parts and tooling.[145] Independence Air provided additional consideration to the other parties entering into these agreements.[146] This consideration included (1) cash payments of $3.5 million; (2) $2.6 million of interest bearing promissory notes; and (3) $20,952,113 million in non-interest bearing notes convertible into 3,619,127 shares of FLYi common stock.[147]

Sixth, Independence Air shed the 30 aircraft which were leased in connection with the DL Agreement.[148] As part of the termination of the DL Agreement, Independence Air could compel Delta to assume those leases.[149] In 2005, Independence Air delivered the 30 aircraft which were leased under the DL Agreement.[150] To compensate the lenders of the leasing arrangements for waiver of any future obligations or claims, Independence Air issued 1.5 million of FLYI common stock.[151]

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[144] *Id.* at 7.

[145] *Id.*

[146] *Id.*

[147] *Id.*

[148] *Id.*

[149] *Id.* at 8

[150] *Id.*

[151] *Id.*

Seventh, Independence Air entered into a $16.2 million term loan agreement with GECAS.[152] The loan was secured by spare engines and spare parts owned by Independence Air.[153] However, the outstanding loan amounts could not exceed the value of the collateral.[154] Independence Air could dispose of the collateral only to the extent that it became surplus to the normal operations.[155]

Finally, Independence Air sold $125 million of Convertible Senior Notes ("Notes").[156] The Notes have a conversion price of approximately $11.08 for FLYi, Inc. common stock, but are only convertible once the common stock reaches a price of $13.30.[157] The Notes were sold in February of 2004 and were to pay interest on a semi-annual basis.[158] However, by February of 2005, Independence Air had announced that it would not be making the second semi-annual payment on time.[159]

Despite the restructuring efforts, Independence Air's financial position plummeted. Independence Air offered numerous deals on fares.[160] However, the competition was brutal. Independence Air was a new carrier competing with legacy

[152] *Id.*

[153] *Id.*

[154] *Id.*

[155] *Id.*

[156] *Id.* at 74

[157] *Id.*

[158] *Id.*

[159] Press Release, FLYi, Inc. Announcement Regarding Interest Payment on Convertible Notes (Feb. 16, 2005) (at http://www.flyi.com/company/pressarchive/2005/feb/021605.aspx)(last visited on April 17, 2006).

[160] Press Room for Independence Air at http://www.flyi.com/company/pressarchive/default.aspx last visited on April 17, 2006.

carriers and new low-cost carriers which were trying to establish footholds in the market.[161] By July 2005, Independence Air realized that successful operations might not be a reality and began exploring other options.[162] In fact, Independence Air was actively seeking alternatives. In Independence Air's Notice of Hearing to Consider First Day Pleadings, it discloses:

> The Company initiated a solicitation process to identify and contact potential strategic and financial investors to provide an investment that would enable the Company to implement its business plan and reorganize as a going concern.
>
> The Company retained Miller Buckfire & Co., LLC ("Miller Buckfire") and ENA Advisors LLC to assist in these efforts and to negotiate with its aircraft and other creditor constituencies. The Company retained Sabre Inc. to assist in modeling various potential operational configurations.
>
> As part of the solicitation process, the Company and Miller Buckfire identified and contacted approximately 60 potential prospective strategic and financial investors. These parties were provided with publicly available information and a non-disclosure agreement ("NDA") to be executed by any party wanting to receive non-public information concerning the Company. Despite the challenging conditions in the airline industry, out of this group, 21 parties expressed interest in evaluating the Company's business and executed an NDA.
>
> Miller Buckfire and the Company provided the parties that executed an NDA with further detailed information on the Company's operations including, as applicable, alternative business plan scenarios. As of the Commencement Date, the Company and Miller Buckfire maintain a dialogue with select strategic and financial parties regarding a prospective investment in the Company.
>
> The Company recognized that cost reductions would make an investment in the Company more attractive by reducing the new capital funds necessary to fund the business plan. At the same time, the Company understood that there could be no assurance that an investor would come forward with a binding commitment and, therefore, that the cost

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[161] Lou Whiteman, *FLYi glides into Ch. 11*, The Daily Deal, November 8, 2005; Bloomberg News, *Independence Air to End Flights Thursday*, N.Y. Times, January 3, 2006, at C2.

[162] Debtor's Notice of Hearing to Consider First Day Pleadings at 21.

> reductions would, in any event, be essential to reduce the Company's cash burn in this difficult operating environment.[163]

So, after only one year of operations as a low-cost independent airline, Independence Air recognized that one of its most viable options would be to use the bankruptcy process to shed costs and liabilities.

## IV. <u>Independence Air Bankruptcy</u>

### Bankruptcy of Independence Air

On November 7, 2005, each of the Debtors (collectively "Debtor") filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code").[164] The Debtors are the following seven entities: FLYi, Inc.; Independence Air, Inc.; Atlantic Coast Jet, LLC; Atlantic Cost Academy, Inc.; IA Sub, Inc.; WaKeeney, Inc.; and Atlantic Coast Airlines, Inc.[165] The seven Debtors were assigned case numbers (collectively, the "Bankruptcy Case") and are currently being jointly administered under Case No. 05-20011.[166] Of the seven Debtors filing for voluntary relief under Chapter 11, "only two have material assets and liabilities- FLYi, Inc. (the parent company) and Independence Air, Inc. (the operating airline)."[167] The

[163] Debtor's Notice of Hearing to Consider First Day Pleadings at 21.

[164] Voluntary Petition for FLYi, Inc.; Voluntary Petition for Independence Air, Inc.; Voluntary Petition for Atlantic Coast Jet, LLC; Voluntary Petition for Atlantic Coast Academy, Inc.; Voluntary Petition for IA Sub, Inc.; Voluntary Petition for WaKeeney, Inc., Voluntary Petition for Atlantic Coast Airlines, Inc.

[165] Voluntary Petition for FLYi, Inc.; Voluntary Petition for Independence Air, Inc.; Voluntary Petition for Atlantic Coast Jet, LLC; Voluntary Petition for Atlantic Coast Academy, Inc.; Voluntary Petition for IA Sub, Inc.; Voluntary Petition for WaKeeney, Inc., Voluntary Petition for Atlantic Coast Airlines, Inc.

[166] Motion of the Debtors for an Order Directing the Joint Administration of Their Chapter 11 Cases; Order Directing Joint Administration of the Debtors' Chapter 11 Cases.

[167] Debtor's Notice of Hearing to Consider First Day Pleadings at 7.

Bankruptcy Case is currently pending before the Honorable Mary F. Walrath, Bankruptcy Judge, United States Bankruptcy Court ("Bankruptcy Court") District of Delaware.

From the onset of the Debtor's Bankruptcy Case, the Debtor contemplated a sale of substantially all of the Debtor's assets free of all liens and liabilities. The Debtor's plans and strategies for the Chapter 11 case were laid out as follows:[168]

> [T]he Company has adjusted its flight schedule so that it only needs to operate 30 CRJs. The Company's flight plan – the "30-12 Plan" – contemplates the continued operation of 30 CRJs and 12 A319s. The Company developed the 30-12 Plan with the assistance of its advisors, and believe[s] that this flight plan represents its optimal configuration utilizing both its fleet of CRJs and A319s. The 30-12 Plan is the plan for which the Company sought investment or strategic alternatives prior to eh Commencement Date and the Company intends to operate under its 30-12 Plan while it is actively seeking investors, strategic partners or purchasers during the chapter 11 cases.
>
> As described above, the Company has been engaged in a process to find investors, strategic partners or purchasers for several months. Based on its current cash position and projections, the Company has determined that the investment/auction process must be brought to conclusion, in the near term, in its chapter 11 cases. To do so, the Company intends to file a motion in the next few days for approval of processes that would implement a proper and orderly solicitation process for proposals for an investment in or strategic combination with the Company, the sale of the business as a going concern, or, if necessary, the sale of the individual assets.
>
> The Company intends to diligently and expeditiously continue this process in its chapter 11 cases, and intends to request that the Court provide an expedited hearing date to approve the procedures for soliciting proposals or bids. The Company believes that a prompt process will maximize the value of its estates and will reduce costs. In addition, promptly locating an investor or purchaser may enable the Company to more quickly undertake operational, contractual, or other changes that such investor or purchaser may require as a condition to investment or purchase. Furthermore, the Company believes that the costs of remaining in Chapter 11 will be sufficiently high that it will be in the best interest of its stakeholders [to efficiently] conclude the investment/auction process. Thus, the Company will propose a schedule

[168] Debtor's Notice of Hearing to Consider First Day Pleadings at 23-24.

> that contemplates the conclusion of this process, if successful, on or before January 5, 2006.

Clearly, Debtor did not intend to reorganize through the Chapter 11 process as a functioning independent airline. However, Independence Air continued to operate flights until January 5, 2006.[169] Therefore, the first month of the Debtor's Bankruptcy Case was filled with motions which allowed Independence Air to continue operations and pay outstanding obligations.[170]

The Debtor entered Chapter 11 with operating assets consisting primarily of its air fleet (i.e., A319 and CRJ aircrafts), related spare parts, inventory and other intangible assets.[171] In addition, the Debtor had non-operating assets of (a) $24 million in unrestricted cash; (b) $46.8 million in restricted cash; and (c) an estimated $1.07 billion claim against United Airlines pending before the United States Bankruptcy Court for the Northern District of Illinois.[172] The Debtor's $46.8 million in restricted cash consisted mostly of $20.2 million in cash securing reimbursement obligations to Wachovia Bank,

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[169] Press Release, Independence Air to Discontinue Operations at http://www.flyi.com/company/pressarchive/ 2006/jan/010206.aspx last visited on April 18, 2006.

[170] Motion of the Debtors for an Order (A) Approving the Continued Use of Their Cash Management System, Bank Accounts and Business Forms; (B) Granting Interim and Final Approval of Investment and Deposit Guidelines; (C) Authorizing Banks Participating in the Debtor's Cash Management System to Honor Certain Transfers and Charge Certain Fees and Other Amounts; and (D) Permitting Continued Intercompany Funding and Granting Administrative Expense Status to Postpetition Intercompany Claims. Motion of the Debtors for an Interim and Final Order (I) Prohibiting Utilities from Altering, Refusing, or Discontinuing Services to, and/or Discriminating Against, the Debtors, and (B) Establishing Procedures for (I)Determining Requests for Assurance of Payment, and (II) Modifying the Amount of Assurance of Payment That a Utility Demands as Adequate. Motion of the Debtors for an Order (I) Authorizing Them to (A) Pay Prepetition Employee Wages, Salaries, and Related Items; (B) Pay Prepetition Employee Business Expenses; (C) Pay Prepetition Contributions to, and Benefits Under, Employee Benefit Plans; (B) Pay Prepetition Administrative Costs; (E) Pay Certain Prepetition Severance and Honor Travel Privileges; and (F) Pay Severance and Honor Travel Privileges for Employees Terminated Postpetition; and (III) Granting Certain Related Relief.

[171] Debtor's Notice of Hearing to Consider First Day Pleadings at 12.

[172] *Id.*

N.A. pursuant to letters of credit issued by Wachovia for the Debtor and $26.5 million in cash resulting from VISA/Mastercard credit card charges processed by Independence for flights booked but not yet flown.[173]

The Debtor's liabilities can be separated into four major categorizes: (w) secured aircraft-related debt; (x) unsecured public debt, notes, and trade debt; (y) aircraft lease obligations; and (z) aircraft purchase commitments.[174] Under Section 1102(a)(1) of the Bankruptcy Code, the committee of unsecured creditors was formed with the following representatives: U.S. Bank National Association; Canadian Regional Aircraft Financed Transaction No. 1 Limited; Air Line Pilots Association; Association of Flight Attendants-CWA; Finova Capital Corporation; Trident Turboprop (Dublin) Limited; Avex Flight Support, Inc.[175] These entities make up four of the top ten unsecured creditors of the Debtor.[176]

So far throughout the bankruptcy, the Debtor's major actions have been to (1) limit trading in claims and equity securities of the Debtor to preserve the net operating losses ("NOL"); (2) reject certain aircraft leases or abandon certain aircraft and designate reclamation by the owners; and (3) sell substantial assets of the Debtor free and clear of any liens or liabilities. The first issue involves preservation of the Debtor's NOL. As stated previously, the Debtor expects to receive $1.07 billion in payment from United Airlines as part of the settlement of the Debtor's claims in the United Airlines

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[173] *Id.* at 13.

[174] Debtor's Notice of Hearing to Consider First Day Pleadings at 7.

[175] Appointment of Official Committee of Unsecured Creditors Filed by United States Trustee.

[176] Voluntary Petition for FLYi, Inc.; Voluntary Petition for Independence Air, Inc.; Voluntary Petition for Atlantic Coast Jet, LLC; Voluntary Petition for Atlantic Coast Academy, Inc.; Voluntary Petition for IA Sub, Inc.; Voluntary Petition for WaKeeney, Inc., Voluntary Petition for Atlantic Coast Airlines, Inc.

bankruptcy.[177] Because this payment might result in a large tax liability, the Debtor sought automatic stay protection under section 362 of the Bankruptcy Code to prevent any claim or equity securities trading which might negatively affect the ability to use the Debtor's NOLs to offset that income.[178] The Debtor's argument is that section 382 of the Internal Revenue Code will disallow a debtor in a Chapter 11 proceeding from utilizing NOLs if the effective change in ownership exceeds a certain percentage during a specific time period.[179] As the Debtor's interpret the statute, an effective change in ownership could occur if the Debtor were to distribute equity to claimholders.[180] Therefore, the Debtor requested that any trades in claims or equity securities should be subjected to the review of the Bankruptcy Court.[181] Several objections were made as to whether the Debtor needed the protection of the Bankruptcy Court as it relates to claims trading.[182] In the end, the Bankruptcy Court honored the Debtor's request to have notice and a review for certain claim and equity trades.[183]

Second, the Debtor sought their right to reject certain aircraft leases and return the aircraft to the proper owners under section 365 of the Bankruptcy Code.[184] The central

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[177] Debtor's Notice of Hearing to Consider First Day Pleadings at 12.

[178] Motion of the Debtor for Interim and Final Orders Authorizing Notification and Hearing Procedures for Trading in Claims and Equity Securities.

[179] *Id.*

[180] *Id.*

[181] *Id.*

[182] Transcript of Hearing Held on November 11, 2005.

[183] Interim Order Establishing Notice and Hearing Procedures for Trading in Equity Securities; Interim Order Establishing Notice and Hearing Procedures for Trading in Claims.

[184] Motion of the Debtors for Entry of an Order (I) Authorizing the Debtors to Conditionally Reject Certain Aircraft Leases and Conditionally Abandon Certain Owned Aircraft, and (II) Establishing Deadlines for Parties to Take Possession of Aircraft.

issue involved in the Debtor's rejection of these leases relates to the return provisions contained within the leases.[185] Basically, many of the planes were in bad condition. Some of the airplanes had been stripped of their engines and other airplanes had not been serviced so that they were safe for flight.[186] The aircraft leases had provisions which required the Debtor to return the aircraft.[187] Much debate evolved over whether that meant the aircraft had to be in flyable condition and exactly what flyable condition meant.[188] It was the Debtor's contention (1) that they could reject the aircraft leases under section 365 of the Bankruptcy Code or abandon aircraft under section 554 of the Bankruptcy Code and (2) that any breaches to the leases were pre-petition unsecured claims.[189] However, several objections were made to this argument stating that actually section 1110 of the Bankruptcy Code applied to five of the leases which requires that the Debtor return any rejected, leased aircraft in compliance with the lease terms.[190] This meant that the Debtor would have to reattach any removed engines from the leased aircraft or repair such aircraft so that the aircraft would be in flyable condition. The Bankruptcy Court was not swayed by the Debtor's interpretation and ordered that the

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[185] Transcript of Hearing Before Honorable Mary F. Walrath Held on November 22, 2005 at 9:30 AM.

[186] *Id.*

[187] *Id.*

[188] *Id.*

[189] *Id.*

[190] *Id.*

rejection and return of these five aircraft were to substantially comply with the return provisions contained within the leases.[191]

Finally, the Debtor sought to sell substantially all of its assets free and clear of all liens pursuant to section 363(f) of the Bankruptcy Code.[192] Section 363(f) of the Bankruptcy Code states:

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of any entity other than the estate, only if –
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Of course, there were objections. One of the most notable objections came from the Metropolitan Washington Airport ("MWA").[193] Basically, the Debtor had a significant lease with MWA because the Debtor had used the Washington Dulles Airport as its major hub. The majority of the Debtor's viable assets for purchase were assets used in connection with the leased facility. MWA objected because it stated that its lease with

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[191] *Compare* Order (I) Authorizing the Debtors to Reject Five CRJ Aircraft Leases, and (II) Establishing Deadlines for Parties to Take Possession of Aircraft *with* Order with Respect to 30 Assigned 328 Jets (I) Authorizing the Debtors to Conditionally Reject Certain Aircraft Leases and Conditionally Abandon Certain Owned Aircraft, and (III) Establishing Deadlines to take Possession of Aircraft. *See also* Transcript of Hearing Before Honorable Mary F. Walrath Held on November 22, 2005 at 9:30 AM.

[192] Notice of Motion of the Debtors for an Order Approving (I) the Selection of a Successful Investment Proposal in the Debtors' Business to (II) the (A) Sale of Substantially All or a Portion of the Debtors' Assets Free and Clear of Interests and (B) Assumption and Assignment of Contacts and Leases in Connection Therewith.

[193] Preliminary Objection and Response of Metropolitan Washington Airports Authority to Motion of the Debtors for an Order Approving (I) the Selection of a Successful Investment Proposal in the Debtors' Business or (II) the (A) Sale of Substantially All or a Portion of the Debtors' Assets Free and Clear of Interests and (B) Assumption and Assignment of Contracts and Leases in Connection Therewith.

the Debtor was not assignable without its consent and the sale included the assignment of the MWA lease.[194] Obviously, MWA would rather control the future occupants of its facilities as well as negotiate the terms of any new lease. The Bankruptcy Court agreed that MWA's lease was not assignable but the Debtor and MWA were able to negotiate the terms of the assignment, so that on February 1, 2006, the Bankruptcy Court approved the sale of a substantial portion of Debtor's assets to United Airlines.[195] Therefore, United Airlines got more than it had ever hoped for: a cherry-picked selection of Independence Air's assets without any of the liabilities and Independence Air's terminal and gate space at MWA for a mere $4.3 million.[196]

**Conclusion**

So what is the moral to this story? If you are a large enough airline and you need to cut costs, then instead of cutting your own costs, it can be much easier to put the squeeze on your outsourced functions. United Airlines tried to use its own bankruptcy process to get more favorable terms with ACA, but ACA would not buckle. United Airlines encouraged, whether officially or not, Mesa Air's hostile takeover of ACA. When these attempts to control ACA's assets did not work, United Airlines let the market destroy ACA which by this time had become Independence Air, because it was management's only hope of retaining control over the company. The market was a fierce competitor and destroyed Independence Air in relatively no time. But happily, United Airlines was there to pick up the pieces it wanted and at the price it wanted to pay. So,

[194] *Id.*

[195] Order Approving the Sale of the Washington Dulles Airport Use Agreement and Premises Lease and Related Equipment to United Air Lines, Inc. See also Transcript of Hearing Held on February 1, 2006, at 2:00 p.m.

[196] Lou Whiteman, *United Airlines buys Dulles gates*, The Daily Deal, January 30, 2006.

the moral of the story is: If you want to eliminate costs, take what you want and eliminate the rightful owner.