Ailing Airlines: Charting financial, operational, and legal courses to survival

David Buchler discusses the different schemes and plans available to help airlines in distress

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While there are a few notable exceptions, airlines generally are not profitable. The late Herb Kelleher, co-founder of Southwest Airlines, once joked: "If the Wright brothers were alive today, Wilbur would have to fire Orville to reduce costs." Exposed to numerous market and external forces, the industry struggles to secure financial longevity and sustainability, finding itself continually striving to manage change.

Not surprisingly, Covid-19 exacerbated the financial fragility of the aviation industry. The market is gradually recovering, but revenues from trading are expected to be insufficient to help battered balance sheets - IATA estimates that airline industry debt levels have increased by more than $220bn to over $650bn during the pandemic. This enormous burden is compounded by ongoing cost pressures, exacerbated by war in Europe, global inflation, higher interest rates, and a requirement to invest in a net zero future.

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Insolvency protections in the Cape Town Convention

Airline restructurings and technical insolvency processes became inevitable early in the pandemic and were soon underway, as carriers grounded their fleets, stopped operating flights and breached their debt and leasing obligations. Some turned to US Chapter 11 insolvency protection, while others addressed the issue in the UK, having entered into leasing and financing agreements governed by English law. Two routes have prevailed: a UK restructuring plan (**RP**) or a UK Scheme of Arrangement (**Scheme**), as refreshed and renewed in by section 26A of the Companies Act 2006. However, the issue for creditors is the impact of Cape Town Convention (**CTC**) insolvency protections in these proceedings. The CTC forms part of English law by The International Interests in Aircraft Equipment Regulations 2015 (CTC Regulations). It is intended to protect the proprietary interests of a lessor or a financier in the event of an airline insolvency.

In English law, the CTC provides that the commencement of insolvency proceedings will trigger a number of insolvency remedies, chiefly: the relevant lease or finance agreement cannot be modified without the consent of the relevant creditor; possession of an aircraft is given to the relevant creditor within 60 days of insolvency proceedings commencing, unless all defaults have been cured in that time by the insolvency office-holder. Moreover, until possession is taken, the insolvency office-holder must preserve the aircraft, maintaining it and its value in line with the provisions of the creditor's agreement.

The impact of restructuring proceedings and schemes

Do RPs and Schemes count as "insolvency proceedings" or "insolvency-related events" that trigger the CTC rules? Both permit the cram-down of dissenting minority creditors within a class of creditors that has otherwise approved the Scheme or RP. In addition, a RP also permits cross-class cram-down, with the result that the court can sanction an RP even where an entire class of creditors has voted against a plan.

These features of RPs and Schemes still contradict the CTC's key creditor remedy of not permitting modifications without creditor consent. Therefore, if an RP or a Scheme can be classed as an insolvency proceeding, then cram-down provisions become redundant and creditors under CTC will retain their ability to consent to any changes and not be required to accept a cram- down.

Guidance by the English courts

English courts have not ruled directly on this specific issue and guidance has been very limited. In the Virgin Atlantic case, all creditors with CTC interests agreed to the proposals, and therefore there was no cross-class cram-down provisions required nor CTC issues. The restructuring of Norwegian Air was carried out under the examinership of the laws in Ireland, and the restructuring plan was agreed, even though further steps were required to raise the necessary funds to implement the proposals.

Nonetheless, it has been argued that Schemes, which are administrative proceedings that can be used in both solvent and insolvent contexts, would *not* constitute an insolvency proceeding for the purposes of the CTC Regulations. In the case of

the *Gategroup* restructuring, Mr Justice Zacaroli suggested, *obiter*, that proceedings based upon general company law, not designed exclusively for insolvency scenarios, should not be considered as being based on laws relating to insolvency, so may not be considered an "administrative insolvency proceeding" for the purposes of the CTC Regulations.

Using the Malaysia Airlines Scheme as an example, all consents were received by the Scheme creditors and so the question whether that Scheme constituted an insolvency-related event for CTC rules did not need to be considered – and that in such as case creditors would not benefit from Cape Town insolvency remedies, including the right to consent to amendments on a bilateral basis. However, in 2021, the Malaysian High Court ruled that AirAsia X's Scheme of Arrangement was indeed an insolvency-related event for the purposes of CTC. Company law is similar in both countries and, while the ruling has no effect in England, it may be of future interest to an English court. In addition, the Aviation Working Group has submitted an expert opinion strongly advocating the inclusion of a Scheme, when entered into in an insolvency context, as an insolvency proceeding

By contrast, an RP – again with no direct ruling – appears more likely to be held to constitute an insolvency proceeding under CTC. The *Gategroup* decision also held that an RP falls within the bankruptcy exception in the Lugano Convention. This would position it within the definition of "insolvency proceedings" for CTC. One further key distinction between a Scheme and a RP is that, in order for a company to qualify for a RP, it must satisfy a threshold test showing it is encountering financial difficulties – reinforcing the definition of an "administrative insolvency proceeding" for CTC.

Most observers believe that, in time, an English court would find that both types of proceedings constitute insolvency proceedings for the purposes of the CTC Regulations. That would not, however, guarantee any Scheme or RP being sanctioned by the court.

Summary

Those are the prevalent technical and legal issues. The work of operational transformation to progress troubled airline and aviation businesses beyond restructurings and constructive insolvency proceedings – in tandem with resolving balance sheet issues and debt negotiations – is far broader and, in some ways tougher:

- New targets need to be set – realistic but erring on the high side, to break comfort zones;
- Remember there is no silver bullet and put everything on the table for questioning and making difficult choices – while always referencing airline customer experience;
- Explore new motivations for management and staff, matching new objectives with employee support and beginning to build a new culture;
- Question the business model – Southwest broke at least one of the moulds, and without the Southwest approach to yield management, easyJet would not have been formed; and
- Track all progress to a granular degree.

Airline and aviation companies will face tough and deeply rooted issues for at least the next five years and beyond. The sector needs all the operational, strategic, commercial and financial restructuring skills it can get its hands on – and it needs them working together at the same time towards a sustainable outcome. ■

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