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Airline Insolvencies - Where To Go Under Chapter 11

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The aviation industry has been one of the heaviest hit sectors by COVID-19. Although recovery has begun to be detected in the Asia Pacific region, especially in China and Europe, some commentators project that a full recovery will be at least three years away. It is reported that governments have provided more than 100 billion US dollars of support to airlines.

Avianca Holdings and certain of its subsidiaries and affiliates filed for Chapter 11 protection in the United States on 10 May 2020. As one of the oldest airline brands in the world, which consists of multiple airline units operating primarily in the Central and Northern part of Latin America, Avianca had been in fragile financial condition for years. Following a management and shareholder change in mid-2019, the airline had made tangible and meaningful progress to improve its financial position in the second half of 2019. It was on the path to recovery and had taken many positive steps in that direction. Unfortunately, the coronavirus crisis struck in early 2020, and suspended Avianca's recovery.

This article provides a brief introduction of Chapter 11 of the U.S. Bankruptcy Code, examining how it affects aircraft lease agreements, and provides a comparison between Chapter 11 and the English and PRC insolvency laws.

I. Chapter 11 Overview

Chapter 11 of the U.S. Bankruptcy Code generally allows debtors to operate their businesses under the supervision of the Bankruptcy Court during the proceeding, and permits them to either reorganize or liquidate as a going concern to maximize value. A successful Chapter 11 reorganization permits the debtor to restructure its debt, sell off selected assets, trim costs, discharge debts, and obtain new financing, while temporarily staying most pre-petition creditors.

A Chapter 11 case starts with a voluntary or involuntary filing of a petition in the U.S. Bankruptcy Court where the debtor has assets, does business, or is incorporated. If the petition is involuntary, the debtor has an opportunity to "answer" the petition by contesting its insolvency, or consenting to relief and proceeding with the Chapter 11 case. The petition may be voluntary or involuntary. A voluntary petition is filed by the debtor. An involuntary petition is filed by unsecured creditors that meet certain requirements proscribed by the Bankruptcy Code.

Once a debtor has filed a Chapter 11 case, or consented to relief in an involuntary case, an order for relief is deemed to be entered, and the debtor is generally permitted to operate under its own management, commonly referred to as a "debtor in possession". A debtor in possession maintains control of its business operations and is tasked with reorganizing the debtor's financial affairs, examining claims and possible assets, interfacing with any committees appointed by the court, such as the creditor's committee, objecting to claims, accounting for assets, filing monthly operating reports, developing a disclosure statement and plan, and confirming a plan. Upon approval of the court, a debtor may employ professionals such as attorneys, accountants, investment bankers, and

other professionals to assist in the case. Such professionals, including the professionals of any official committee, are paid by the debtor's estate as approved by the court.

Once a petition is filed, an automatic statutory stay of most actions against the debtor and its assets is in effect. Consequently, creditors, with limited statutory exceptions, may not pursue existing or new collection activities unless the court issues a modification to the stay after notice and a hearing. This provides an opportunity for debtors to prepare a plan as to all pre-petition creditors without a need to litigate on multiple fronts.

Except where the Bankruptcy Court extends the "exclusive period", debtors have the exclusive right to propose a plan, which may provide for a reorganization or a liquidation, for 120 days from entry of the order for relief, and 180 days from entry of the order for relief, to confirm the plan. These exclusive periods are often extended by the court after notice and a hearing for cause. Plans must designate classes of creditors and interests, and provide for the treatment of such classes. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to statutory priorities, general unsecured creditors, and equity holders. The plan, subject to certain rules, may modify the amounts and terms for repayment of the creditors. As with other types of bankruptcy proceedings, repayment amounts are often lower than the original debt amounts. To be confirmed, a plan must be voted for by impaired creditors with at least two-thirds in dollar amount in favour and at least on-half in number in favour, and approved by the court. If a plan is not so approved by impaired creditors, a debtor may seek to confirm a plan as a "cram down" plan, in which case, the debtor must prove, *inter alia*, that creditors are receiving at least what they would receive in a liquidation, that it is fair and equitable, and at least one class of impaired creditors subordinate to an objecting class is voting in favour of the plan.

Generally, confirmation of a reorganization plan (not a liquidating plan) discharges a debtor from most pre-petition debts, except certain statutorily exempt claims. After the plan is confirmed, the debtor is required to make distributions in accordance with the plan. Essentially, the confirmed plan creates new contractual rights, replacing the pre-bankruptcy contracts.

If the debtor's plan is not approved, the court can either convert the case to a Chapter 7 liquidation, where an independent trustee takes control of the debtor and its assets, and liquidates all assets and distributes the proceeds in accordance with a statutory scheme, or permit creditors to propose a plan, or simply dismiss the case.

How Chapter 11 affects aircraft lease and financing agreements

Section 1110 of the Bankruptcy Code creates an important decision point for airlines 60 days after they file a voluntary Chapter 11 petition. Essentially, they must cure any defaults under leases or security agreements concerning aircraft, aircraft engines and aircraft spare parts, and obtain court approval of the Bankruptcy Court for all such cures. Otherwise, the lessor or secured party may exercise its rights to take possession of such items after 60 days, and the debtor must immediately surrender the items to the lessor or secured party.

More specifically, for the automatic stay to continue for more than 60 days after an order for relief is entered in a U.S. bankruptcy of an air carrier with an operating certificate for aircraft capable of carrying 10 or more individuals, or 6,000 pounds or more of cargo, as to, *inter alia*, aircraft, aircraft engines, propellers, appliances, or spare parts sold or leased to such an air carrier, the air carrier must: (a) subject to approval of the court (an "approval order"), agree to perform all obligations of the debtor under the security agreement or lease before the date that is 60 days after the order for relief, and (b) any default under the security agreement or lease that occurs before the date of the approval order must be cured before the 60-day period expires and any default that occurs after the date of the approval order and before the expiration of the 60-day period must be cured before the later of 30 days after the default or the expiration of the 60-day period. Moreover, any default under such a security agreement or lease that occurs after the 60-day period, must be cured in accordance with the relevant agreement, if a cure is permitted under such agreement. Upon a failure of an air carrier debtor to comply with these provisions, the debtor must immediately surrender the aircraft, aircraft engines, propellers, appliances, and/or spare parts to the lessor or secured party.

Application of Automatic Stay Effect

The previously mentioned automatic stay no longer protects an air carrier debtor that fails to comply with the 60-day, and other, provisions of Section 1011 of the Bankruptcy Code. Therefore, an airline debtor will need to have the financial ability to cure any defaults under any leases or security agreements concerning its aircraft, aircraft engines, propellers, appliances, or spare parts within the first 60-days of its chapter 11 case, at least as to any such items that it needs to operate. Otherwise, it will lose possession of any aircraft, aircraft engines, propellers, appliances, or spare parts that it owns or leases.

The goal of filing for Chapter 11 bankruptcy protection is usually to restructure the debtor's finances, sell off or abandon any unwanted assets, and to emerge with an stronger balance sheet and become profitable. For airlines, a significant part of any restructuring is accelerated by the 60-day rules of Section 1011. For example, in Avianca's chapter 11, it will close its Peru division, and scale back fleets elsewhere. Fourteen aircraft were listed as surplus, namely one B787-8, two A330-300s, two A321s, seven A320s, and two A319s within the 60-day period.
For affected lessors, they may have an incentive to work with the airline lessee/borrowers and consider compromises as the 60-day deadline approaches to keep their aircraft or parts operating and cash flowing, unless the aircraft are commercially marketable.

II. Primary Difference in Chapter 11 and PRC Bankruptcy Restructuring

In China, bankruptcy procedures include restructuring, settlement and liquidation. For purposes of this article, bankruptcy restructuring is to be discussed and negotiated. Bankruptcy restructuring refers to the reorganization of the business of a company that may already be in a bankruptcy but has the value of maintenance and hope of regeneration through the application of interested parties, with the presidency of the court and the participation of interested parties and debt adjustments to help debtors discharge financial distress and restore their business capacity.

Generally, a PRC bankruptcy restructuring has a number of similarities to U.S. Chapter 11 cases, both are focused on the recovery and profitability. Also, once the PRC court accepts the restructuring petition, the exercise of a security interest is suspended, the preservation measures taken against the debtor's property shall be lifted, and the execution procedure shall be stayed.

However, there are some notable differences between these two regimes, including:

i. Who can file for restructuring?
Under PRC law, the investor(s) in the business are entitled to apply for restructuring during a bankruptcy liquidation procedure and thus convert the case from liquidation into restructuring. While both the debtor and any creditor can file a restructuring petition in the court, if a creditor petitions for liquidation of the debtor, the debtor or an investor whose capital contribution accounts for 10% or more of the debtor's registered capital may file a restructuring petition; however, only creditor or debtor could file for Chapter 11 protection.

ii. Will an administrator/trustee be appointed?
Upon the PRC law bankruptcy petition being accepted by the court, an administrator will be appointed by the court, who will normally take charge of the property and the operation of the debtor. If a restructuring petition is filed and further accepted, the debtor may apply to the court and subject to the court's approval, the debtor may resume management of its property and business matters under the supervision of the administrator. Under a U.S. Chapter 11 case, however, the appointment or election of a trustee (a similar role of PRC bankruptcy administrator) occurs only in a small number of cases. Generally, the debtor in possession operates the business of a Chapter 11 debtor and oversees the operations of the debtor's business, unless a party makes a motion for the appointment of a trustee or to convert the case to a Chapter 7 liquidation case[1]

[1] The U.S. bankruptcy court, on motion by a creditor or party in interest, or the U.S. trustee, and after notice and hearing, may appoint a trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement.

iii. Who can draft the plan of restructuring/reorganization?

The PRC restructuring administrator (or the debtor in possession of the business in a U.S. Chapter 11 case) shall submit a draft restructuring plan to the court and creditors within six months after the restructuring petition being accepted by the court, which could be extended to nine months by the court. If the administrator or the debtor (as the case may be) fails to submit the draft plan within the specified period, the court will directly rule to terminate restructuring and declare the debtor bankrupt and entering into liquidation.

Under Chapter 11, as stated above, a debtor in possession has an exclusive period to file and solicit confirmation of a plan for 120 days and 180 days, respectively. If this exclusive period, or any extensions thereof by the court after notice and a hearing, expire, or is terminated by the court for cause shown, any creditor or party in interest may file a plan. Such a creditor plan may compete with a plan filed by the debtor.

iv. How could the plan of restructuring/reorganization be accepted and confirmed?

Similar to a Chapter 11 reorganization plan, a PRC restructuring plan shall also be adopted by the creditors and confirmed by the court. A PRC restructuring plan will designate classes of claims and the claim holders/creditors will be classified accordingly. Each class of creditors shall vote on the draft plan separately. Also, if more than one class (but not all) of the creditors vote to object, the plan can still be confirmed by the court as long as certain requirements are met. However, the PRC restructuring allows the debtor or administrator (as the case may be) to hold consultation with the disapproving class, and to hold a second vote thereafter.