SheppardMullin

Cross-border Airline Insolvencies: Will the Cape Town Convention's Alternative A Limit the Automatic Stay in a Foreign Airline Chapter 11[1]

By:
Edward H. Tillinghast III and Nicholas Dugdale, SheppardMullin

Section 1110 of the United States Bankruptcy Code (the "Code") provides eligible secured creditors and lessors with special remedies in Chapter 11 airline cases, including relief from the automatic stay to repossess aircraft if the debtor does not agree to perform its obligations and cure any defaults under the lease or security agreement within 60 days. However, Section 1110's limitations on the automatic stay only apply to airline debtors that are FAA-certificated United States air carriers, *i.e*., not foreign airlines that file a Chapter 11 case in the United States.

The importance of this limitation is highlighted by the potential desirability of Chapter 11 proceedings for foreign airlines located in less debtor/restructuring-friendly jurisdictions, and the rise in airline bankruptcies due to the COVID-19 pandemic. However, in certain circumstances, this limitation regarding Section 1110's protections for aircraft financers and lessors can be filled by Alternative A under the Protocol to the Cape Town Convention on International Interests in Mobile Equipment (the "CTC"). Alternative A of the CTC is similar to Section 1110 in that it provides secured creditors and lessors of aircraft a right to repossess their collateral after a specified waiting period, but unlike Section 1110, it is not restricted to only United States airlines. Specifically, if a non-United States airline whose "principal insolvency jurisdiction" (the "PIJ") is in a country that has declared Alternative A were to file for Chapter 11 protection in the United States (which is a CTC contracting state), it is possible that a secured creditor/lessor could demand the return of their aircraft collateral following the expiration of the PIJ's declared waiting period if the airline does not perform its obligations and cure any defaults, thereby modifying any automatic stay imposed by the Code. However, a creditor seeking to utilize Alternative A in this manner may have to persuade the United States Bankruptcy Court that its repossession rights should not be limited by the automatic stay, on the basis that the forum in which the insolvency case is pending is required under the CTC to recognize and defer to a debtor's PIJ's adoption of Alternative A.

Section 1110 of the Code

Section 1110 of the Code was designed by Congress to provide aircraft financiers and lessors with certain unique remedies in the event an airline files a Chapter 11 case, which were seen as necessary due to the importance of airlines to the United States economy, the significant costs involved in aircraft financing, and the high incidence of United States airline bankruptcies. Most significantly, Section 1110 creates an exemption to the automatic stay that is ordinarily imposed under Section 362(a) of the Code upon the filing of a Chapter 11 case, which, *inter alia*, prevents a secured creditor or lessor from repossessing its equipment without first obtaining judicial relief. Instead, Section 1110 provides a secured party or lessor of an aircraft, aircraft engine, propeller, appliance, or spare part the right, within 60 days of the filing of a debtor's petition, to force the debtor to either (a) cure all defaults and agree to perform

[1]By Edward H. Tillinghast, III and Nicholas Dugdale, who are a partner and an associate, respectively, in Sheppard Mullin Richter & Hampton LLP's Finance and Bankruptcy Group.

all of its obligations under the financing documents, or (b) if a debtor fails to cure its defaults and agree to perform its obligations, "take possession [of the collateral] . . . and to enforce any of its other rights and remedies" without limitation by any other provision of the Code or power of the court, including the automatic stay.[2] The result is that, unless an airline debtor cures all defaults and agrees to perform its obligations within the 60-day waiting period, an eligible creditor may demand the immediate return of an aircraft, saving considerable time and expense. However, while Section 1110 can be an extremely valuable tool for aircraft financiers, there is one key caveat: Section 1110 is only applicable to debtors holding an air carrier operating certificate issued pursuant to chapter 447 of title 49 for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo at the time of the financing transaction.[3] In effect, Section 1110 only applies to United States certificated air carriers, and not to foreign airlines that might seek Chapter 11 protection.

Alternative A of the CTC

Under the CTC and the associated Protocol to the Convention on Matters Specific to Aircraft Equipment (the "Protocol"), contracting states to the CTC can elect to establish a special insolvency regime (either Alternative A or Alternative B) to govern creditors' rights in relation to aircraft objects that is closely based on Section 1110(b). Under Alternative A, the debtor, no later than the earlier of (a) the end of a specified waiting period (usually, 30 or 60 days) or (b) the date on which the creditor would be entitled to possession if the CTC and Protocol did not apply, is required to either (i) give possession of the aircraft object to the creditor under the security agreement, title reservation agreement or lease or (ii) cure all defaults other than a default constituted solely by the insolvency proceedings, and agree to perform all future obligations under the agreement. The waiting period begins on the date the insolvency proceedings are commenced, and does not require any notice or demand.

For the CTC's insolvency regime to apply, a contracting state must declare pursuant to Article XXX(3) of the Protocol that it will apply Alternative A or Alternative B[4] of Article XI of the Protocol, which will then apply to the types of insolvency proceedings specified by the contracting state in its declaration, and must specify the duration of the waiting period.[5] A contracting state may also decide to make no such declaration, in which case neither Alternative will be applicable and the existing domestic insolvency regime in that jurisdiction will govern.

Article XI of the Protocol only applies to insolvency proceedings (i) where a contracting state that is the debtor's PIJ has made the applicable declaration, and (ii) there has been an "insolvency-related event".[6] Once an insolvency-related event has occurred**,** in any proceeding that occurs in a contracting

[2] 11 U.S.C. §1110(a)(3)(i) (1999).
[3] 11 U.S.C. §1110(a)(3)(i) (1999).
[4] Mexico is currently the only contracting state to have declared that it will apply Alternative B, so this article focuses on Alternative A.
[5] Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Mobile Equipment, art. XXX(3), Nov. 16, 2001, UNIDROIT. Under Article XXX(3) of the Protocol, a contracting state electing to apply Alternative A or B must apply the entirety of that Alternative. *Id*.
[6] Protocol, *supra* note 5, at art. XI(1). ROY GOODE, OFFICIAL COMMENTARY ON THE CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND THE PROTOCOL THERETO ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT, Part 5.15, 4th ed., 2019. An "insolvency-related event" under the Protocol includes not only actual insolvency proceedings, but also a situation in which (i) there has been a declared intention to suspend or actual suspension of payments by the debtor and (ii) the creditor's right to institute insolvency proceedings against the debtor or to take remedies under the CTC has been prevented or suspended by law or state action. Protocol, *supra* note 5, at art. I(2)(m).

state, "the forum shall apply Article XI in conformity with the Article XXX(3) declaration made by the debtor's PIJ [contracting state]."[7] The foregoing applies whether or not any insolvency proceedings have been commenced in the debtor's PIJ.[8]

A debtor's PIJ is defined under Article I(2) of the Protocol as "the Contracting State in which the center of the debtor's main interests [("COMI")] is situated, which is presumed to be the debtor's statutory seat (or, if none, the place where the debtor is incorporated or formed) unless proved otherwise." According to the Second Annotation to Professor Sir Roy Goode's Official Commentary to the CTC (the "Second Annotation"), the presumption that a debtor's COMI is situated in its statutory seat (or, if none, place where the debtor is incorporated or formed) may not be displaced lightly, and the party asserting a different location has a substantial burden of proof.[9] The test to override this presumption is "whether a different state is visible to creditors in doing business with the debtor as the main state in and from which the ordinary course activities and decision-making relating to the debtor's overall business and operations with respect to aircraft objects are conducted."[10] The primary factors in determining that a debtor's COMI differs from its statutory seat (or, if none, place where the debtor is incorporated or formed) are that:

> (a) the debtor's management team with whom the creditors conduct business in relation to its aircraft objects is situated in a state that is different from its statutory seat;
> (b) the debtor's primary base of operations for, and where decisions relating to, its aircraft objects is located in a state that is different from its statutory seat; and
> (c) the debtor derives its authority to operate its aircraft objects, and/or authority to operate its aircraft objects on particular routes, from a state that is different from its statutory seat.[11]

Professor Sir Roy Goode's Official Commentary to the CTC (the "Commentary"), which is the definitive guides to the CTC and its Protocols, notes that the text of the definition of PIJ was derived from the COMI concept under the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"). However, as the Second Annotation explains, whereas under the Model Law the purpose of the COMI determination is to select a state's insolvency court as the forum for the debtor's main insolvency proceeding, under the CTC the purpose of determining a debtor's PIJ is "to determine in any proceeding, regardless of which Contracting State is the venue, which Contracting State's declaration under Article XXX(3) applies to the international interests created by the debtor, such Contracting State being the debtor's PIJ."[12]

United States Bankruptcies and the CTC

If an airline debtor with its PIJ in a CTC contracting state outside the United States that has declared Alternative A, were to file a Chapter 11 case in the United States, the effectiveness of the

---

[7] Second Annotation to Professor Sir Roy Goode's Official Commentary, Fourth Edition (UNIDROIT, 2019), Cape Town Convention Academic Project, July 13, 2020, at 1.

[8] *Id. See also* Protocol, *supra* note 5, at art. XXX(4), which provides that "The courts of Contracting States shall apply Article XI in conformity with the declaration made by the Contracting State which is the primary insolvency jurisdiction."

[9] Second Annotation, *supra* note 7, at 2.

[10] *Id*.

[11] *Id*.

[12] *Id*.

automatic stay could be modified by a secured creditor or lessor asserting its right to repossess the aircraft under Alternative A, but this issue has not been adjudicated by a court.

The United States adopted the CTC and the Protocol on October 28, 2004, and the United States Congress adopted amendments to the Transportation Code (49 U.S.C., subtit. VII, pt. A) and FAA Regulations (14 C.F.R. §§ 1, *et seq*.) to implement the CTC. As a contracting state to the CTC, the United States courts should apply Article XI of the Protocol in conformity with the Article XXX(3) declaration made by the debtor's PIJ – for example, Alternative A with a 30-day or a 60- day waiting period. Under the Supremacy Clause the United States Constitution, treaties entered into by the United States are considered the supreme law of the land, as are federal laws. Where there is a conflict between a treaty and a federal statute, the most recent or more specific one should control.[13] Further, Section 1503 of the Code provides: "To the extent that this chapter [Chapter 15] conflicts with an obligation of the United States arising out of any treaty or other form of agreement to which it is a party with one or more other countries, the requirements of the treaty or agreement prevail." To date, the issue of whether a United States court would apply Alternative A in such a situation remains open. [14]

Therefore, the special remedies and stay limitation provided to secured creditors and lessors of aircraft by Alternative A of the Protocol may apply to a foreign airline that files a Chapter 11 case in the United States if its PIJ has adopted Alternative A.

---

[13] The exception to this is if a treaty is non-self-executing, which is an issue that is beyond the scope of this article. *See, e.g*., Frederic L. Kirgis*, International Agreements and U.S. Law*, AMERICAN SOCIETY FOR INTERNATIONAL LAW INSIGHTS, May 27, 1997, at 2:5.

[14] Although a United States court has not ruled on the applicability of the CTC in such a case, the recent Chapter 15 proceeding involving Oceanair Linhas Aéreas S.A. d/b/a Avianca Brazil ("Avianca"), *In re* Oceanair Linhas Aéreas S/A, No. 18-14182 (S.D.N.Y., filed January 15, 2019), may be instructive. Avianca is a Brazilian headquartered airline (Brazil is a CTC contracting state that declared Alternative A with a 30-day waiting period), and filed for judicial reorganization in the Brazilian Bankruptcy Court in December 2018. After initially granting emergency relief to indefinitely stay actions filed by several lessors seeking to repossess aircraft, the Brazilian Court prohibited the lessors from exercising their rights under the CTC and under their lease agreements until the expiration of the 30-day waiting period. During this 30-day waiting period, Avianca also filed a Chapter 15 in the United States, where it requested that the court impose the automatic stay as to Avianca's property within the territorial jurisdiction of the United States. Debtor's Verified Petition of Foreign Representative for Recognition of Foreign Main Proceeding and Motion for Order Granting Relief Pursuant to Code Sections 1515, 1517, 1520 and 1521, *In re* Oceanair Linhas Aéreas S/A (No. 40). The United States Bankruptcy Court entered a provisional order granting provisional recognition and imposing a stay within the territorial jurisdiction of the United States beyond the expiration date of the 30-day waiting period specified by the Brazilian court pending the recognition hearing. Order Granting Motion of Foreign Representative for Provisional Relief, *In re* Oceanair Linhas Aéreas S/A (No. 24). Despite the lessors' objections, the court declined to modify the provisional order and agreed with the foreign representative, who argued that the purpose of Chapter 15 is for the United States court, acting in its ancillary capacity, to aid the foreign insolvency proceeding, rather than second guess the Brazilian court or impose a contrary rule that might undermine Avianca's ongoing restructuring efforts in Brazil**.** Foreign Representative's Reply in Support of Verified Petition for Recognition of Foreign Main Proceeding and Motion for Order Granting Related Relief, *In re* Oceanair Linhas Aéreas S/A (No. 47). The United States Bankruptcy Court further declined to interfere with the Brazilian stay when the Brazilian Court later extended its stay beyond the 30-day waiting period established by Brazil's adoption of Alternative A. Order Granting Recognition of Foreign Main Proceeding and Discretionary Related Relief, *In re* Oceanair Linhas Aéreas S/A (No. 47-2). Thus, it remains unclear whether a United States court would apply a debtor's PIJ's Alternative A declaration in accordance with the CTC in a Chapter 11 proceeding where it is presiding over the main, or only, insolvency case, rather than merely an ancillary proceeding as in the Avianca case.