HERBERT SMITH FREEHILLS

GOVERNANCE: CORPORATE INSOLVENCY AND GOVERNANCE ACT 2020: IMPACT ON AIRLINE INSOLVENCY (UK)

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Legal Briefings

In July 2019, we published a briefing on the recommendations proposed by the Airline Insolvency Review's final report,[1] which was commissioned by the UK Government to assess the existing protections available to passengers in the event of a future airline insolvency and make recommendations to ensure taxpayers no longer foot the repatriation bill.

Just over twelve months on, the insolvency landscape has changed significantly with the enactment of the Corporate Insolvency and Governance Act 2020 (the "**Act**"), which received royal assent on 25 June 2020 and came into force the day after.[2] The Act was introduced on an expedited basis in response to the ongoing Covid-19 crisis and contains the most far-reaching reforms to UK insolvency law in over 30 years.

Whilst the reforms introduced by the Act are likely to impact all companies across all sectors, in this briefing we analyse the potential impact of the Act on UK airline insolvency. In particular, we note that whilst the new moratorium introduced by the Act may appear to change the usual position that UK airlines will immediately cease to fly in an insolvency proceeding, there are still numerous challenges associated with the moratorium which may make it less suitable to facilitate airline restructurings.

OVERVIEW OF THE ACT

In summary, the Act contains the following permanent reforms:

1. **New moratorium**: A new free-standing moratorium is available to eligible companies which are, or are likely to become, unable to pay their debts. The moratorium is effective for a period of up to 40 business days without court or creditor approval (and is subject to further extension with court or creditor consent), during which: (i) a payment holiday will apply to all pre-moratorium debts with certain exceptions (notably liabilities to financiers and employees) and (ii) there is a prohibition on legal proceedings being taken against the company, including enforcement of security (other than financial collateral). Significantly, the moratorium is a "debtor-in-possession" process. The directors retain management control of the company with supervision from an insolvency practitioner appointed as "monitor", whose role is to ensure that the moratorium is likely to result in rescue of the company as a going concern. The monitor's consent is required for the majority of company payments and liabilities incurred during the moratorium (including rent) are payable as expenses. If moratorium debts and pre-moratorium debts (other than those which are covered by the payment holiday) cannot be paid as they fall due, the moratorium must be terminated. Subject to certain limitations, fixed and floating charge assets are capable of disposal by the company with the permission of the court (which will only be granted if the court thinks that it will support the rescue of the company as a going concern), provided that the company is required to apply the net proceeds of any such disposal towards discharging sums owed to the relevant secured creditors.

2. **Restructuring plan**: A new restructuring plan is available to companies in financial difficulties affecting their ability to carry on business as a going concern. The restructuring plan is effectively an enhanced scheme of arrangement and operates in a similar fashion. However, a key difference is that a restructuring plan allows the court to impose a compromise on a dissenting class of creditors or shareholders (a so-called "cross-class cram-down"), provided that (i) no member of a dissenting class would be worse off under the restructuring plan than they would be under the "relevant alternative" (namely, the scenario most likely to occur if the plan is not approved) and (ii) at least one class that would receive a payment or would have a genuine economic interest in the company under the "relevant alternative" votes in favour of the plan. The approval threshold is 75% in value of the creditors (or class of creditors) or shareholders (or class of shareholders) present and voting.

3. ***Ipso facto* clauses**: Subject to various exclusions (including in relation to lending activities and financial contracts, which are not affected), contractual provisions allowing a supplier of goods or services to terminate or vary the terms of a contract solely on the grounds of the customer's insolvency will cease to be effective. In addition, whilst a company is the subject of an insolvency procedure, its suppliers are prohibited from exercising any pre-existing right to terminate (even if this is not insolvency-related). Furthermore, suppliers are not entitled to withhold supply to the insolvent company until pre-insolvency debts are paid, preventing ransom payments being sought. However, one notable exception is that suppliers may apply to the court for permission to terminate a contract on the grounds of "hardship", although this is not defined by the Act.

In addition to the permanent reforms outlined above, the Act also introduces certain temporary measures designed to provide further relief to companies during the Covid-19 crisis, including a temporary suspension of the wrongful trading regime and temporary restrictions on the use of statutory demands and winding-up petitions.

IMPACT ON AIRLINE INSOLVENCY

Although the Act is intended to be of broad application and consequently does not directly address many of the aviation-specific issues highlighted by the Airline Insolvency Review (for example, the funding of repatriation costs in the event of an airline collapse), certain features of the Act could potentially have a significant impact on the conduct of any future UK airline restructuring or insolvency.

Given the Act has introduced a new debtor-in-possession moratorium, there could be an increase in the number of airlines considering whether a moratorium may assist in trading through distress. To date, UK airlines have typically ceased flying immediately when entering insolvency proceedings (as demonstrated by the recent insolvencies of Monarch, Thomas Cook and Flybe). There are a number of reasons for this, but primarily this is due to the significant risk of liability or reputational damage on the part of an administrator or liquidator should an accident occur whilst the airline is under their control. Under the new moratorium, the directors retain management control of the company (under the supervision of the monitor). This should mean that, in theory, an insolvent airline is more likely to continue flight operations during the new free-standing moratorium than would be the case under an administration or liquidation.

However, there remain a number of significant challenges for an airline seeking to continue trading through the moratorium. These include:

- **Exclusions to pre-moratorium payment holiday**: the moratorium does not provide for a payment holiday in relation to financial services obligations. This is important in two respects:
    - financial indebtedness, including (*inter alia*) any borrowing and any hedging/swap liabilities, is excluded from the payment holiday and will need to be paid as it falls due. Consequently, there is nothing to prevent a lender from accelerating debt during a moratorium (although, in doing so, it would not benefit from “super-

priority" status in respect of the accelerated debt, as mentioned below). If the accelerated debt cannot be repaid in full, the moratorium will be required to terminate.

  - "financial leasing" contracts are also excluded from the payment holiday. Whilst it is unclear what constitutes a "financial lease" for the purposes of the Act, it is likely that any aircraft leases other than "pure" operating leases would be covered by the exclusion. If so, all arrears in relation to such aircraft leases will need to be paid. Again, if they cannot be paid, the moratorium must be terminated.

  Similarly, wages are also excluded from the payment holiday so pre-moratorium remuneration would need to be paid. Please see below for some further analysis on other considerations relating to pre-moratorium debts.

- **Obligation to pay operating costs incurred during moratorium**: all moratorium debts must be paid as they fall due. Ongoing operating costs are likely to be significant for an airline and would include rent, lease payments, wages, airport charges, air navigation charges, aircraft maintenance costs and so on.

- **Exceptions to *ipso facto* prohibition**: whilst the *ipso facto* prohibition will generally apply in a moratorium, it does not:

  - affect "financial contracts", including (*inter alia*) loan agreements and "financial leases" as noted above; or

  - prevent termination on the basis of an insolvency event if a security agreement or lease is registered under the Cape Town Convention ("**CTC**"). Aircraft financiers and lessors with registered international interests under the CTC should therefore still be able to terminate and repossess in the usual way, subject to the 60 day waiting period. Please see below for some further analysis on the interplay between the CTC and the Act.

- **Operating licence**: the airline must continue to hold a valid operating licence (or obtain a temporary operating licence). In particular, this requires the airline to satisfy the CAA that it will be able to meet its financial obligations over the next 12 months (or in the case of a temporary operating licence, that there is a realistic prospect of a satisfactory financial reconstruction within that time period). Whether this test is satisfied will, of course, depend on the airline in question and the severity of its financial difficulties.

However, the prospect of implementing a restructuring plan under the Act could potentially be a powerful tool in demonstrating to the CAA that a successful restructuring of the airline can be achieved within the 12 month time period (as demonstrated by the recent use of the new restructuring plan by Virgin Atlantic as part of its solvent recapitalisation). Retaining a valid operating licence is also a pre-requisite for the airline to be re-allocated valuable slots at constrained airports such as Heathrow and Gatwick, which is vital to ensure continued flight operations.

- **Recognition of moratorium overseas**: airlines often have a variety of overseas creditors, particularly airports, fuel suppliers and maintenance providers. The recognition of the moratorium abroad is untested – for example, we note that the administration moratorium does not have extra-territorial effect (although in certain situations can operate to have a similar effect). Will, for example, fuel suppliers in foreign jurisdictions continue to supply fuel for ongoing trading if arrears have not been paid? If they do not, will it be possible to quickly compel them to do so in the foreign courts if necessary? Please see below for some further analysis on jurisdictional risk.

Despite the numerous challenges outlined above, any ability to keep the fleet flying during the new moratorium could facilitate the repatriation of passengers overseas in the event that ultimately it is not possible to rescue the airline as a going concern, including under a restructuring plan or other arrangement. Indeed, this was one of the key objectives of the airline “special administration” regime proposed by the Airline Insolvency Review’s final report, although it should be noted that the Act does not address how to fund the potentially significant costs of a repatriation exercise.

CAPE TOWN CONVENTION

The Act makes clear that the new moratorium and the *ipso facto* prohibition do not affect the rights of a lessor or financier under the CTC (as implemented in the UK pursuant to the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015). This means that (provided they have the benefit of a registered international interest under the CTC) lessors and financiers will still have the right to repossess leased or financed aircraft upon expiry of the 60 day waiting period under the "Alternative A" insolvency regime, notwithstanding the new moratorium. In addition, the parties will retain the freedom to contractually designate insolvency as a "default" for the purposes of the CTC, notwithstanding the *ipso facto* prohibition. These express exclusions in the Act will be welcomed by aircraft lessors and financiers and provides additional comfort that the reforms introduced by the Act should not materially affect their insolvency analysis.

Having said that, it appears that the new “cross-class cram-down” regime under a restructuring plan may not be entirely compatible with certain insolvency provisions of the CTC, namely those which state that no obligations of the debtor may be modified without the consent of the creditor.[3] However, this may be mitigated to some extent by a provision in the Act which states that a compromise may not be imposed on any non-consenting “relevant creditor”[4] under a restructuring plan which is implemented during the 12 week period after the end of the moratorium.

JURISDICTIONAL RISK

The prospect of UK airlines continuing to operate during an insolvency process may give rise to concerns regarding increased jurisdictional risk from the perspective of aircraft lessors and financiers. If, as has been the case previously, an airline ceases flying immediately on an administration or liquidation appointment, usually timed at a point when all (or most) aircraft are in the UK, there is a high degree of certainty that the lessor or financier will ultimately be able to recover the asset promptly. In contrast, if an airline continues to fly during the new moratorium, there is an increased risk of aircraft becoming trapped in other (potentially non creditor friendly) jurisdictions.

Whilst this risk may be mitigated to some extent if the jurisdictions in question are contracting states under the CTC (although, at present, the CTC remains untested in most contracting states), a key challenge will be ensuring that the new moratorium and *ipso facto* prohibition are respected in other jurisdictions. In reality, foreign creditors (such as overseas airports or maintenance providers seeking to recover unpaid airport charges or maintenance costs) may still demand to be paid before releasing aircraft, notwithstanding the provisions of the Act.

OTHER CONSIDERATIONS RELATING TO PRE-MORATORIUM DEBTS

It is notable that an airline’s debt obligations under its loan agreements or finance leases are not subject to the pre-moratorium payment holiday, whereas pre-moratorium operating lease rentals are caught. At first glance, this would seem to put aircraft financiers and other lenders (together with employees, whose wages also fall outside the scope of the payment holiday) in a strong position relative to operating lessors and other (non-financial) creditors.

Furthermore, the Act grants “super-priority” status to certain pre-moratorium debts (including secured and unsecured banking and finance arrangements and intra-group loans) where a company enters into administration or insolvent liquidation within 12 weeks of a moratorium ending. These super-priority debts would rank ahead of all other unsecured debts and floating charge security (albeit not any fixed security) and even ahead of a liquidator’s or administrator’s own remuneration. However, the Act provides that any accelerated pre-moratorium debts do not benefit from super-priority status, thereby preventing lenders from attempting to secure super-priority status for their entire debt by accelerating during the moratorium.

CONCLUSION

The Act has introduced a number of far-reaching reforms, some of which could potentially have a significant impact on the conduct of any future UK airline restructuring or insolvency. In particular, the potential ability of UK airlines to continue operating under the new debtor-in-possession moratorium, together with the prospect of a "cross-class cram down" under a restructuring plan, could increase the likelihood of struggling airlines being rescued as a going concern. However, airlines will continue to face significant challenges in seeking to trade during a moratorium, not least the requirement to continue servicing moratorium debts and (to the extent not covered by the payment holiday) pre-moratorium debts as well as the uncertainty surrounding the ability to enforce the moratorium overseas.

From a creditor perspective, the rights of aircraft financiers and lessors under the CTC remain largely unaffected, although the precise interaction between the CTC (which is yet to be tested in the English courts) and the Act seems unclear in certain key respects. To some extent, the reforms appear to have strengthened the hand of aircraft financiers and other lenders in an airline insolvency when compared with operating lessors and other (non-financial) creditors, on the basis that financial indebtedness is excluded from the pre-moratorium payment holiday and "super-priority" status is granted to (non-accelerated) pre-moratorium financial debts in any subsequent insolvency proceedings. In the aircraft finance space, this could potentially encourage banks and other financial institutions to lend directly to UK airlines rather than indirectly through an operating lessor financing, especially where the latter adopts a limited recourse structure.

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1. https://www.herbertsmithfreehills.com/latest-thinking/airline-insolvency...
2. http://www.legislation.gov.uk/ukpga/2020/12/contents/enacted
3. A recent Annotation to the Official Commentary to the CTC confirms that a restructuring plan under the Act should constitute an "insolvency proceeding" for the purposes of the CTC (thereby falling within the scope of the Alternative A regime). http://ctcap.org/wp-content/uploads/2020/06/CTCAP-–-annotation-1-to-OC-4th-Ed–-reorganisation-arrangements.pdf
4. "Relevant creditors" is defined to mean (i) a creditor afforded "super-priority" in respect of pre-moratorium debts (thereby including financiers in respect of non-accelerated debt) and (ii) a creditor in respect of moratorium debts (thereby including both financiers and operating lessors).

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

TIM HUNTER-JONES
SENIOR ASSOCIATE, LONDON
+44 20 7466 2559
tim.hunter-jones@hsf.com

REX ROSALES
PARTNER, LONDON
+44 20 7466 2586
rex.rosales@hsf.com

JAHNAVI RAMACHANDRAN
PARTNER, LONDON
+44 20 7466 2408
Jahnavi.Ramachandran@hsf.com

JOHN CHETWOOD
PARTNER, LONDON
+44 20 7466 7548
John.Chetwood@hsf.com

KEVIN PULLEN
PARTNER, LONDON
+44 20 7466 2976
Kevin.Pullen@hsf.com

JOHN WHITEOAK
PARTNER, LONDON
+44 20 7466 2010
john.whiteoak@hsf.com

ANDREW COOKE
PARTNER, LONDON
+44 20 7466 7566
Andrew.Cooke@hsf.com

ROBERT MOORE
PARTNER, LONDON
+44 20 7466 2918
robert.moore@hsf.com

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