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Airline insolvency and repossession – United States

What are the principal types of insolvency proceedings?

Most insolvencies in the US are governed by the US Bankruptcy Code (the **Bankruptcy Code**).

Chapter 11 provides for restructuring, and is the most frequently used vehicle for companies wishing to restructure their business and shed debt. In contrast, Chapter 7 is the liquidation provision of the Bankruptcy Code and is a business termination process.

Chapter 15 is the vehicle by which a foreign debtor's representatives can obtain the assistance of the US bankruptcy courts to address assets located in the US, and is intended to foster cooperation among insolvency courts of different jurisdictions. To qualify as a debtor under the Bankruptcy Code a debtor must typically reside, have a domicile or place of business or property in the US. It is notable that the US courts have deemed these requirements met by foreign airlines that engaged in some business in the US, have US creditors or bank accounts with US banks and/or have retained US bankruptcy counsel.

Recent local insolvencies include three major non-US based airlines: Avianca, LATAM and Grupo Aeromexico, each of which chose to restructure during the COVID-19 crisis by filing for bankruptcy protection under Chapter 11 in the US Bankruptcy Court for the Southern District of New York.

Virgin Atlantic recently filed an ancillary Chapter 15 proceeding in the US, relating to the primary restructuring proceedings it commenced in the UK.

Restructuring & Chapter 11

Upon filing of a Chapter 11 bankruptcy petition, an automatic stay on enforcement is imposed which prohibits creditors from seeking to terminate leases, repossess or otherwise assert control over the debtor's aircraft. Any actions taken by creditors in violation of the automatic stay are deemed void or voidable and of no legal effect. Willful violations of the stay are subject to sanctions and damages are available to debtors. While the stay can be lifted for cause with court permission, such motions are rarely granted early in the case and what constitutes cause is a

fact-based inquiry.

Chapter 11 is a debtor-in-possession process, and the debtor's management and board will continue to run the company during the restructuring. There is some judicial oversight of the company's decisions at this time (particularly material ones), but generally the US courts will defer to the business judgment of the debtor's management of the day-to-day business during the Chapter 11 process.

A Chapter 11 debtor may obtain new financing during this time (so-called "DIP financing"). With court approval, DIP financing can prime existing liens and/or rank equally with or in higher priority to existing secured creditors. Existing secured creditors must be provided with adequate protection against loss of value to their collateral during the pendency of the bankruptcy case¹.

The Chapter 11 debtor has the exclusive right to propose a plan of reorganization for the first four months after the filing of the petition (extendable by the court for up to 18 months). A plan of reorganization is, in effect, a contract between the debtor and its creditors, and will be binding on all creditors (including dissenting creditors) if it meets the Bankruptcy Code requirements and is approved by the bankruptcy court.

A debtor airline may choose to reject aircraft leases which are not on market terms. Rejection is deemed a breach of the lease but, in the absence of security, breach damages will be paid in the same priority as other unsecured creditor claims. Provided the debtor cures all pre- and post-petition defaults, it may assume aircraft leases and may assign them to third parties².

Section 1110

If Section 1110 of the Bankruptcy Code applies³, the debtor airline must cure any default that occurs within the first 60 days of the bankruptcy proceeding by the later of such 60th day or 30 days after the default. If a debtor fails to do so, creditors may exercise remedies provided for in the applicable financing agreements or leases, including repossessing aircraft, and the automatic stay will not prevent the exercise of these remedies. Section 1110 provides for consensual extensions of the 60-day period with bankruptcy court approval and this often enables lessors and debtors to reach compromise.

For airlines not subject to Section 1110 of the Bankruptcy Code, an airline debtor typically has until confirmation of the plan of reorganization to assume or reject a lease, but must begin to make lease payments no later than 60 days after the filing of the petition i.e. on day 61. Section 365 of the Bankruptcy Code permits extension of this time period if "...the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof." The "equities of the case" is not defined and will depend on applicable facts and case law. If a debtor ultimately rejects a lease but has used the aircraft post-filing, the lessor may be able to assert an administrative claim for the period the aircraft was used. Such claims rank in higher priority to unsecured claims.

Liquidation – Chapter 7

By contrast, Chapter 7 of the Bankruptcy Code is a liquidation procedure. Upon filing of a Chapter 7 petition, a trustee is appointed to replace management and the board of the debtor, and this trustee will gather and liquidate all assets for the benefit of creditors. Proceeds of the liquidation (after payment of liquidation costs and trustee fees) are distributed to creditors under the waterfall provisions of the Bankruptcy Code.

It should be noted that, in certain circumstances, a lease can be deemed a disguised financing where a debtor has

the ability to own the aircraft at the end of the lease term for a nominal amount and certain other elements indicative of financing rather than true lease are present. The Uniform Commercial Code (**UCC**) provides a list of elements indicative of a true lease as opposed to a financing. The recharacterization of a lease can result in the debtor being deemed the true owner of the aircraft and, if the lessor has failed to perfect its security interest in the aircraft or lease payments, the lessor can be deemed an unsecured creditor.

Have any recent measures or legislative changes (temporary or permanent) been introduced to prevent or mitigate airline insolvencies?

Because of the COVID-19 crisis, US airlines have been allocated US\$50 billion under the CARES Act⁴ for COVID-19 relief. Some of those funds, which are in the form of grants or loans, are to be used primarily to pay employees. Airlines are required to repay 30% of funds borrowed, could not furlough employees until 30 September 2020, must limit executive compensation and cannot issue dividends or buy-back stock until 2021. In addition, there has been a temporary suspension of the 7.5% excise tax usually levied on all airline tickets. The end of the employment assistance grants has resulted in some airlines giving notice of layoffs, effective 1 October. At the time of writing, it is unclear whether the US Congress will approve more financial assistance to airlines.

Has the US adopted the 2001 Cape Town Convention and its Aircraft Equipment Protocol (together, Cape Town)?

Yes, in part. As of 2006, the US recognizes the International Registry as an additional place for the filing of interests, including prospective interests, in certain airframes, helicopters and aircraft engines. In order to register an international interest with the International Registry, the relevant party must first obtain authorizing entry point codes (AEP codes) from the Federal Aviation Administration (**FAA**).

Cape Town declarations

"Alternative A" insolvency regime	Yes, 60-day waiting period
IDERAs	Yes
Self-help remedies	Yes (but see below)
Choice of law	Yes

The US did not adopt "Alternative A" pursuant to Article XI of the Aircraft Protocol when it ratified Cape Town. Alternative A was modeled after Section 1110 of the Bankruptcy Code which is discussed above, though not all debtor airlines will fall within the scope of Section 1110.

Can creditors use "self-help" to repossess leased or mortgaged aircraft?

Yes. The US UCC (adopted in most US states) permits creditors to repossess leased personal property in a commercially reasonable manner and without disturbing the peace. Additionally, in its ratification of Cape Town, the US declared that any self-help remedy available to creditors under Cape Town would be exercisable in the US without leave of the court. The UCC provides that after an event of default has occurred, the lessor has the right to take possession of the property. There are no specific guidelines on what is considered to "breach the peace" and case law of each US state can vary on what is acceptable or reasonable conduct. It may therefore be advisable to seek court intervention by bringing an action for repossession and breach of contract if repossession is contested by the lessee.

How long does the aviation authority typically take to deregister an aircraft when an IDERA is invoked?

An IDERA request with regard to aircraft subject to Cape Town will only be honored on an expedited basis if so requested, typically within two days. The IDERA must be properly submitted to the FAA's registry with a detailed description of the aircraft and the country to which it is to be exported, along with evidence that certain prior security interests have been satisfied with confirmation of priorities. A detailed description of procedures and documentation required are available on the FAA's website.⁵

Are there any non-consensual liens which would take priority to an ownership interest/ mortgagee's rights as a secured creditor?

Yes. These include for US federal tax liens (filed with the relevant state); possessory mechanic's and warehouse liens; and non-possessory mechanic's liens (in each case to the extent provided under applicable state law). While some of these liens must be filed with the FAA, the FAA Registry does not pre-empt state laws on perfection of liens. Some states provide that a mechanic's lien securing material and labor used in repairs must be filed with the FAA, as well as with the clerk of the county where the aircraft was located when the services were provided. Other states, however, have statutes that require retention of possession of the aircraft or spare parts in order to perfect such liens rather than a written recording. The laws of the relevant state and not just federal law should be consulted.

Are there any "fleet liens" (i.e. a lien for debts relating to one aircraft that may be asserted against any aircraft in the airline's fleet, regardless of ownership)?

No.

Other notes and key considerations for lessors and financiers

- Foreign creditors – In recent Chapter 11 filings of foreign airlines, the debtors have sought orders that purport to apply the automatic stay extra-territorially to creditors outside the US. Foreign creditors of an airline that regularly do business in the US (and therefore could be deemed subject to US jurisdiction) would be wise not to take actions that could be deemed to be a violation of the stay as sanctions and punitive damages are available.
- Speed – Lessors are advised to monitor carefully the financial health of their lessees, and prompt notices of default / terminations of leases are advisable (pre-petition if possible to avoid the automatic stay).
- Letters of credit – Generally, they are not subject to the automatic stay as they are deemed contracts between the issuer and the beneficiary lessor, but a notice requirement to the lessee can complicate this. A practical example of when the automatic stay can be problematic arises with the drafting of some letters of credit. If the letter of credit is drafted to require a notice of default to be issued to the lessee before a demand can be made on the issuer, permission would be required from the court to lift the stay solely for compliance with this notice requirement in order to draw down on the letter of credit. This can be a costly process, and it is advisable to draft letters of credit so that they do not require notice of default to the lessee before demand can be made to the issuer for a drawdown; they should simply require certification of default by the management of the beneficiary.
- A confession of judgment can eliminate delay in repossession of aircraft under some state laws, such as New York. It is signed by the debtor prior to default and, upon default, it can be filed with a court; however, the better approach is to negotiate and document an orderly repossession in the operative documents.

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1. Often existing secured creditors will provide DIP financing and exit financing to avoid priming of their liens. "Adequate protection" can take many forms including, but not limited to, interest payments or liens on previously unencumbered assets.↵
 2. Clauses containing prohibitions on assignment are unenforceable in Chapter 11 as are "ipso-facto clauses" (clauses that provide a contract is terminated upon the occurrence of an insolvency event). There are exceptions for loan agreements.↵
 3. Section 1110 of the Bankruptcy Code applies to airlines controlled by US citizens and is therefore not applicable to most foreign airlines.↵
 4. The Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted on 27 March, 2020, as Public Law 116-136.↵
 5. <https://www.faa.gov>↵

Your Key Contacts



Lee P. Whidden
Partner, New York
D +1 212 632 8389
lee.whidden@dentons.com



Robert E. Richards
Partner, Chicago
D +1 312 876 7396
M +1 630 235 2470
robert.richards@dentons.com



Lynn P. Harrison III

Partner, New York

D +1 212 768 5325

M +1 332 234 2875

lynn.harrisoniii@dentons.com



Claude D. Montgomery

Partner, New York

D +1 212 632 8390

claudio.montgomery@dentons.com