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Should the UK adopt Cape Town's Alternative A insolvency regime? Lessons from the US and Canada

KEY POINTS

- The UK is consulting on whether to incorporate a Cape Town's Alternative A insolvency regime into English law.
- Alternative A is based on s 1110 of the US Bankruptcy Code and is in force in many states, including Canada.
- Section 1110 appears to have been very successful in the US in promoting cheaper capital markets funding for airlines and successful restructurings of many major US airlines. However, UK administrations already provide creditors with robust and flexible rights in airline insolvencies.
- If the UK adopts Alternative A thought will have to given as that regime will work in tandem with administration.

INTRODUCTION

The US experience relating to s 1110 of the United States Bankruptcy Code (s 1110) (from which Cape Town's Alternative A insolvency regime derives) includes:

- successful restructurings of many major US airlines; and
- cheaper capital markets funding for US airlines using Enhanced Equipment Trust Certificate (EETC) programmes.

Air Canada has also enjoyed impressive pricing for its EETCs, with the ratings agencies placing great weight on Canada's adoption of Alternative A. However, the Canadian experience also shows adopting Alternative A can sometimes have unintended consequences for a state's insolvency laws.

It is not completely clear how Alternative A (which is less sophisticated and flexible than its s 1110 parent) would mesh with the UK administration regime. This, and the already robust and flexible nature of aircraft creditors' rights under English insolvency law, raise the question of whether the UK case for Alternative A goes much beyond potentially better bond pricing for UK airlines. Though the likely progressive impact of Basel III and CRD IV on commercial bank debt pricing, and the increasing cost of export credit supported aircraft financings, make the capital markets argument for Alternative A very powerful in itself.

THE UK CONSULTS ON ALTERNATIVE A

In the summer of 2014, the UK announced it will ratify the 2001 Cape Town Convention on International Interests in Mobile Equipment and its Aircraft Equipment Protocol (together, the CTC). However, the UK government wishes to consult on the terms of that ratification – including whether to adopt Alternative A. It appears to be concerned that Alternative A might hamper UK airline restructurings. In this article, among other things, the we look at whether the US and Canadian experiences validate that concern.

ALTERNATIVE A

The CTC aims to:

- reduce the risks and costs of financing and leasing aircraft into countries whose pre-CTC insolvency and other laws are not creditor-friendly; and
- thereby increase the supply, and lower the costs, to aircraft operators of financings and leasings into those states.

Key to achieving these objectives is the CTC's optional Alternative A insolvency regime – which is largely based on s 1110. States ratifying the CTC (CTC states) can opt to make Alternative A part of their insolvency laws.

Broadly, Alternative A will apply between a lessor (including under a hire purchase, conditional sale or instalment sale) or mortgagee of an aircraft (the creditor) and its lessee or mortgagor (the debtor) if (among other things):

- the debtor was resident in, or the aircraft was registered on the civil aircraft register of, a CTC state when its lease or mortgage with the creditor (the agreement) was executed;
- the debtor's centre of main interests (as defined in the CTC) is situated in a CTC state that has made Alternative A part of its insolvency laws; and
- the debtor is in insolvency proceedings in that CTC state.

Where Alternative A applies to a debtor's insolvency proceedings, the debtor has a fixed "waiting period" (typically 60 days) to hand the aircraft back to its creditor or:

- cure all defaults under the agreement (other than the fact of the insolvency proceedings); and
- undertake to comply with the agreement in the future.

Any breach of that undertaking entitles the creditor to repossess immediately.

SECTION 1110 IN THE US

Section 1110 dates back to 1978, when the US adopted a new federal Bankruptcy Code (the code). Section 1110 aimed to preserve aircraft financiers' rights to repossess their collateral within a fixed period if a US air carrier in bankruptcy failed to perform its obligations under a lease or mortgage. Through s 1110, aircraft financiers have been granted truly exceptional status in bankruptcy proceedings (one of the code's premises is equality of treatment of all creditors) that allows them to repossess their collateral for a default where most other creditors may not.

Under s 362 of the code, once an airline files for bankruptcy, its creditors are in most cases automatically stayed from taking any action to collect amounts owed under a financing or enforce security over an aircraft. The stay also prohibits a lessor from terminating a lease solely for a default caused by the bankruptcy filing. There must be another default under the lease.

Under s 1110, despite the stay, the aircraft lessor or mortgagee regains its rights as such to repossess an aircraft and enforce its other rights within 60 days (the s 1110 period) unless the debtor makes a s 1110(a) election before the s 1110 period ends, thereby agreeing:

- to cure existing defaults under its lease; and
- to perform all current and future obligations under a lease or mortgage.

Often an airline will use the s 1110 period to decide how to right-size its fleet within that period. Further, with the court's approval, it may enter into a s 1110(b) stipulation, whereby the creditor agrees to extend the 60-day period in exchange for resumed payments at a negotiated rate.

If the debtor fails to make a s 1110(a) election or to enter into a s 1110(b) stipulation, the debtor risks its creditor seizing the aircraft at any time. However, often market conditions favour the airline. If they cannot re-lease or sell the aircraft, many financiers agree to significantly reduced rentals or loan payments, on the theory that some revenue is better than none.

Despite its creditor-friendly nature, s 1110 has greatly benefited US airlines. Aircraft financiers rarely repossess from defaulting US airlines before a bankruptcy filing (giving the airline a chance to fix its problems outside bankruptcy without disrupting operations) knowing they can repossess, if necessary, if the airline files for bankruptcy. This makes financing aircraft less risky for financiers and less costly for airlines. This is most apparent in the EETC market, where US issuances are thought to benefit from a one or two notch credit rating enhancement due to s 1110.

Most major US airlines (including American, Continental, United, Delta, Northwest and US Airways) have successfully restructured over the past decade or so without having found s 1110 an impediment. Section 1110 has been widely recognised as a success – with the recent widespread ratification of Alternative A by many CTC states a testament to this.

THE CANADIAN EXPERIENCE

On 1 April 2013, the CTC was ratified into Canadian law. Despite the added benefits the CTC offers, its entry into force under Canadian law has led to a legislative void in the insolvency protection historically provided to certain aviation creditors.

The CTC began its introduction into Canadian law in 2005. However, the 2005 legislation would not become Canadian law until ratified by the federal government and implemented by a majority of the provinces. In the interim, the federal government introduced stop-gap provisions into the various Canadian federal insolvency laws similar to those found under the US's s 1110 and the CTC's Alternative A. This was to encourage lessors and financiers (who were aggrieved by the way Canadian insolvency law had worked in various Canadian airline insolvencies) to continue doing business with Canadian carriers and to keep Canada on a level playing field with competing markets.

With the successful implementation of the CTC into Canadian law on 12 December 2012, the stop-gap insolvency provisions were repealed with effect from the date of the CTC's entry into force on 1 April 2013. This created a situation where, on a strict reading of the law, only agreements concluded and registered under the CTC on or after 1 April 2013 could receive the benefit of Alternative A in Canada.

This has introduced uncertainty as to the rights of certain aviation creditors under pre-April 2013 agreements. Our view is that the 2005 stop-gap amendments to Canadian federal insolvency laws should have been retained, but only in favour of pre-April 2013 interests. The federal government admits, in retrospect, that this was an "oversight"; its intention was not to deprive holders of pre-April 2013 interests of Alternative A. It also says it is unlikely to act to fix this problem, which will resolve itself as pre-April 2013 interests expire.

Consequently, there is now a void in Canadian insolvency legislation with respect to agreements concluded prior to April 2013. As a result of this void, aircraft creditors under pre-April 2013 agreements must petition the court and rely on the discretion of the judge to lift the stay to repossess their aircraft in insolvency proceedings of an aircraft operator.

Some aircraft creditors have requested their debtors execute an "aircraft object security agreement" to fill this gap. Whether the resulting agreements will be sufficient to give aircraft creditors the benefit of Alternative A in Canada is yet to be tested in an airline insolvency with competing creditors.

A UK PERSPECTIVE

Most UK aircraft operators lease their aircraft. The moratorium in an English administration extends to repossession of leased equipment to facilitate a turnaround of the operator's business and lasts for the entire duration of the administration, which can be a year or more. However, the English court's interpretation of the UK provisions

Biog box

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which enable the stay to be lifted have led to an expectation on all sides that the administrators will pay the rentals for the aircraft they wish to retain: the threat of long term retention of the aircraft without payment, which s 1110 addresses, is not present in the UK market.

A fixed waiting period of 60 days may be less favourable to lessors of UK aircraft. It would run counter to the flexibility of the current arrangements. Under these arrangements, if the administrator plans to trade the business, s/he is adept at striking new deals with lessors for the continued use of the aircraft s/he requires at an early stage. Market and regulatory conditions in the UK are such that, if the business is going to trade on, the administrator's trading strategy, including fleet requirements, will be pre-planned.

Absent a degree of pre-planning, an unanticipated failure will most likely result in immediate closure of the airline and the availability of the aircraft for immediate repossession. Indeed the more likely consequence of having had the time to pre-plan, will be the immediate transfer of the business by the administrator to a new operator via a "pre-pack".

The UK insolvency profession may also be concerned that Alternative A might increase their administration expenses, which are payable out of a limited pot of assets which may not cover all of their outgoings and would rank ahead of the administrator's own remuneration. Alternative A requires the administrator to:

- agree to perform all future obligations under the lease;
- cure all defaults under the lease; and
- maintain the aircraft.

A particular problem here is the maintenance obligation (which is not in s 1110; only in Alternative A). It may be a factor which inhibits the rescue of the business if the exposure to increased costs acts as a deterrent to trading on in administration.

The evidence from the US suggests that Alternative A may be highly conducive to successful airline restructurings. However, if Alternative A were adopted in the UK, it may be advisable to consider how it would mesh with existing UK insolvency law, including in relation to administration expenses. Under EU law, the UK cannot, in ratifying the CTC, adopt Alternative A, but is permitted to replicate Alternative A by separate legislation. If the UK decides to do this, it may want to consider devising a more flexible version of Alternative A, that is designed to work with the UK's current insolvency regime. ■

Further reading

- Part 1: the aviation industry [2010] 4 *CRI* 175
- Enforcement issues in the aviation industry: part 2 [2011] 2 *CRI* 63
- Olympic Airlines: a first step to tighter controls in secondary insolvency proceedings? [2013] 5 *CRI* 129
- MK Airlines: a tale of two quarters [2012] 4 *CRI* 131