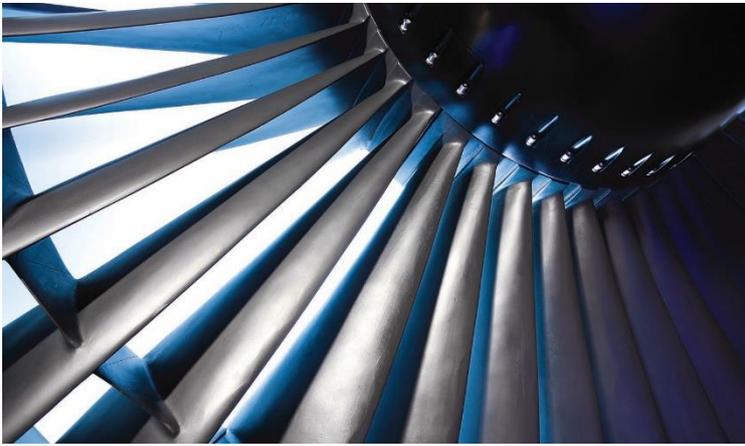


WATSON FARLEY
&
WILLIAMS

COVID-19 AVIATION RESTRUCTURING
REPORT

6 APRIL 2020



WFW KEY FACTS

160+ PARTNERS
500+ LAWYERS

"THEY OFFER GOOD VALUE FOR MONEY, AND WE GET EXCELLENT ADVICE FROM HIGHLY EXPERIENCED LAWYERS WHO KNOW THE MARKET VERY WELL."
CHAMBERS GLOBAL 2020

ESTABLISHED 1982
20+ LANGUAGES SPOKEN

"IT IS A HIGH-CALIBRE TEAM THAT IS COMMERCIALY MINDED AND OFFERS AN OUTSTANDING BREADTH OF EXPERIENCE."
CHAMBERS UK 2019

15 OFFICES
12 JURISDICTIONS

"WE CAN TRUST THEM TO DELIVER AN EXCELLENT AND TIMELY SERVICE."
CHAMBERS UK 2019

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INTRODUCTION

Airlines across the globe are fighting for their survival in the midst of the COVID-19 pandemic. The crisis has caused an unprecedented fall in passenger demand reinforced by widespread travel bans and populations going into lockdown. As of 31 March 2020, the International Air Transport Association (IATA) expects the airline industry to lose up to US\$252bn in passenger revenue in 2020 because of this crisis. This would represent a downturn of 44% on the 2019 figure. Airlines worldwide are slashing schedules and furloughing employees to curtail their expenditure during this period.



The sudden dearth of passenger revenue represents a liquidity crisis for airlines and, in turn, aircraft lessors. In the short term, airlines will seek to increase cash by drawing any available credit facilities and realising unencumbered assets through secured financings and sale and leasebacks. Executing such transactions under current market conditions will be challenging due to uncertainty over how long the crisis will last, whether there will be a sustained depression in passenger numbers (similar to what was seen after 9/11), and downward revisions to asset values and airline ratings as a result of the crisis. For sale and leasebacks, the low lease rate factors that have been seen in recent years will not be achievable in the current market. Also, while there may be many bidders for one, two or three aircraft deals there are only a handful of players in a position to bid on more sizeable deals.

While financings and sale and leasebacks may provide some relief to airlines with the luxury of unencumbered aircraft, airlines with already financed aircraft and leased fleets will not be able to access cash so readily. Where airlines are unable to remedy their liquidity issues, they will need significant creditor and State support in order to stave off defaults and insolvency and, ultimately, survive the crisis. Currently, airlines are turning to their creditors to help with their liquidity crisis by requesting payment holidays. The scale of this issue has resulted in some creditors receiving such requests in respect of the majority of their portfolios. The requests they are receiving are also escalating from initial three-month periods up to twelve months in some cases as the length of the crisis remains unclear.

In this guide, we will examine the possible challenges that may arise as a result of the liquidity crisis in the aviation industry and how they may be overcome.

FINANCING AND LEASING DEFAULT

Certain provisions commonly seen in aircraft finance and leasing transactions may be triggered by the prevailing global problems. Any breach of a provision of a facility or lease agreement is likely to constitute an event of default either immediately or after a contractual grace period which will entitle a lender to accelerate outstanding amounts and enforce security and a lessor to terminate the leasing, claim damages and repossess the aircraft. The following customary provisions are relevant in the current circumstances and may apply to both financing and leasing of aircraft to airlines but also to financing of aircraft by lessors. Therefore, lessors may need to engage with their own financiers before taking action or agreeing to any position with their lessees.

“A PROLONGED GLOBAL DOWNTURN AND SPATE OF AIRLINE INSOLVENCIES ARE LIKELY TO NEGATIVELY AFFECT AIRCRAFT VALUES, WHICH WOULD HAVE A MEASURABLE IMPACT WHERE A FACILITY INCLUDES LOAN-TO-VALUE PROVISIONS.”

Non-payment and insolvency

Where payment deferrals are not agreed, it may not take long before payment defaults occur. Arguably, the likelihood of being unable to meet a payment known in advance is an indicator of insolvency or an incipient default. Because there is always a chance that the payment will be made when due, facility and lease agreements usually give the benefit of the doubt until the payment default has, in fact, occurred. However, one of the major challenges with highly structured financing is that easing short-term cashflow issues by, for example, introducing new money, may be constrained due to the existing financing arrangements.

While the virus will be transient, its long-term impact on airlines may be considerable. Cashflow or balance sheet insolvency events of default may occur where a company's working capital is finely balanced, or where there is a sharp fall in the value of its key assets such as aircraft. However, determining whether a company is balance sheet or cashflow insolvent is not always straightforward and the accounting and legal rules can be different.

Financial covenants

With reference to financial covenants, the borrower friendly markets of recent years have led to a general trend of financial “covenant-lite” facilities being agreed. Financial covenants contain tests intended to provide an early indication that a business is not performing as planned and offer a more comfortable default for lenders to rely on without risk of challenge or need to prove materiality. Although financial covenants are not prevalent in aircraft financing to airlines, loan-to-value tests may be relevant. Financings to lessors, especially where lease revenues are the principal source of funds (for example, warehouse and portfolio financings), will usually contain a broader suite of financial covenants, that often include loan-to-value, minimum tangible net worth and debt service cover ratio tests.

Loss of income and a deterioration in asset values will negatively impact a borrower's and airline's financial position generally. A prolonged global downturn and spate of airline insolvencies are likely to negatively affect aircraft values, which would have a measurable impact where the facility includes loan-to-value provisions. Nevertheless, lenders may be kept waiting by test dates since valuations are often restricted to set times per year or annually, which might give borrowers and airlines some breathing space. Similarly, the reduction in asset values and reduced cash flows will likely have a bearing on any minimum tangible net worth test dates.

In more structured facilities for lessors (for example, warehouse and portfolio financings) where the loan repayments rely on specific rental income, a breach by the lessee to pay rent on time may trigger an event of default under the facility

agreement. Some such facilities may also have debt service cover ratios which are triggered where the rental income amongst the relevant portfolio of aircraft does not exceed the debt service by the agreed percentage. Financial covenant triggers may lead to an event of default or a cash trap of rental proceeds.

Operational covenants

Where an aircraft is not being used, airlines will consider parking them to reduce costs until travel restrictions are relaxed and demand for air travel increases. Most facility or lease agreements will include provisions which seek to prevent the removal of aircraft from regular operation and which impose strict requirements around any long-term storage of the aircraft. With many airlines around the world grounding much of their fleet, it would seem advisable that clauses of this type are reviewed to ensure that the aircraft are being treated in accordance with the terms and conditions of the agreement. There is a distinct possibility that so many aircraft being grounded simultaneously means airlines may struggle to meet the usage and storage obligations contained in their finance and leasing documentation.

Even where no such clause is included, such action may well trigger what is an LMA standard default, namely that the borrower or an obligor suspends or threatens to suspend all or a material part of its business. This latter provision might be subject to a qualification that such suspension is likely to have a material adverse effect on the ability of the borrower or obligor to perform its (payment) obligations. Grounding a substantial part of the fleet has the potential to force a temporary suspension of the business. Airlines will therefore have to consider carefully how to curtail or suspend operations, albeit temporarily, without triggering event of default provisions of this kind.

“THERE IS A DISTINCT POSSIBILITY THAT SO MANY AIRCRAFT BEING GROUNDED SIMULTANEOUSLY MEANS AIRLINES MAY STRUGGLE TO MEET THE USAGE AND STORAGE OBLIGATIONS CONTAINED IN THEIR FINANCE AND LEASING DOCUMENTATION.”

Cross-default

Governments, lenders and lessors are either agreeing to or considering payment holidays, but most finance and leasing transactions will include cross-default provisions referencing widely defined concepts of borrowing, leasing and transactions having similar commercial effect. These often include cross-defaults in derivatives transactions and counter-indemnity obligations for guarantees and letters of credit issued in support of borrower payment obligations to counterparties. The purpose of such provisions is to try and ensure that creditors are not excluded from discussions which a debtor may be having with other creditors or precluded from exercising their rights whilst other creditors are exercising their own rights to refinance, require early repayment and/or take enforcement action. Accordingly, debtors need to be aware that discussions with respect to the granting of a payment holiday or re-scheduling existing indebtedness could trigger events of default under other facilities.

"THE ECONOMIC IMPACT OF THE COVID-19 PANDEMIC ON THE AVIATION INDUSTRY SHOULD NOT BE UNDERESTIMATED AND MANY... DEFAULTS MAY BE EXPECTED TO OCCUR OVER TIME."

Breach of laws

If governmental advice on business conduct during an epidemic or pandemic is not adhered to, a covenant or repeated representation as to compliance with applicable laws and regulations may be breached.

Material adverse change (MAC)

The economic impact of the COVID-19 pandemic on the aviation industry should not be underestimated and many of the above defaults may be expected to occur over time. The MAC clause event of default can be a useful starting point for creditors wanting to begin a commercial discussion without waiting for payment default, breach of covenant, cross-default or misrepresentation. Their terms vary widely since they are always heavily negotiated and there is no real 'market standard', with the LMA offering various options in its precedent documentation. To the extent they are included, most will be triggered by circumstances resulting in a deterioration in financial condition likely to impact a debtor's ability to service its debt obligations. Less debtor friendly versions will extend to any material adverse effect on its business, operations, property condition (financial or otherwise) or prospects. By now it is clear that COVID-19 will have a significant impact on the aviation sector.

Creditors however should be wary of relying on MAC provisions unless they are very sure that the provision has been triggered because any action or inaction in breach of their contractual rights and obligations would most likely result in them being obliged to pay substantial damages as well as the accompanying reputational damage. In the circumstances there are several factors which suggest that creditors are unlikely to seek to rely on COVID-19 having a material adverse effect. To have a material adverse effect:

- the change cannot be simply temporary;
- the creditor needs to provide evidence of the adverse effect on the relevant obligor beyond general or market changes and such evidence may not be readily available; and
- the material adverse effect will only occur as a result of a change in financial condition if it significantly affects the company's ability to perform its relevant obligations in the relevant finance document.



If a company is currently performing its obligations, then absent a specific provision addressing a pandemic or similar occurrence, creditors would have a heavy burden to show that the effects of the Covid-19 outbreak would constitute a MAC and, if it is not, then there will undoubtedly be other events of default which the creditor can rely on in preference to the MAC clause.

REPOSSESSION AND REMARKETING ISSUES

In the event of a borrower or an airline default (including as a result of insolvency), the traditional approach has been for creditors to enforce their rights by repossessing aircraft and re-deploying them with another airline (although this approach is to be contrasted to the United States, where airline Chapter 11 bankruptcies leading to restructurings have been common). The quicker this can be done, the better for the creditor.

Repossessing an aircraft can be challenging for creditors at the best of times but may prove impossible under the current circumstances where technical teams and flight crews are unable to travel to the aircraft, international flight permits cannot be obtained and government departments responsible for aircraft registrations are operating with skeleton crews.

“REPOSSESSING AN AIRCRAFT CAN BE CHALLENGING FOR CREDITORS AT THE BEST OF TIMES BUT MAY PROVE IMPOSSIBLE UNDER THE CURRENT CIRCUMSTANCES”

Even if an aircraft repossession is achievable during this period, remarketing the aircraft would present further challenges to the creditor in achieving an acceptable sale price for the aircraft in the current market or re-leasing the aircraft when all airlines are grounding their fleets to reduce capacity. During the remarketing period, the creditor would be responsible for arranging and paying for the insurance, maintenance and storage of the aircraft. A wave of repossessions would destroy value through an oversupply of aircraft in the market and exacerbate the challenges to a successful remarketing.

Whilst repossession and remarketing may no longer be the preferred option for creditors in the current climate, it may be the only option if an airline enters formal insolvency proceedings and cannot be successfully restructured. In these circumstances, creditors may need to decide whether its remarketing efforts should focus on (i) a short-term solution so that the aircraft is at least placed with an airline and maintained until the market recovers, or (ii) a long-term solution with an airline well placed to weather the crisis and looking to take advantage of the oversupply of aircraft in the market. In either case, options will be very limited and there will be a natural tension between airlines seeking to drive lease rates down on the basis of the oversupply and creditors taking a more cautious approach having just been stung.

Creditors should be seeking to preserve value wherever possible during the current crisis. Whilst payment holidays and restructurings may be painful for creditors in the short-term, aircraft will be more valuable in the hands of surviving airlines as they reinstate their schedules and increase capacity when the crisis subsides and global passenger demand recovers.

FORMAL RESTRUCTURING PROCESSES



In various jurisdictions, insolvency and bankruptcy law provide for a process by which an airline can seek to restructure its debts under the supervision of the court. The most obvious example is the United States, where Chapter 11 of the US Bankruptcy Code has been used by numerous airlines over the years, including all the leading US airlines, to restructure their debts. Court supervised restructuring processes commonly include the following features:

- a moratorium or ‘stay’ on creditor claims and enforcement of security or other proprietary rights;
- enabling a company to raise super-priority rescue financing (DIP financing) to fund operations during the restructuring process;
- a structure for the negotiation between the company and its creditors and the process for making of a proposal to those creditors following those negotiations;
- clear rules on how creditors are to be divided into different classes reflecting their pre-insolvency rights and their treatment in the restructuring for the purposes of approving a restructuring plan; and
- providing a means for imposing a compromise on creditors, including hold-out creditors or classes of creditors who can be crammed down, subject to safeguards and approval of the court.

For airlines, in general the moratorium would prevent repossession of aircraft by lessors or enforcement of security over aircraft by lenders. However, this moratorium is limited in some jurisdictions, such as under §1110 of the US Bankruptcy Code for US airline debtors and, for any Cape Town Convention contracting state, by the ‘waiting period’ under Alternative A pursuant to Article XI of the Aircraft Protocol, if the contracting state has opted into that provision.

Court supervised restructuring processes are generally more favourable to the debtor airline, which is given a better chance of restructuring its debts under the protection of the court and through being able to cram down dissenting creditors who do not voluntarily sign up to the restructuring. Creditors may also benefit from the process to the extent that it increases the recoveries they would receive compared to their recoveries in a liquidation of the airline’s business.

“IF, AS HOPED, THE DISRUPTION TO THE AIRLINE INDUSTRY IS SHORT-LIVED WITH GROUNDINGS LASTING ONLY A FEW MONTHS, THE NEED FOR THE WHOLESAL RESTRUCTURING OF AN AIRLINE WITH A RADICAL RESETTING OF ITS COST BASE AND DEBT WRITE OFFS MAY NOT BE NECESSARY.”

However, experience is mixed as to whether these processes can save the airline in the medium to long term. For the larger airlines, the time, expense and effort of going through a court supervised restructuring process may well be worth it; for smaller carriers, it is less certain that that is the case. Even where a court supervised restructuring process is likely to be successful, the significant costs involved mean that all stakeholders would be likely to benefit from a less court-intensive legal process that increases the overall cost of the restructuring.

In addition, while some jurisdictions have effective court-supervised restructuring processes, that is by no means always the case. For example, in the UK a formal insolvency process will almost invariably lead to the airline ceasing to fly and to it losing its operating license and air operating certificate (although ceasing to fly may not be as disruptive in the current situation with mass groundings being the norm due to travel restrictions to fight the virus). In other jurisdictions, a formal insolvency process designed to restructure a company may not be well tested or may be perceived as too debtor friendly and therefore not providing a suitable forum for creditors to achieve the optimum outcome from the restructuring negotiations.

Another issue is whether a formal insolvency process is the best forum for addressing a transitory issue such as COVID-19. If, as hoped, the disruption to the airline industry is short-lived with groundings lasting only a few months, the need for the wholesale restructuring of an airline with a radical resetting of its cost base and debt write offs may not be necessary. Instead, payment holidays involving all creditors may be enough to give an airline breathing space to weather the crisis. While a limited restructuring along these lines could be implemented by a formal process, it may be that this solution could be more efficiently achieved through voluntary restructuring processes that are less formal, at lower cost and with less delay.

VOLUNTARY RESTRUCTURING PROCESSES

An alternative to a formal insolvency or bankruptcy restructuring process is for the creditors of an airline to negotiate a consensual restructuring to be implemented by agreement. There are various forms that such negotiations can take, with differing levels of formality, including:

- bilateral negotiations between the airline and individual creditors;
- ad hoc group negotiations between the airline and a group of creditors; and
- coordinated negotiations between the airline and a coordinating committee established by the airline's creditors.

“BILATERAL NEGOTIATIONS ARE THE DEFAULT SCENARIO, FOR EXAMPLE WHERE AN AIRLINE APPROACHES ITS LESSORS AND LENDERS INDIVIDUALLY ASKING EACH ONE FOR A RENT HOLIDAY OR DEFERMENT OF INTEREST AND/OR PRINCIPAL. HOWEVER, NEGOTIATING ON A BILATERAL BASIS HAS MANY DISADVANTAGES.”

These approaches each have their own advantages and disadvantages for creditors and the airline, which we discuss below.

Bilateral negotiations

Bilateral negotiations are the default scenario, for example where an airline approaches its lessors and lenders individually asking each one for a rent holiday or deferment of interest and/or principal. However, negotiating on a bilateral basis has many disadvantages.

First, while bilateral negotiations may deliver quick results with some lenders and lessors, the more likely scenario is that individual creditors hold off agreeing to defer what they are owed until they have a better idea of what other creditors are willing to agree. Creditors will be particularly alive to the danger of some creditors who hold out for their full claim while other creditors agree to restructure. Even if all creditors agree to some form of accommodation for the airline, individual creditors do not know whether they are getting a similar deal or whether another creditor is more favoured than they are.

Second, creditors may seek to address their concerns around free-loading by other creditors or unequal treatment by making any agreement to restructure their debt conditional on other creditors also agreeing to restructure and on similar terms. However, such conditions can be difficult to negotiate and, if agreed, to enforce in practice.

Third, effective negotiation may require confidential information to be shared with and between creditors. In the context of airlines with debt or equity securities that are listed or traded, parties will need to be mindful of the need to comply with the EU Market Abuse Regulation and equivalent legislation in other relevant jurisdictions. It is also essential that any such exchange takes place only after careful and detailed consideration of competition/antitrust law risks. Steps must be taken to ensure no information is exchanged unless it has been through antitrust review, that the exchange of specific information is strictly and genuinely essential to achieve a legitimate outcome, and that there is no spill-over to competition between creditors outside the specific situation of the airline. In this context, it may be worth considering the use of “clean teams” to handle such sensitive data.

Fourth, managing a large number of bilateral negotiations is an expensive exercise in terms of time and effort for the airline and also puts the onus on individual creditors to commit resources to the negotiation. If the airline is required to pay the costs of the restructuring negotiations (e.g. pursuant to an indemnity in a loan agreement) precious cash may also be spent on multiple sets of lawyers.

Against these disadvantages, for some creditors bilateral negotiations may be preferable, as it allows creditors with a strong position (or a stubborn streak) to extract a more favourable outcome than others. For some airlines, a divide and conquer approach may also be beneficial. Stronger airlines may be better able to leverage their relationships with their creditors to extract better terms than would be possible if the creditors organised and bargained collectively.

To be successful, bilateral negotiations between an airline and its creditors require a large number of individual agreements to be reached. This process may take longer and cost more both in monetary terms and in management time than the airline is able to bear, resulting in its insolvency before the negotiations can be completed. Therefore, some level of creditor organisation is likely to be beneficial for all parties by giving the airline a better chance of survival so that it can continue to pay its creditors at least some of what it owes.

“AN AD HOC GROUP IS BEST SUITED TO SITUATIONS WHERE CREDITORS ARE LIKELY TO BE ALIGNED DUE TO THEIR RIGHTS BEING THE SAME OR VERY SIMILAR (E.G. WHERE THEY ARE COVERED BY A SINGLE DEBT INSTRUMENT AND SO EACH CREDITOR HAS IDENTICAL ECONOMIC RIGHTS).”

Negotiations with ad hoc groups

One alternative to bilateral negotiations is for an ad hoc group of creditors to seek to negotiate with the airline, with a view to reaching an agreement to be put to the wider body of creditors for their subsequent approval. This approach, common in bond restructurings, generally involves a self-appointed group of motivated creditors organising amongst themselves and approaching the company to agree terms acceptable to them in the hope and expectation that these terms find favour with those creditors outside the ad hoc group when they are offered to the wider body of creditors (although there is no guarantee that will be the case).

While an ad hoc group of creditors can in some circumstances streamline a restructuring negotiation with a company, the lack of formality can hamper its effectiveness. Further, where there are multiple creditor classes a single ad hoc group is unlikely to be able to cross those classes effectively and instead is more likely to represent a single constituency; an ad hoc group is best suited to situations where creditors are likely to be aligned due to their rights being the same or very similar (e.g. where they are covered by a single debt instrument and so each creditor has identical economic rights). Given that:

- some airlines have multiple loan and lease agreements that create different types of relationships between the airline and the creditor depending on whether they are a lender or a lessor; and
- other airlines only have leased aircraft where the individual leases may have different economic terms,

it is very unlikely that any commonality will be found amongst these different classes, or within a class, of creditor.

Therefore, while ad hoc groups (or combinations of ad hoc groups) may be of some use for certain airlines, their informality and narrowness may not be the most effective way of organising negotiations between an airline and its creditors.

“GIVEN THE NEED TO MANAGE THE COMPLEXITY THAT RESULTS FROM AN AIRLINE’S DIFFERENT CREDITOR CONSTITUENCIES AND WITHIN CONSTITUENCIES, IT IS LIKELY THAT A MORE COORDINATED APPROACH IS NECESSARY. IN PARTICULAR, FORMAL COCOMS ARE LIKELY TO BE MOST EFFECTIVE IN MANAGING THE VARIOUS ISSUES THAT ARISE IN BILATERAL NEGOTIATIONS OR NEGOTIATIONS WITH AN AD HOC GROUP OF CREDITORS.”

Coordinating Committees

Given the need to manage the complexity that results from an airline’s different creditor constituencies and within constituencies, it is likely that a more coordinated approach is necessary. In particular, formal coordinating committees (**CoComs** - sometimes referred to as steering committees) are likely to be most effective in managing the various issues that arise in bilateral negotiations or negotiations with an ad hoc group of creditors.

The principle of CoComs is enshrined in best practice for multi-creditor workouts in the INSOL ‘Statement of Principles for a Global Approach to Multi-Creditor Workouts’ (2000). As explained further below, CoComs have been used with success in another asset intensive industry, namely maritime, which suffered a massive downturn in the wake of the 2008 financial crisis.

A CoCom consists of a number of representative creditors who provide an interface between the company and its wider body of creditors. Through the CoCom, the company can engage in in-depth discussions about its financial position and share with the CoCom information relevant to the restructuring. The aim is to facilitate and manage the restructuring negotiations, which would otherwise be unwieldy or less open if all of a company’s creditors were involved. The ultimate commercial decision on whether to accept a proposed restructuring remains with each individual creditor, but reaching an agreement with the CoCom, which usually consists of some or all of the most significant creditors of the company, should indicate that the proposal stands a good chance of being acceptable to creditors as a whole.

A CoCom is the creation of an agreement between the company and its creditors (the LMA has precedent documentation for this purpose). Therefore, there is a degree of flexibility in how it is constituted. Commonly, it will be created by the company in conjunction with its senior lenders (i.e. amongst a single class of lender with the same or very similar rights) but in certain circumstances it can be representative of the wider body of creditors (perhaps with sub-committees for different classes). Alternatively, several CoComs can be formed to represent different classes of creditors.

The CoCom will almost invariably appoint a financial advisor and a legal advisor to assist it. While these advisors will not be advising the general body of creditors (save in relation to certain specific pieces of advice), they streamline the process and remove some element of duplication from individual creditors taking their own legal advice (which they are still able to do if they wish). The company will pay the fees of these advisors but may not pay for the advisors of individual creditors.

Issues around confidentiality and public/private side issues where the company has a listing of its equity or debt can be managed through the CoCom and its appointed advisors by limiting the sharing of price sensitive information to those willing to be restricted in their dealings in the listed securities. Certain information can also be anonymised to address confidentiality or other regulatory concerns.

The documentation forming the CoCom will generally include indemnities and exclusions and disclaimers of liability for the members of the CoCom and will also set out other constitutional matters and address the payment of advisors’ fees.



“WFW HAVE ADVISED ON MORE RESTRUCTURINGS OF MARITIME ASSETS THAN ANY OTHER LAW FIRM AND HAVE A TRACK RECORD ADVISING COCOMS. THIS, COUPLED WITH OUR IN DEPTH UNDERSTANDING AND EXPERIENCE OF THE AVIATION INDUSTRY, MEANS THAT WE CAN DRAW ON THE COMPLETE SET OF SKILLS NECESSARY TO NAVIGATE THIS NEW PARADIGM OF AIRLINE RESTRUCTURINGS.”

The benefit of a CoCom for creditors is that it offers efficiencies for those creditors who do not want to fully engage and negotiate with the company, either because they have a smaller exposure than other creditors or because management time would be better spent elsewhere (for example, in relation to another airline also in financial difficulties). For the company, the benefit of a CoCom is that it offers a more efficient and reliable process for pursuing restructuring negotiations with its creditors. Costs should also be reduced by needing to fund only one set of advisors’ fees for its creditors.

In the case of airline restructurings precipitated by the COVID-19 crisis, CoComs are likely to be well suited to the challenges faced by lessor and lender creditors operating in the aviation industry, where they will need to engage with most if not all airlines to agree some form of restructuring to avoid the insolvency of those airlines. The alternative to a successful voluntary restructuring is either the insolvency of the airline and its liquidation or a court-imposed solution that creditors may not control. In any event, absent the division of labour that can be organised through CoComs, lessor and lender creditors may be as overwhelmed by the crisis as are the airlines.

As noted above for bilateral negotiations, it will be equally important for those participating in a CoCom to pay close attention to competition/antitrust law compliance, specifically, avoidance of creating an agreement between competing lenders that unlawfully restricts competition that would otherwise exist, or avoidance of abusing a dominant position towards the airline. This can be a tricky balancing exercise between understanding the nature and degree of the restriction or practice (in the context of the airline’s immediate situation) and the benefits (not least, to the airline) or the objective justification, of the proposed solution. The issue can be effectively managed through compliance steps initiated at the outset of the process, with critical focus given to the extent to which competitively-sensitive information may be exchanged, and how.

Experience of CoComs

Whilst there has not been a need for the wide use of CoComs in the aviation industry in recent times, experience of CoComs in other sectors is instructive as to how they can assist in the current crisis in the aviation sector. A particularly good example is the maritime sector, where CoComs have been used successfully to restructure shipping companies. The maritime sector has gone through various global downturns in recent years due to overcapacity in the market and distress caused by falls in the oil price. Mortgage enforcement against a vessel is not the favoured route, as vessels are sometimes bespoke and costly to repurpose and many sales at a time of poor demand would result in little more than the scrap value of the vessel being realised. The lesson that can be drawn from these periods of financial distress caused by a sharp drop in global demand is that coordinated action by creditors is key to preserving value and saving those companies that are viable were it not for the downturn. This coordination has resulted in successful restructurings of shipping companies, safeguarding value and leading to better returns for creditors.

Watson Farley & Williams have advised on more restructurings of maritime assets than any other law firm and have a track record advising CoComs. This, coupled with our in-depth understanding and experience of the aviation industry, means that we can draw on the complete set of skills necessary to navigate this new paradigm of airline restructurings.

AIRLINE CREDITORS

An airline will have various creditor constituencies, each with their own specific characteristics and drivers in the restructuring negotiations. These constituencies include:

- aircraft lessors under operating leases;
- bank lenders secured by specific aircraft and finance lessors; and
- lenders (secured or unsecured) through loans or bonds/debt securities where the funding is used for general corporate purposes.

Aircraft lessors under operating leases

The leasing of aircraft is a major part of the aviation industry, with some (generally smaller and weaker) airlines operating asset light models where almost the entirety of their fleet is leased. More than 40% of the world's commercial aircraft are leased and, for most airlines, where its aircraft are not leased the vast majority of its remaining aircraft are financed by bank debt or finance leases (including JOLCOs and other tax lease products).

The fact that the lessor owns the aircraft leased to the airline can impact its economic position in a restructuring in several ways. The most important issue for an operating lessor is residual value risk. The value of any aircraft returned to the lessor or any reduction in lease rate will impact whether an operating lessor can recoup, or profit from, its capital investment in the aircraft. Residual value is heavily dependent on the aircraft type and age. The residual value of different types of aircraft can vary significantly, with newer, more fuel-efficient models being more valuable and in higher demand from airlines. In comparison, older planes are less fuel efficient, contribute more significantly to climate change and are more expensive to operate compared to newer aircraft. Additionally, certain aircraft types are less favoured by airlines (e.g. the A380 has very limited demand compared to other wide body aircraft). Therefore, lessors of older and less popular aircraft types may find themselves at greater risk, compared with lessors of newer and more popular types, in a market in which airlines are likely to be seeking a reduction in fleet and selecting aircraft they wish to return to lessors.

In this scenario, the ability of the lessor to remarket the aircraft at an attractive (or economic) rate is doubtful in the short-term. An alternative approach for the lessor is to sell the aircraft, but in a falling market that option may not be feasible, or at least not at a price that works for the lessor. These issues, present even in a normal market, will clearly be exacerbated by the COVID-19 crisis and any increase in airline failure that results from it. Therefore, the lessor will be under pressure to find a solution that keeps the aircraft with the airline.



An additional burden on a lessor is that, if an aircraft is returned and cannot immediately be successfully remarketed or sold, the lessor will need to store and continue to maintain the aircraft. Storage and maintenance will lead to additional costs that must be borne by the lessor and further increase the incentive to keep an airline flying so that the airline continues to operate the aircraft.

Another factor relevant to lessors is that lease rates have generally been on a downward trend over the last few years, as money from Chinese investors and other new sources of funding have led to an over-supply of aircraft, meaning that lease rate factors are at historic lows. In any restructuring, there may be a push to equalise

lease rates, so that lessors benefiting from earlier vintage leases with better lease rates take a greater cut to their lease rate than lessors with more recent leases.

Finally, it should be noted that operating leases generally do not include financial covenants (in comparison with loans and finance leases). Therefore, absent payment default, lessors do not formally have as much leverage as a bank lender (although this issue may be less relevant if an airline is seeking a payment holiday under the lease).

For lessors, an additional complication will be that they themselves are financed by either bond or bank debt. As part of these financing transactions, the lessor will have often agreed limits to exercising their discretions under leases and assigned the lease by way of security for the financing. Therefore, such financings add a further dynamic to restructuring negotiations, where the lessor's financiers exert some level of control over the lessor's negotiations.

Bank lenders secured by specific aircraft and finance lessors

The position of a bank lender with security over an aircraft is very different to that of a lessor. Typically, a bank will loan against an aircraft at a loan to value ratio of 70-80% on day one. Therefore, if the bank enforces its security it has a buffer between the value of its loan and the value of the aircraft that will protect it if aircraft values fall (although if aircraft values fall too precipitously, this buffer may be insufficient to fully protect the lender).

The result of the difference in a bank's and a lessor's position is that a lessor needs the airline to keep flying much more than a bank does. A bank does not have the same residual value risk or potential burden of storing or maintaining aircraft that have been handed back by the airline.

One complication for bank lenders will come from export credit agency (ECA) backed financings. Like lessors who have their own financings in the background, lenders who have ECA-backed loans will need to be careful to comply with the terms of their credit guarantee or insurance and any restructuring is likely to be effectively controlled and run by the ECA.

"TYPICALLY, A BANK WILL LOAN AGAINST AN AIRCRAFT AT A LOAN TO VALUE RATIO OF 70-80% ON DAY ONE. THEREFORE, IF THE BANK ENFORCES ITS SECURITY IT HAS A BUFFER BETWEEN THE VALUE OF ITS LOAN AND THE VALUE OF THE AIRCRAFT THAT WILL PROTECT IT IF AIRCRAFT VALUES FALL."

General corporate lenders

An airline may have general corporate loans or bonds as part of its capital structure alongside its more specific aircraft financings. These may be secured over other assets of the airline (such as take-off and landing slots) or be unsecured financings. It is likely that any successful restructuring would need to include this general corporate debt.

As the lenders of this general corporate debt will not have interests in specific aircraft and will be subordinated behind lessors and banks who have provided finance secured on aircraft, their interest will be in keeping the airline operating as a going concern. Therefore, their interests will to some extent be aligned with those of the lessors. However, they will also want to see the airline's cost base reduced and right-sized so that the airline is in a viable position going forward, and so reductions in lease rates and debt service is in their interest.

AIRCRAFT ABS ISSUES

The last six to seven years have seen record amounts of dollars invested in aircraft asset-backed securitisation (**ABS**) debt securities, which have been used as a source of funding for aircraft lessors. These securities are typically issued in Series A, B and C tranches, as well as equity securities (**E-Notes**), the latter being issued either on a strict §4(a)(2) private placement basis or, more commonly in recent ABS, in liquid form under a Rule 144A/Reg. S issuance. The non-recourse nature of aircraft ABS means that all cash flows directly or indirectly derive from the proceeds of the aircraft collateral portfolio. Moreover, recent aircraft ABS have seen a slackening of portfolio parameters, including higher proportions of widebodies, and lower average remaining lease terms. These factors put additional pressures on collateral remarketability and mean that investors are relying more heavily than ever on the aircraft lessor servicer's skill, experience and specialism in managing an aircraft portfolio of a particular type (for example, a lessor who manages a large proportion of widebody aircraft in its own fleet).

“ON 31 MARCH 2020, FITCH PLACED 35 OUTSTANDING TRANCHES OF AIRCRAFT ABS (AIRCRAFT AND ENGINE) NOTES ON ITS RATING WATCH NEGATIVE.”

An event of default in an aircraft ABS has, to our knowledge, never occurred. This is because, like other similarly structured aircraft finance products, they have been deliberately structured so as to survive turbulence in the airline market. Features such as ultimate (rather than timely) payment of principal, liquidity facility advances (covering shortfalls of interest for noteholders of senior ranking debt over a period of nine months) and concentration limits go a long way to protect against a bumpy market, whether localised to a particular geographic region, or as a result of a global but temporary event. However, the COVID-19 crisis is exceptional because it has potential to affect the whole of the global airline market for a sustained period. In the short term, it will result in the suspension of almost all lease rental cash flows across ABS collateral portfolios to cease as lease rental deferral agreements are concluded with airlines; in the long term it will probably cause a global recession which may suppress lease rental revenues for many years to come as passenger numbers take a hit. On 31 March 2020, Fitch placed 35 outstanding tranches of aircraft ABS (aircraft and engine) notes on its Rating Watch Negative.

Notwithstanding the exceptional nature of the COVID-19 crisis, even this will not likely cause an aircraft ABS event of default unless, after nine months, there are insufficient lease rental cash flows to service the senior ranking debt; (the liquidity facility will be drawn down to plug the shortfall during the nine-month period). As for the junior ranking debt, non-payment of interest typically does not trigger an event of default in and of itself; rather, it is capitalised onto the outstanding principal under a 'payment in kind' or 'PIK' mechanism. Additionally, in some ABS structures junior ranking noteholders benefit from amounts deposited into a modest reserve account, which can be utilised to plug interest payment shortfalls over short periods.

As for investors holding equity securities in aircraft ABS, investors do not, or should not, have an absolute expectation for regular payments and may have more appetite for a longer 'play' given they benefit from the residual value of the aircraft collateral; however, the ABS issuer group is a 'mini' aircraft leasing business in its own right, albeit a passive one heavily reliant on the actions and expertise of the servicer. Thus, to this extent, equity investors do find themselves in the same position as traditional aircraft lessors, and their fortunes will be tied to those of the aircraft lessor servicing the ABS portfolio and its skill and expertise in dealing with such an event. That lessor (usually the seller/sponsor) must service the managed aircraft portfolio in accordance with the standard of care and conflict standard as set out in the servicing agreement. This means that, with respect to any rent deferrals being negotiated between the

lessor and its airline customers, the servicing aircraft lessor must, in the aggregate, not favour owned aircraft over managed aircraft. Aircraft ABS aircraft will (or should) therefore benefit from the deal the servicing lessor has struck with respect to its own aircraft.

Even though the COVID-19 crisis may be less acute for ABS investors than aircraft lessors or traditional lenders, it is worth discussing how the crisis will affect them, and what other options may be available to them not available to lessor and traditional lenders.



Are aircraft ABS investors (of ABS in capital markets format) likely to join airline creditor CoComs?

For investors holding ABS debt securities issued in the capital markets the answer, in short, is probably no. This is for a number of reasons. First, debt investors are not creditors of an airline directly, and so they would have to act through the ABS issuer (of which they would be the controlling party unless an event of default occurs).

Second, ABS debt investors are often a dispersed and diverse mixture of passive investors. Unlike lenders in a loan syndicate, any issue that requires them to coalesce to take action and issue a direction will be very slow (not because the investors are not capable or diligent, but because of the practicalities of first determining the extent of the investor group and then convening them). Furthermore, they are passive investors and have had no input in the structure, terms or negotiation of the transaction, and will have relied predominantly on the rating assigned to the debt security by the rating agencies. They are unlikely to have the same specialised knowledge in aircraft finance that banks providing aircraft finance have.

Third, the very protections available to investors holding senior ranking debt mean that they are not incentivised to act quickly. Under the ABS liquidity facility, they have nine months of protection and as such will be monitoring the situation on an ongoing and gradual basis. Only when it becomes clear that nine months may not be long enough, will the threat of an event of default appear and a decision need to be made. By that point, CoComs will probably already have been formed and airline restructurings may have already taken place. For the investors holding junior ranking debt, there may be slightly more of an incentive, but interest on the junior notes will be capitalising under the PIK mechanism, something which was identified as a risk from the outset. More importantly, they will not be the controlling party, so even if they wanted to join a CoCom, they would be unable to do so in a meaningful way without the approval of investors holding senior ranking debt. While investors holding junior ranking debt have buy-out rights in respect of the senior debt, the buyout price will be at par value. At the time of exercise, it seems likely, given the market view of the airline industry, that the senior notes will be trading at a discount, making the exercise of any buyout right at par value unattractive.

As for equity investors, the answer is also probably no. As mentioned above, the equity investors will be looking to the servicer to take the lead in how the leases should be restructured. Accordingly, aircraft lessors who do form CoComs will be doing so in respect of both their own leased aircraft and for managed assets in aircraft ABS portfolios. That said, it could be the case that certain participants such as anchor investors, who have a deeper market knowledge and expertise in the aviation sector, may want to play an active role on a more informal basis and, on such basis, work together with the aircraft lessors servicing the ABS portfolio.

“ONE OPTION AVAILABLE TO INVESTORS IN AIRCRAFT ABS WHICH WILL NOT BE SO READILY AVAILABLE TO LESSORS AND LENDERS IS TO SELL THEIR DEBT, ALBEIT AT A HEAVILY DISCOUNTED PRICE.”

Other exit options available to ABS investors

Given the highly liquid nature of aircraft ABS debt securities and many equity securities in the capital markets, one option available to investors in aircraft ABS which will not be so readily available to lessors and lenders is to sell their debt, albeit at a heavily discounted price. This may give rise to opportunities for distressed debt and equity trading funds, who may have deeper market knowledge, be less risk averse and make a play on buying and holding such securities until the market recovers, then later cashing out.

Liquidity facility providers

Finally, it is worth briefly mentioning the position of the liquidity facility provider, who will also be looking to future lease revenues to be repaid in respect of any advances it has made for the benefit of senior noteholders during the nine-month period of coverage. The standard position under an aircraft ABS is that, for a number of months, typically 20 after the facility is fully drawn (i.e. likely to be 39 months after the first advance) or unless an earlier event of default has occurred, the senior noteholders will remain the controlling party. Thus, the liquidity facility provider will have little formal say in how the underlying situation is managed. However, there is some scope, with rating agency consent and the satisfaction of other conditions in the trust indenture, for the liquidity facility to sell down its position and exit from the deal, provided, that a buyer can be found.

STATE SUPPORT

“WITH A CRISIS THAT IS OPEN-ENDED, EVEN IF ULTIMATELY TEMPORARY, THE QUESTION FOR GOVERNMENTS IS HOW MUCH MONEY TO BET ON THE POST-CRISIS STRUCTURE OF THE MARKET.”

More than all previous shocks, the outbreak of COVID-19 challenges governments’ willingness to support airlines.

Already, in Europe, we have seen opposite approaches: Italy has re-nationalised Alitalia, while the UK has (at the date of publication) so far refused industry-wide support, asking carriers first to exhaust private means. In between we have seen State support for Norwegian, SAS and Finnair.

In the United States, part of the mammoth CARES Act (Coronavirus Aid, Relief and Economic Security Act) signed into law by President Trump on 27 March 2020, is devoted to support principally for the passenger and cargo airline industries.

The different approaches reflect not only different views towards support of airlines generally – the Italian government has a long history of supporting its flag carrier – but perhaps also different views to what should be supported in the future.

With a crisis that is open-ended, even if ultimately temporary, the question for governments is how much money to bet on the post-crisis structure of the market. For the industry, returning supply to the market is the easier part. The demand that has been lost during the crisis is lost forever; the question is how quickly demand will return to long-term trend. This in turn depends not only on when the crisis can be considered “over” (in the sense that lock-downs and quarantines are no longer required to contain the outbreak, whether at origin or destination) but the willingness and financial ability of consumers (including business customers) to return to the skies.

The European Union

The EU has a long-standing and increasingly sophisticated anti-subsidy law, part of its competition rulebook, which regulates what EU Member States (including – for this year at least – the UK as a former Member State) can do to support their aviation industries.

An EU Member State, which grants State Aid, infringes EU law, unless that aid falls within specific categories that are, or may be, compatible with the EU’s internal market. This law is found at Article 107 of the Treaty on the Functioning of the European Union (TFEU).

A State, which wishes to support an airline, must structure its support either so it is not State Aid, or if it is, that it is or may be “compatible” aid. The first option is to structure financial support so it does not count as State Aid. Under Article 107:

“any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.”

If State support does not meet all these criteria, it will not be State Aid, and the Member State can disperse the funds according to its chosen policy.

In many cases, however, financial support will constitute State Aid. After the airline industry was liberalised in 1992, several Member States have been investigated for the State Aid they have given, or sought to give, to airlines.

“THE OUTBREAK OF COVID-19 IS CONSIDERED BY THE EU TO BE AN “EXCEPTIONAL OCCURRENCE” AND THE COMMISSION HAS NOW ESTABLISHED A FRAMEWORK FOR EU MEMBER STATES TO NOTIFY AID UNDER THE “EXCEPTIONAL OCCURRENCE” CRITERION.”

How do airlines benefit from lawful State Aid?

One much-used framework for aid is found in the Guidelines on Rescue and Restructuring Aid, most recently updated in 2014. This is a framework for “*undertakings in difficulty*”. An undertaking is in difficulty if, without the intervention of the State, it will almost certainly be condemned to going out of business in the short or medium term. A Member State which proposes to grant aid in accordance with these guidelines must demonstrate on objective grounds that the undertaking is in difficulty. The guidelines then set out the rules for three different types of support: short term “*rescue*” aid, “*restructuring aid*”, and “*temporary restructuring support*.” Member States notifying the Commission must show how the proposed aid meets the EU Commission’s criteria for compatibility.

EU airlines have benefited from Rescue and Restructuring Aid on many occasions. Most recently, on 24 February 2020, the EU approved Romania’s €36.7m (estimated) Rescue Aid to TAROM, in the form of a loan. Note, this was unconnected with the outbreak of COVID-19. Before that, on 14 October 2019, the Commission approved a €380m temporary loan to Condor, also as Rescue Aid. By contrast, proposed Rescue Aid of €900m (by bridging loan) by the Italian State to Alitalia went into a full investigation by the European Commission which was ongoing at the time of Alitalia’s renationalisation.

Frameworks established in response to COVID -19

European law provides two legal bases for State Aid that responds to crisis situations:

- aid to make good the damage caused by natural disasters or *exceptional* occurrences (Article 107(2)(b) of the TFEU), which *shall* be considered compatible aid; and
- aid to remedy a *serious disturbance* in the economy of a Member State (Article 107(3)(b) of the TFEU), which *may* be considered compatible aid.

Exceptional occurrences – damages framework

The outbreak of COVID-19 is considered by the EU to be an “*exceptional occurrence*” (decision of 12 March 2020) and the Commission has now established a framework for EU Member States to notify aid under the “*exceptional occurrence*” criterion. Annex I to this framework sets out, for the transport sector (airlines, airports, ground handling, rail and bus undertakings, maritime companies etc.), specific information the Commission needs to assess the level of damage caused, and the period over which it has been caused. This includes identifying additional costs and foregone revenues, finding a reference period when the situation was comparable to the COVID-19 outbreak, and a calculation of the damage caused, through comparing the situation during the outbreak with that reference period.

The Commission has clarified that the “*one-time, last time*” principle in the Rescue and Restructuring Guidelines does not apply to this framework as aid and would not be rescue, restructuring or temporary restructuring support. This means that even airlines benefitting from Rescue and Restructuring Aid can also benefit from exceptional occurrences aid.

On 31 March 2020, the Commission approved a French aid scheme to permit airlines with a French operating licence to defer payment of certain aeronautical taxes, to mitigate the damage to airlines’ cash flow from the COVID-19 outbreak. This is the first State aid measure to be notified by an EU Member State to mitigate

COVID-19 damages in the aviation sector. It allows the airlines the possibility of deferring the payment of certain taxes that would in principle be due between March and December 2020 to after 1 January 2021, and to pay the taxes over a period of up to 24 months.

Serious disturbance – temporary framework

On 19 March 2020, the Commission issued a Communication entitled “*Temporary Framework for State Aid measures to support the economy in the current COVID-19 outbreak.*” Here, the Commission confirms that the COVID-19 outbreak does qualify as a “*serious disturbance*” but requires Member States to show that proposed measures are necessary, appropriate and proportionate to remedy such disturbance, and that the specified conditions for aid are met.

To date, the Temporary Framework has been used by several Member States, and the Commission has obliged with very fast decisions on the notified aid schemes. Only France to date has addressed the airline industry specifically. The EFTA Surveillance Authority (“ESA”) has also approved Norway’s guarantee scheme for new loans to all airlines in Norway (of which there are twenty-four). Critical to this scheme was the Norwegian government’s support. As stated in the ESA decision of 31 March 2020, the Norwegian authorities considered “*the airline industry as a necessary part of Norway’s critical infrastructure and a major contributor to Norway’s economy.*”

It will be for airlines, working with Member States, to devise either individual support packages or aid schemes that can be notified to and cleared by the Commission.

The United States

On 27 March 2020, President Trump signed into law a substantial economic stimulus package, which, among other things, includes support for the aviation industry, subject to detailed conditions.



Title IV of the CARES Act sets out the Coronavirus Economic Stabilization Act of 2020, which is of immediate relevance to air carriers. The Act authorises the Secretary of the Treasury to make loans, loan guarantees, and other investments in support of eligible businesses, States and municipalities up to US\$500bn. Eligible businesses include air carriers or a US business that has not otherwise received adequate economic relief by loans or loan guarantees provided elsewhere in the Act. For the aviation industry, this support comprises loans, loan guarantees and other investments, and support for workers of air carriers.

Loans, loan guarantees and other investments

Subject to numerous conditions imposed by the Act (including with respect to security, interest, duration, share buybacks and dividends), loans, loan guarantees and other investments may be made as follows:

- not more than US\$25bn as loans and loan guarantees for passenger air carriers and eligible businesses approved to perform inspection, repair, replacement or overhaul services, and ticket agents;
- not more than US\$4bn as loans and loan guarantees for cargo air carriers; and
- not more than US\$17bn as loans and loan guarantees for businesses critical to maintaining national security.

Air carrier worker support

Section 4112 provides for "*pandemic relief for aviation workers*". The Secretary of the Treasury shall provide financial assistance that shall be exclusively used for continuing to pay employee wages, salaries and benefits to:

- passenger air carriers, in an aggregate amount up to US\$25bn;
- cargo air carriers, in an aggregate amount up to US\$4bn; and
- contractors, in an aggregate amount up to US\$3bn.



This relief is also conditional. The air carrier or contractor must enter into an agreement with the Secretary or otherwise make certain certifications (including with respect to furlough, pay, share buy-backs, dividends and continuation of service).

It remains to be seen how much use the airline sector makes of the offered support, particularly given the conditions that apply. The conditions were imposed in the context, in part, of media (and, therefore, public) opposition to potential carrier bail-outs.

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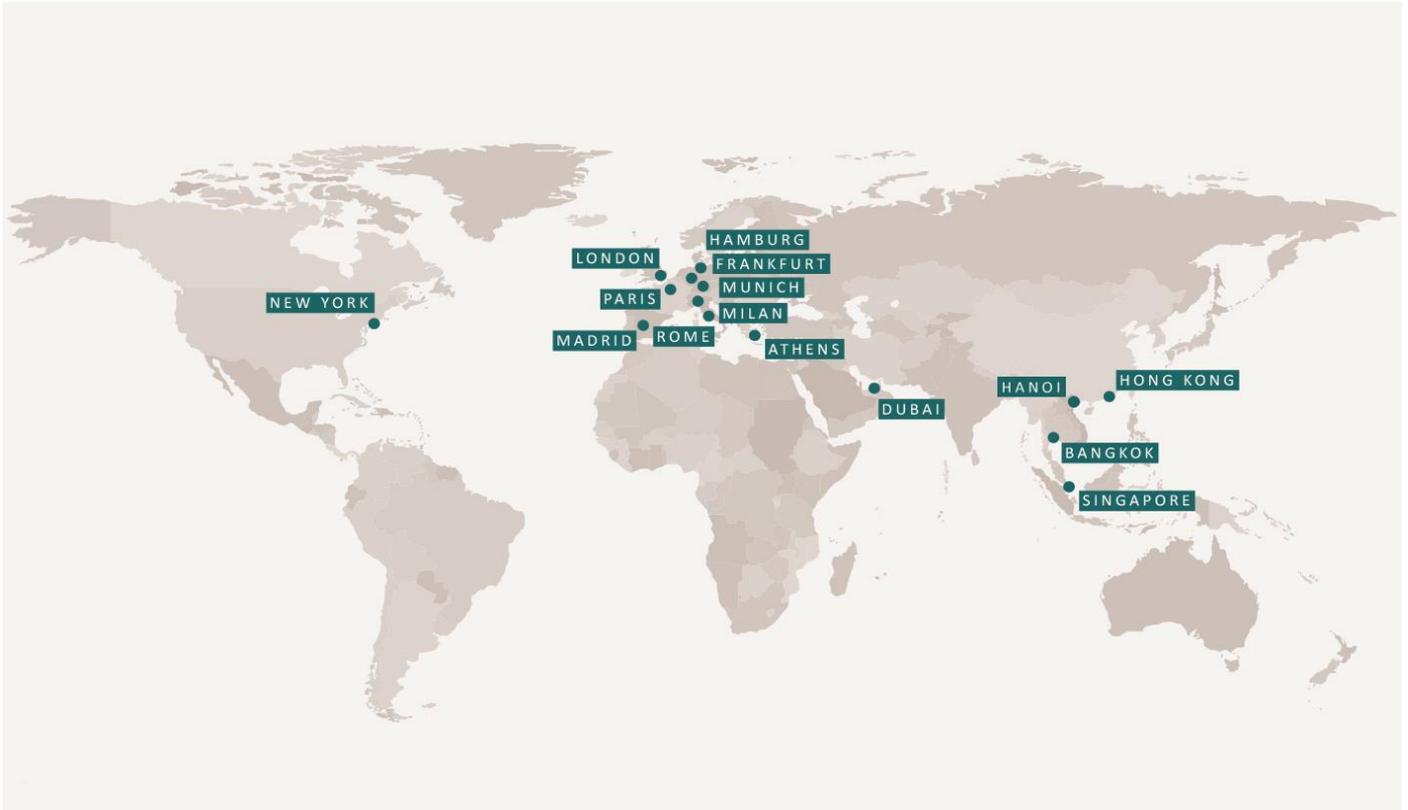
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