WATSON FARLEY
&
WILLIAMS

COVID-19 AVIATION RESTRUCTURING REPORT

SECOND EDITION – APRIL 2021

"WFW ARE A HUGELY EXPERIENCED PARTNERSHIP WITH A HUGE DEPTH OF EXPERTISE IN AVIATION FINANCING AND AIRCRAFT LEASING."

LEGAL 500 UK, 2021

CONTENTS

WINNER OF BEST RESTRUCTURING DEAL OF THE YEAR
ISHKA AWARDS, 2019

TIER 1 IN TRANSPORT FINANCE AND LEASING
LEGAL 500 UK, 2021

WINNER OF RESTRUCTURING DEAL OF THE YEAR
IFLR EUROPE AWARDS, 2021

FOREWORD

Over a year on from the start of the pandemic, those airlines that have so far survived the crisis continue to face a challenging and uncertain outlook. The International Air Transport Association ("IATA") estimated that the airline industry lost US$118.5bn during 2020, with full-year traffic down 66% on 2019 and passenger traffic not expected to return to pre-2019 levels until at least 2024. Hopes that revenues would begin to recover with the start of the New Year and vaccine roll-out were dampened as new variants of the virus emerged and governments in Europe and beyond re-imposed lockdowns and travel bans. While 2020 saw a raft of airline insolvencies and restructurings, many in the market expect that there will be still greater numbers in 2021 and into 2022.

When we published the first edition of this report in April last year, the length and scale of the Covid-19 pandemic was yet to be seen. The immediate challenges, however, were clear. On the one hand, airlines faced an unknown period of significantly reduced revenues. On the other, so long as the market was supressed and there remained limited remarketing opportunities for aircraft, repossession could not provide an effective remedy for lessors and financiers. Less clear at that time was how the market would respond to these challenges.

Drawing on experience from other sectors which had suffered sudden and drastic drops in demand, including the helicopter and maritime sectors, the first edition of this report set out the principal issues that market participants were likely to encounter as well as the restructuring techniques that had been developed and successfully employed in those sectors. Now almost a year on from that report, the market's response has developed, trends have emerged and there have been significant changes to legislation in the UK warranting this second edition.

In addition to having updated the original sections of the report, this edition incorporates a new section titled 'Trends since the onset of Covid-19' and includes additional commentary on the new UK restructuring plan, a table comparing the key features of a UK scheme of arrangement, a UK restructuring plan and the US's Chapter 11 rehabilitation procedure as well as case studies on the restructurings of Virgin Atlantic Airways and Malaysian Airlines Berhad.

"WITH FULL-YEAR TRAFFIC DOWN 66% ON 2019 AND PASSENGER TRAFFIC NOT EXPECTED TO RETURN TO PRE-2019 LEVELS UNTIL AT LEAST 2024."

US$118.5BN
estimated cost to the airline industry during 2020

TRENDS SINCE THE ONSET OF COVID-19

Deferral requests
As an immediate response to the pandemic and national lockdowns, airlines were quick to approach their creditors for temporary financial relief, requesting the deferral of rent payments under leases and of interest and principal instalments under debt financings. These requests were intended to provide airlines with breathing space in addressing what might have been, and many hoped would be, a transient issue and this was reflected in the terms of the waivers granted. Typically, the duration of a deferral was either three or six months and preserved the original economics of the transaction, pushing out and spreading the deferred payments.

Such requests were often denied where they appeared to be opportunistic or, in the case of requests to a lessor, consents required under the lessor's own financing for the aircraft were not forthcoming. In many cases, however, requests were accommodated so as to avoid the rigmarole of repossession and the impact on capital adequacy requirements of holding a defaulting loan. Indeed, certain banks applied a blanket policy of agreeing deferrals received from their customers.

As deferral periods expired last summer, the crisis deepened with several airlines entering formal insolvency procedures and restructuring processes. The prospects for remarketed aircraft remained weak and renewed deferral requests were often granted, effectively 'kicking the can' further down the road while lessors sought to avoid crystallising the residual value loss.

Early insolvencies and restructurings
The onset of Covid-19 was enough to immediately push some already struggling airlines into insolvency or substantive restructurings. European examples include Flybe and Norwegian Air Shuttle.

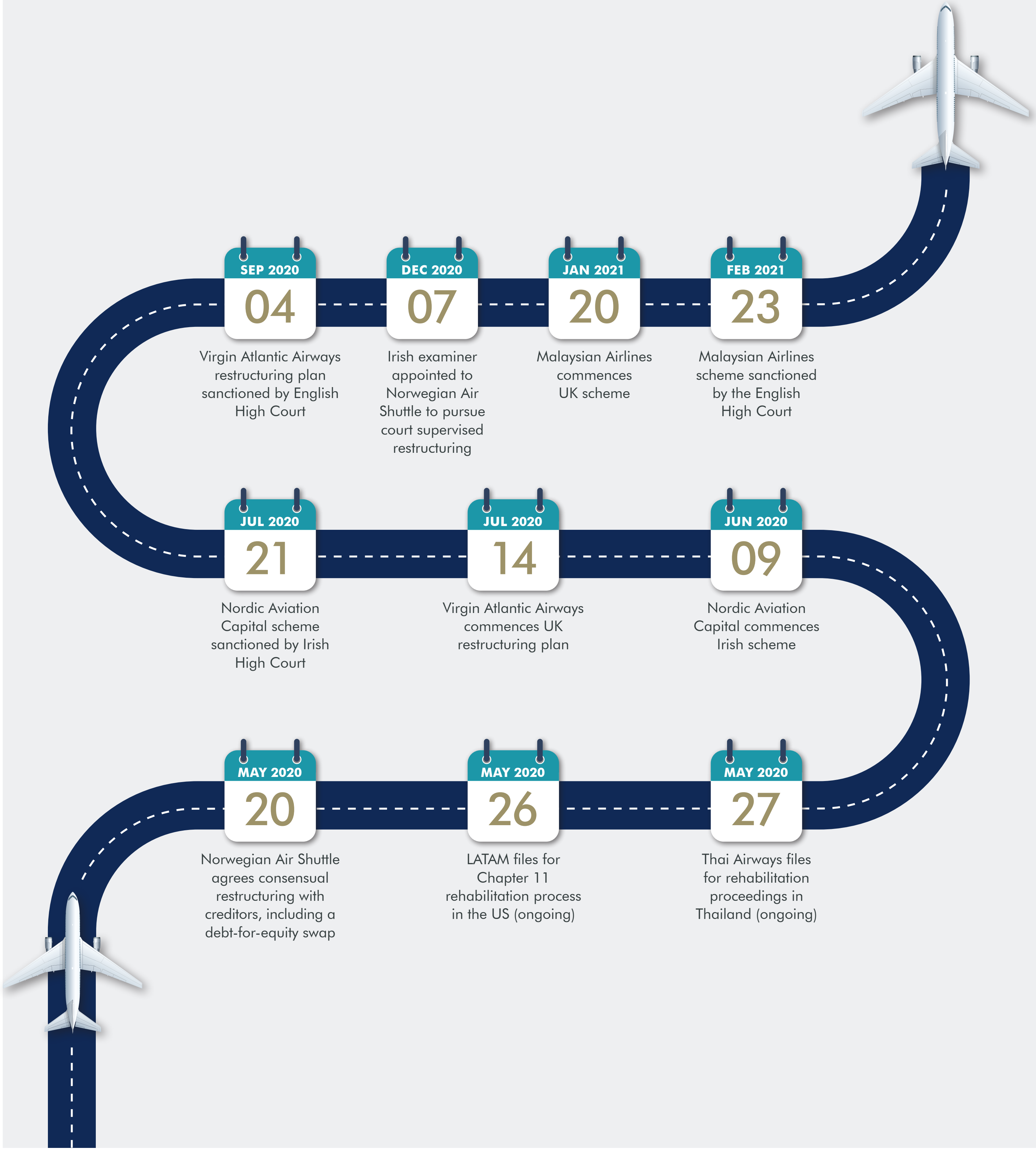
With demand for aircraft at an historic low and large proportions of airlines' fleets grounded, lease rates tumbled and new lending to the sector was suspended by many of the established banks in the market. Without certainty as to when and to what extent flights and revenues would resume, several airlines sought to reduce their fleet size and to permanently renegotiate their lease terms to reflect the prevailing market conditions and reduced medium-term demand for flights.

Various South American airlines, including LATAM, AeroMexico and Avianca, followed a well-trodden path by filing for Chapter 11 bankruptcy in the United States. This process entitles debtor airlines to reject existing leases and return aircraft to lessors, while also providing protection from creditors in the form of a worldwide stay on enforcement and a formal procedure under which to implement a restructuring plan. Other airlines, particularly in South East Asia, simply sent RFPs to existing lessors requesting their best offers for the continued leasing of aircraft already placed with the airline, stating the intention to simply walk away from a portion of their leased fleet.

"AS DEFERRAL PERIODS EXPIRED LAST SUMMER, THE CRISIS HAD DEEPENED WITH SEVERAL AIRLINES ENTERING FORMAL INSOLVENCY PROCEDURES AND RESTRUCTURING PROCESSES."

COVID-19 AIRLINE RESTRUCTURING TIMELINE

Timeline of prominent court-supervised restructuring processes indicating timescales involved



This 'divide and conquer' approach attempted to attribute losses to the airlines' lessors, apportioned unequally depending on lessors' willingness to renegotiate existing deals. An airline's request was regularly coupled with a threat that, in the alternative, it would file for an insolvency procedure or simply transfer to a new or sister company those assets and operations it wished to continue while leaving the remainder to be liquidated. Often with little clarity around the airline's restructuring plan or prospects, and lacking visibility over the process and engagement from other creditor constituencies, many lessors refused to make blind concessions.

More successfully, airlines have conducted restructurings using schemes of arrangement and, following legislation passed during the summer, the new UK restructuring plan. CityJet and Nordic Aviation Capital used Irish schemes. Virgin Atlantic Airways was the first airline, and indeed the first company of any sort, to apply for a UK restructuring plan. Following speculation that Malaysian Airlines Berhad would attempt an aggressive use of a UK restructuring plan to return aircraft to its lessors, it ultimately employed a UK scheme to restructure its operating leases while implementing restructured terms with other creditors out of court on a voluntary basis.

Each of these court processes was ultimately completed with almost unanimous consent of the relevant creditors, in most cases following extensive discussions and negotiations between the debtor and those creditors. In achieving such support, it is notable that each of these restructurings treated the creditors within each class equally. In particular, lessors were grouped into a single class and were each offered the same set of options for restructuring the terms of their transactions with the airline.

One expected trend we have not seen emerge, has been the use of 'CoComms', by which negotiations are conducted by a representative committee on behalf of creditors as a whole. A significant reason for this has been the 'divide and conquer' approach taken by airlines seeking to treat lessors differently in the restructuring, depending on whether they intend to continue leasing a particular lessor's aircraft or not. In these circumstances, airlines have pitted lessors against one another in such a manner that coordinated negotiation by creditors has not been possible.

We have, however, seen airlines steering creditor groups to use a single law firm to represent them, reminiscent of the 'designated lender counsel' approach developed in the leverage finance market. This has the benefit of efficiency, both in terms of time and costs, for the airline.

Cape Town Convention issues

In light of this 'divide and conquer' approach, there has been widespread discussion within the lessor and legal communities on the question of whether schemes of arrangement and UK restructuring plans constitute "insolvency proceedings" and "insolvency-related events" for the purposes of the Cape Town Convention. The question has potentially significant consequences for international interest holders who would benefit from the repossession and anti-cramdown provisions of 'Alternative A' of the Convention's Aircraft Protocol (to the extent applicable) only where an "insolvency-related event" has occurred with respect to the airline.

In response to this debate, the Cape Town Convention Academic Project issued an annotation to the Official Commentary to the Cape Town Convention seeking to clarify the basis on which the term "insolvency proceedings" should be interpreted. Additionally, the Aviation Working Group (the "AWG") submitted a written opinion in the *Malaysian* case expressing the view that schemes of arrangement and UK restructuring plans would indeed constitute "insolvency proceedings" when used as an alternative to a formal insolvency process, and thus trigger the protections of 'Alternative A'.

To-date, there has been no UK or Irish court decision directly on this point. However, two recent cases serve as persuasive authorities supporting the AWG's view. In the recent *gategroup* case, the English High Court found a UK scheme to be an "insolvency proceeding" for the purposes of the Lugano Convention. In the *Air Asia X* case, a Malaysian scheme of arrangement (itself modelled closely on the UK's own scheme) was found to be an "insolvency proceeding" for the purposes of the Cape Town Convention.

These cases are likely to abate lessors' concerns that airlines would use schemes and UK restructuring plans as a means to cram-down lease liabilities or even return aircraft to lessors.

CASE STUDY
SPOTLIGHT ON VIRGIN ATLANTIC AIRWAYS

In the summer of 2020, Virgin Atlantic underwent a c.£1.2bn solvent recapitalisation using the then newly available UK restructuring plan. Following negotiations with its creditors and the execution of 'lock-up agreements' (agreements to vote in favour of the scheme or plan), the company made its initial application to the court in July, with the plan finally being sanctioned and implemented in early September, having received the approval of all the creditors who voted on the plan (almost 100% of the eligible creditors).

"KEY TO THE PLAN'S SUCCESS IN GARNERING CREDITOR SUPPORT APPEARS TO HAVE BEEN THE FACT THAT THE TERMS DID NOT SIMPLY REQUIRE CONCESSIONS FROM THE COMPANY'S CREDITORS."

The principal terms of the plan included:

- a capital injection of £200m from Virgin Group;
- the deferral of c.£400m of shareholder payments such as brand fees and joint venture-related costs;
- the provision of £170m of new secured debt financing from Davidson Kempner Capital Management, an alternative investment fund;
- the conversion of its revolving credit facility into a term loan, with an increased margin, adjusted covenants, extension to the maturity date and revised security package;
- revised lease terms agreed with its operating lessors; and
- a 20% discount to invoices with each of its trade creditors (other than those to whom it owed less than £50,000) and deferral of payments to such creditors.

Houlihan Lokey was appointed by Virgin Atlantic as the company's financial advisor for the purposes of the restructuring. Key to the plan's success in garnering creditor support appears to have been the fact that the terms did not simply require concessions from the company's creditors but also included compromise arrangements and new capital from the company's shareholders.

In contrast to the 'divide and conquer' approach taken by other airlines, Virgin Atlantic's operating lessors were each offered the same selection of restructured lease terms, including either a deferral of rentals, a reduction of rentals with a bullet payment or lease termination and return of the aircraft, at the lessor's option.

CASE STUDY
SPOTLIGHT ON MALAYSIAN AIRLINES BERHAD

In late summer 2020, Malaysian Airlines Berhad ("MAB") contacted its lessor-creditors with a restructuring proposal which was anticipated to be implemented using a new UK restructuring plan under Part 26A of the UK Companies Act.

This initial proposal sought to create at least two different classes of lessor, including those whose leases would be continued under the plan on restructured terms and those whose leases would be terminated, with their aircraft returned.

In so doing, MAB sought an aggressive use of a UK restructuring plan by taking advantage of new provisions in Part 26A of the UK Companies Act allowing for 'cross-creditor class cram-down'. Such a cram-down allows a debtor, if the court is satisfied certain threshold conditions are met, to implement a restructuring plan notwithstanding the fact that it has not been approved by the requisite majority of creditors in each class.

The calculation appeared to be that the class of lessor-creditors whose aircraft it wanted to return would likely not agree to the proposed restructuring plan but by putting them into a separate class, that would not matter as the plan could nevertheless be implemented against their wishes.

While it is unclear whether MAB had been advised by external financial advisors at this stage, its initial proposal received a largely hostile response from its lessor-creditors. The proposal also brought to a head the debate among leading aircraft finance lawyers on the extent to which any UK restructuring plan (under Part 26A) or UK scheme (under Part 26) is compatible with the Cape Town Convention's anti-cramdown provision.

Article XI(10) of the Aircraft Protocol to the Cape Town Convention, which applies upon the occurrence of an "insolvency-related event", provides that no obligations of a lessee-debtor under a lease agreement may be modified without the consent of the lessor-creditor. The effect of such provision, if a UK restructuring plan or scheme of arrangement does constitute an "insolvency proceeding" for the purposes of the Cape Town Convention, is to prevent lessor-creditors from being crammed-down and bound by a plan or scheme that they have voted against, but which has nevertheless been sanctioned by the court on the basis of approval by the requisite threshold of creditors or by way of cross-class cram-down.

Following the rejection of MAB's initial proposal by its lessors, in late 2020 MAB revised its proposal. Significantly, the revised proposal was to be implemented using a UK scheme of arrangement under which, unlike a UK restructuring plan, no 'cross-creditor class cram-down' is available. The revised proposal therefore did not seek to divide lessors into separate classes and rather gave the same set of restructuring options to each.

Also notable was that: (a) the proposal targeted only some of MAB's lessor-creditors, presumably excluding those which it calculated would likely dissent and with whom it had entered into or would enter into a bilateral restructuring arrangement, (b) unlike a UK restructuring plan, it is not a condition of a UK scheme that it may only be used in circumstances where the debtor is in or anticipates financial difficulties, potentially adding an extra hurdle for creditors to successfully argue that MAB's scheme falls within the scope of the definition of "insolvency proceedings" under the Cape Town Convention and (c) separate bilateral restructuring arrangements were implemented in parallel with other creditor groups outside the ambit of the scheme proceedings.

Under the revised proposal, MAB's lessor-creditors were offered either lease termination and return of the aircraft or one of three different rent deferral options. This even-handed treatment of its lessors reportedly resulted in much more collaborative and constructive discussions and, ultimately, resulted in almost all the affected lessors entering 'lockup agreements' before the scheme was launched.

On 21 January 2021, the UK High Court approved the convening of a single scheme meeting for certain aircraft lessors of MAB in relation to its proposed UK scheme of arrangement, and subsequently sanctioned the scheme on 22 February 2021.

Given the unanimous consent of the lessor-creditors subject to the scheme, the court did not need to determine whether a UK scheme of arrangement under Part 26 of the UK Companies Act constitutes (or could constitute in certain circumstances) an "insolvency-related event" or "insolvency proceedings" within the meaning of the Cape Town Convention; however:

- in the first (convening) hearing, the court noted, obiter, that while MAB's counsel made 'powerful arguments' that the scheme was not an "insolvency-related event", there had not been any opportunity for opposing arguments to be made;
- had the court been required to decide on the issue, notwithstanding support from the vast majority of the lessor-creditors subject to the scheme, the court would be concerned as to whether it was right to sanction a scheme which might be thought to breach the Cape Town Convention; and
- certain of the lessor-creditors subject to the scheme reserved their position to argue in a future case that a scheme was an "insolvency-related event".

Impact of government support and ability to raise additional capital

Governments continue to provide various financial support packages to airlines. In 2020 alone, such support was estimated to total US$173bn. However, the availability, level and form of support has varied from one country to another. In some cases, support has been subject to conditions that airlines would likely resist in better times – stipulations as to equity stakes, restrictions on dividend payments, reductions in carbon emissions, the implementation of cost cutting measures, the renegotiation of existing liabilities and adjustments to employment conditions.

The provision of such support has, however, in many cases enabled airlines to raise additional capital in the market. Of particular note are US airlines which, having received significant support under the CARES Act, raised significant amounts of new debt by leveraging their alternative assets, including their brand, loyalty programmes and airport take-off landing slots ("SGRs"). These transactions include a US$2.5bn issuance by American Airlines, secured against a slot portfolio, and US$9bn raised by Delta Air Lines against its SkyMiles frequent-flyer programme.

> "WFW POSSESSES STRONG EXPERTISE ON AVIATION REGULATORY ISSUES, AS WELL AS AVIATION-RELATED DISPUTES, FINANCING AND EMPLOYMENT MATTERS."
>
> CHAMBERS ASIA-PACIFIC, 2021

Current outlook

The rollout of vaccines provides airlines, lessors and investors with a basis on which to make assumptions and projections for recovery. These will inevitably carry caveats around the emergence of new variants of the virus and the possibility of further travel restrictions being imposed in countries on significant routes. However, with a great deal of liquidity ready to be deployed, it potentially signals a turning point and the bottom of the market approaching.

Many of the major airlines have been successful until now in avoiding insolvency or significant restructuring. Others have undergone significant recapitalisations and first-round restructurings that have enabled them to 'trade through', until this point.

However, we have not yet seen the return of aircraft to lessors and financiers in significant numbers. This leaves a significant market correction still to be made if business models are to be adjusted in-line with the projected demand for flights following the pandemic. As such, we expect to see a number of insolvencies and more aggressive restructurings than the examples seen in the market to date. Many of the first-round restructurings may need to be revisited, with some airlines already back at the negotiating table with their creditors.

The radical shock to the market will inevitably impact existing investors with some exiting the market permanently. We have seen 'sunny-day' investors and established banks marketing aircraft loan portfolios. However, the change also presents opportunity for new entrants to the market with different investment strategies. Names synonymous with distressed investing have already appeared in a number of airline restructurings to date and several alternative investment funds are preparing for investment as the market begins to turn.

FINANCING AND LEASING DEFAULT

Any breach of a provision of a loan facility or lease agreement is likely to constitute an event of default, either immediately or upon expiry of a contractual grace period, entitling a lender to accelerate outstanding amounts and enforce security or a lessor to terminate the leasing, claim damages and repossess the aircraft. The following customary provisions are those which are most likely to become relevant in the current market conditions under an airline's loan and lease agreements or a lessor's own financing agreements. Before taking any enforcement action or agreeing to a waiver or amendment of the terms of any lease agreement, a lessor should consider the implications and possible restrictions under its own financing arrangements for the aircraft.

In responding to any default, a creditor should consider whether there are likely to be other creditors whose enforcement rights have been triggered, whether enforcement action by such other creditors may frustrate the borrower's ability to reach a negotiated solution to the default and the risk that the default may result in the borrower's insolvency. Where a creditor is not minded to take enforcement action, the occurrence of a default nevertheless provides it with leverage to extract commercial concessions from the airline and to include conditions to any waiver or deferral that may be granted. Commonly, in the current environment, these would include enhanced financial reporting requirements and provisions that would allow the creditor to effectively monitor the financial position of the borrower and the status of any discussions it may be having with other creditors.

> "WHILST A PAYMENT DEFAULT WILL ARISE ONLY UPON THE ACTUAL FAILURE TO MAKE PAYMENT WHEN DUE, OTHER EVENTS OF DEFAULT MAY ARISE DUE TO THE COMPANY'S FINANCIAL DIFFICULTIES PRIOR TO OR ABSENT ANY PAYMENT DEFAULT."

Non-payment and insolvency

The payment obligations of a lessee under an aircraft lease are usually expressed to be absolute, on 'hell or highwater' terms. In the recent case of *Salam Air SAOC v Latam Airlines Group SA* [2020] EWHC 2414 (Comm), the English High Court deemed it "highly improbable" that a lessee would be relieved from its obligation to pay rent under the doctrine of frustration on the basis that its commercial operations had been impacted by the pandemic.

Where payment deferrals have not been agreed in advance, any non-payment of an amount due under a lease or financing agreement is likely to trigger an immediate event of default (often subject to a short grace period for technical or administrative issues delaying the payment).

While a payment default will arise only upon the actual failure to make payment when due, other events of default may arise due to the company's financial difficulties prior to or absent any payment default.

Typically, an insolvency event of default will be drafted to be triggered not only on the company becoming insolvent according to a cashflow or balance sheet test but also if the company admits its inability to pay its debts as the same fall due or if it commences negotiations with its creditors with a view to rescheduling its indebtedness. Borrowers and lessees need to be mindful of these provisions both when making public statements regarding their financial condition and when approaching their creditors to negotiate deferrals or amendments. Prior to commencing such discussions, a company would usually require each creditor to enter into a non-disclosure agreement and to provide a waiver with respect to any defaults which would otherwise arise as a result of those discussions taking place.

The prolonged effect of the pandemic has increased the likelihood of a cashflow or balance sheet insolvency event of default for many airlines. Reduced revenues and depleted liquidity positions present the risk that an airline may no longer be able to meet its obligations on a current basis and a sharp fall in the value of aircraft has reduced the value of airlines' net assets. However, determining whether a company has in fact become cashflow- or balance-sheet insolvent at any particular point in time may not be straightforward without financial statements demonstrating the same. Even then, consideration must be given to differences in accounting and legal rules.

Financial covenants

Financial covenants provide tests intended to present 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 and minimum liquidity covenants may be relevant.

Financings to lessors, especially where lease revenues are the principal source of funds (for example, under 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 coverage ratio tests. In such cases, a default may occur as a result of a breach by the lessee to pay rent on time or where rental income amongst the relevant portfolio of aircraft does not exceed the debt service by the agreed percentage. The dramatic reduction in airline incomes and deterioration in aircraft values as a result of the pandemic has inevitably caused financial covenant breaches, under both airline and lessor financings. Creditors have often been left waiting in anticipation of a default arising by the fact that the covenants are tested only periodically and usually constructed such that a default will not arise before the testing date. This provides affected borrowers with time to explore and formulate potential restructuring options and remedies before finding themselves at the mercy of their creditors.

Commonly, the provisions of a negotiated financial covenant will provide the borrower with a specific means to remedy its default – the positing of cash collateral in the case of a loan-to-value covenant or an equity cure in the case of a cashflow-based covenant. In the current market, however, borrowers have often been unable or unwilling to tie up vital liquidity by providing additional collateral to their creditors and, where further injections of shareholder capital have been a possibility, they have sought additional creditor support or concessions in return. In any event, with revenue projections having been written down in the medium term, borrowers have sought a permanent resetting of their financial covenant thresholds.

Operational covenants

When aircraft are 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 significant proportions of their fleet, clauses of this type should be 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 with so many aircraft being grounded simultaneously, airlines may struggle to meet the usage and storage obligations contained in their finance and leasing agreements.

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 therefore have to consider carefully how to curtail or suspend operations, albeit temporarily, without triggering event of default provisions of this kind.

Cross-default

Most finance and leasing transactions will include cross-default provisions referencing widely defined concepts of borrowing and leasing and transactions having similar commercial effect. These often include derivatives transactions, counter-indemnity obligations for guarantees and letters of credit issued in support of a borrower's payment obligations to its counterparties. The purpose of such provisions is to ensure that creditors are not excluded from discussions which a debtor may be having with other creditors or precluded from exercising their rights while 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.

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 impact of the Covid-19 pandemic on airlines' and lessors' financial position and business cannot be understated. The MAC clause event of default can be a useful starting point for creditors wanting to begin a commercial discussion without waiting for a 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 a MAC event of default is included, it will likely 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.

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 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 and has been made even more uncertain due to the current circumstances where technical teams and flight crews may be subject to travel restrictions (including quarantine) making it difficult to travel to the aircraft in question. There may be restrictions on obtaining international flight permits and government departments responsible for aircraft registrations are operating remotely and with reduced crews. However, due to the continued reduced passenger demand and airlines cutting capacity accordingly, creditors may find airlines more willing to agree and cooperate with the early termination of the leasing and redelivery of aircraft.

Remarketing repossessed aircraft presents further challenges to the creditor in achieving an acceptable sale price for the aircraft in the current market or re-leasing the aircraft into a depressed market with severely reduced demand. During any remarketing period, the creditor is responsible for insuring, maintaining and storing the aircraft.

The oversupply of certain types of used aircraft, particularly older generation models and older variants of current generation wide-bodies is exacerbating the challenges to a successful remarketing.

While repossession and remarketing is no longer 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, a creditor needs 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, the options are very limited and it is a 'buyer's market' where creditors should be braced for reduced lease rates and be ready to explore opportunities with airline credits below normal expectations.

Creditors should be seeking to preserve value wherever possible during the current crisis. While 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.

"DUE TO THE CONTINUED REDUCED PASSENGER DEMAND AND AIRLINES CUTTING CAPACITY ACCORDINGLY, CREDITORS MAY FIND AIRLINES MORE WILLING TO AGREE AND COOPERATE WITH THE EARLY TERMINATION OF THE LEASING AND REDELIVERY OF AIRCRAFT."

FORMAL RESTRUCTURING PROCESSES

Substantive insolvency processes

In various jurisdictions, insolvency and bankruptcy laws 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 process for making a proposal to those creditors following such 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. Such processes enable the airline to engage all their creditors in a single restructuring process, making them suitable for substantive, wholesale restructurings not limited to financial creditors. In the Chapter 11 context, airlines additionally have the power and discretion to reject operating leases to which they are a party, enabling them to effectively 'cherry pick' operating leases, hand back aircraft to lessors and use the process to reduce their fleets.

In the current market conditions, the threat of returning aircraft in this manner also enables the airline to renegotiate the terms of the leases which it intends to continue with after implementation of 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.

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 reduces the overall cost of the restructuring.

In addition, there may be features of any court-supervised restructuring process that render it ineffective for the specific purpose of restructuring an airline debtor. For example, in the UK the appointment of an administrator will almost invariably lead to the airline ceasing to fly and to it losing its operating license and aircraft operator's 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 the required restructuring warrants an extensive process that will affect all the airline's creditors or whether it could be more efficiently achieved through an alternative or voluntary process that is less formal, at lower cost and with less delay.

> "THE WFW TEAM MET VERY DEMANDING DEADLINES AND WERE SOLID IN THEIR DEAL IMPLEMENTATION - WE WOULD USE THEM AGAIN AND AGAIN!"
>
> LEGAL 500 EMEA, 2020

Schemes of arrangement and UK restructuring plans

A scheme of arrangement is a statutory process available to both domestic and international companies in the UK and other jurisdictions, such as Ireland, Malaysia, Singapore and Australia, which may be used by a company for various purposes, including the implementation of a restructuring.

The process involves the company applying to court to convene a meeting of its creditors to vote on proposals formulated by the company. The content of such proposals is not prescribed or limited and may include, for example:

- amendments to the commercial terms of existing agreements, such as financial covenants, or the rescheduling of debt;
- the restructuring of security packages or guarantees;
- the incurrence of new debt; and/or
- debt for equity swaps.

Creditors are divided into classes, as proposed by the company and scrutinised by the court, for the purpose of voting on the scheme. In order to be 'sanctioned' or approved by the court, the scheme must be approved by the requisite threshold of creditors in each class (75% by value and a majority by number of those present and voting in the case of a UK scheme). Once sanctioned by the court, the terms of the scheme will bind dissenting creditors, who will effectively be crammed-down (subject to restrictions on cram-down which may apply under, for example, the Cape Town Convention).

The principal benefits of a scheme of arrangement compared with a more substantive insolvency process, such as Chapter 11 or a UK administration, include:

- the fact that the company only has to involve those creditors whose debts it seeks to compromise or whose agreements it wishes to amend;
- a much lower level of court involvement and supervision of the company's affairs while it undergoes the process;
- the relative speed with which the process can be completed (six to eight weeks for a largely uncontested scheme), resulting in lower associated costs and greater value preservation for the company; and
- as compared with a UK administration process, the existing management of the company remains in place throughout the process, enabling an airline to continue operating flights.

In June 2020, the UK enacted legislation providing for an enhanced version of a scheme of arrangement – a UK restructuring plan. A UK restructuring plan shares its principle features and process with the UK scheme of arrangement, however, it may only be used by a company experiencing financial difficulties which may affect its ability to continue as a going concern.

Importantly, however, cross-creditor class cram-down is available under a UK restructuring plan. Where the plan proposed by the company has not been approved by the requisite threshold of creditors (75% by value of the creditors present and voting in each class), the court may nevertheless sanction the plan, imposing its terms on dissenting creditors, if (a) at least one creditor class has voted to approve the plan and (b) no creditor in a dissenting class would be put in a worse position under the plan than it would be in the "relevant alternative" (being the most likely outcome if the plan was not to pass – in most cases, this will be the liquidation of the company).

As a result, a UK restructuring plan may provide a more aggressive means for cramming-down dissenting creditors and discriminating between creditors that are offered favourable restructuring terms and others which are simply put in the position they would realise in a liquidation scenario.

COMPARISON OF UK AND US RESTRUCTURING PROCESSES

The following table compares the key features of a UK scheme of arrangement, a UK restructuring plan and Chapter 11.

	UK Scheme of Arrangement	UK Restructuring Plan	US Chapter 11 Bankruptcy
Availability to foreign entities	Yes, provided the company has a "sufficient connection" to the UK. Debt and/or leases governed by English law would typically be sufficient.	Yes, provided the company has a "sufficient connection" to the UK. Debt and/or leases governed by English law would typically be sufficient.	Yes, provided the company has assets in the US (very low threshold).
Debtor in possession regime	Yes (low level of court supervision).	Yes (low level of court supervision).	Yes (high level of court supervision).
Moratorium terms	No.	No*. *Implementing legislation includes a separate moratorium regime which may become relevant but which is much more limited in scope than the Chapter 11 worldwide stay. It is not yet clear how this will be used in practice.	Imposes worldwide stay on enforcement until confirmation of plan. Section 1110 gives mortgagees and lessors the right to recover "aircraft equipment" after 60 days from a domestic US airline, if defaults are not remedied.
Are creditors' rights under the CTC triggered by virtue of an "insolvency proceeding" in relation to the company?	Untested by the courts, although recent decisions on related points provide support for the argument that CTC rights would be triggered.	Untested by the courts, although recent decisions on related points provide support for the argument that CTC rights would be triggered.	Yes.
Ability to handback leased aircraft	Only as part of the scheme terms, if approved.	Only as part of the final restructuring plan, if approved.	Yes – 'executory contracts' can be affirmed or rejected by the company. Gives company power to 'cherry pick' operating leases and contracts.
Creditor classes	Classes should include creditors whose interests are "not so dissimilar as to make it impossible for them to consult together with a view to their common interest".	Classes should include creditors whose interests are "not so dissimilar as to make it impossible for them to consult together with a view to their common interest".	Generally grouped on basis of the creditors' claims in one class being substantially similar.
Consent threshold required to approve restructuring plan	Approval of 75% of creditors by value and a simple majority by number in each class.	Approval of 75%, by value, of each creditor class.	Approval of 2/3rd by value and a simple majority by number of each class. Dissenting minority is bound, provided they would receive at least that which they would in a liquidation.
Cross-class cramdown	Not available.	Available at the discretion of the court, provided that: 1. One class of creditor votes in favour; and 2. No member of a dissenting class would be worse off than in the "relevant alternative".	Available at the discretion of the court, provided that, amongst other things: 1. at least one class of "impaired" creditors votes in favour; 2. the plan is 'fair and equitable' to dissenting and junior classes; and 3. the plan provides each creditor at least what it would have received in liquidation.
Timing	Uncontested process can be completed within 6 to 8 weeks. If contested, process may take longer.	Uncontested process can be completed within 6 to 8 weeks. If contested, process may take longer.	Pre-confirmation stage is typically 6 to 12 months. Post-confirmation implementation stage is typically a number of years (3 to 5 is common).
Costs	Limited by relatively short process.	Limited by relatively short process.	Relatively high due to length of process. Often in the millions of dollars pcm.
Forum for winding-up	No. If restructuring fails, a separate insolvency process would be required under domestic laws.	No. If restructuring fails, a separate insolvency process would be required under domestic laws.	If restructuring fails, Chapter 11 process can be turned into a Chapter 7 winding-up.

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.

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 from 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 that some creditors may 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.

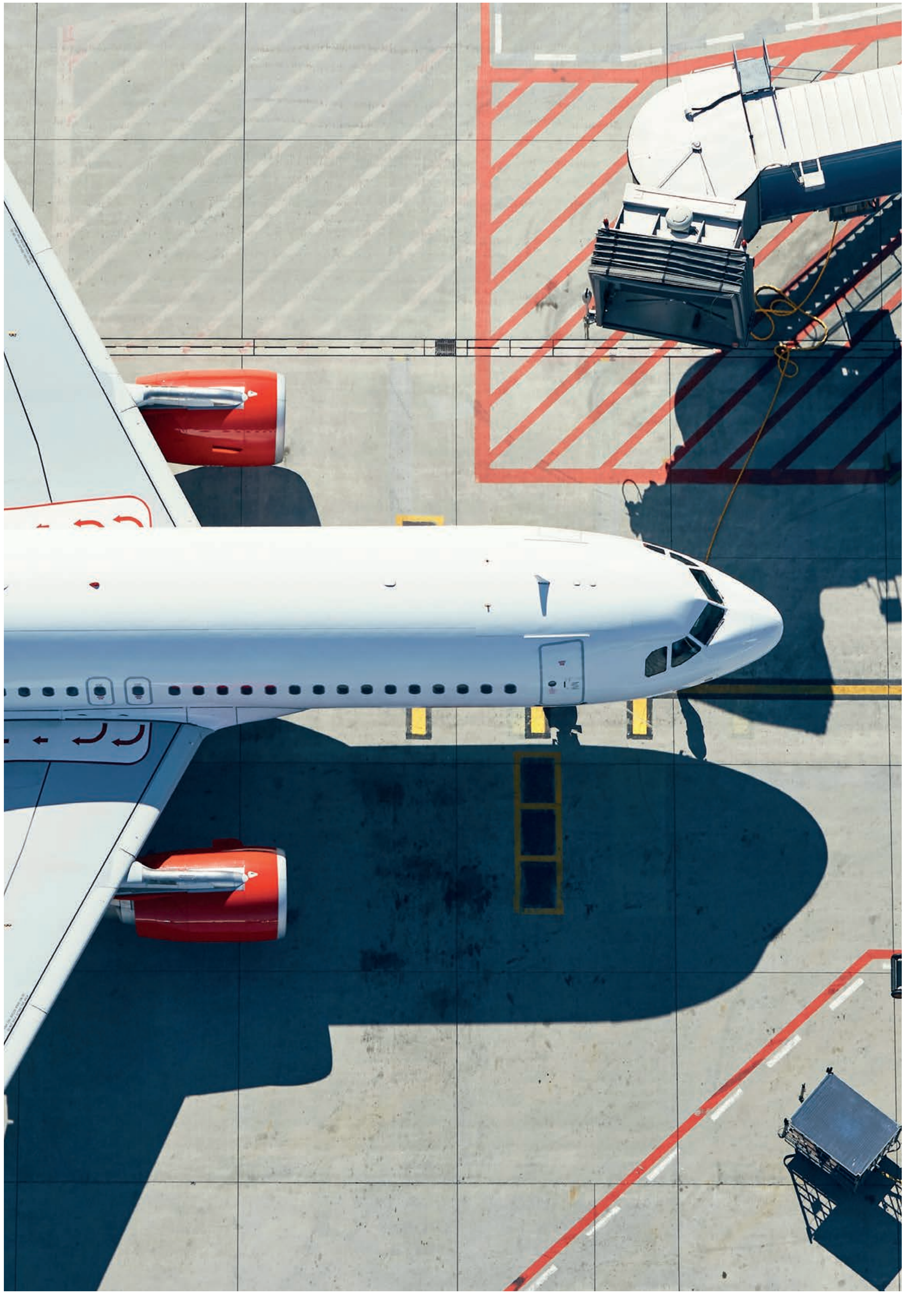
Second, creditors may seek to address their concerns around free-loading by other creditors or unequal treatment by making any agreement to restructure their debt conditional on other creditors also agreeing to restructure and on similar terms. However, such conditions can be difficult to negotiate and,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

Third, effective negotiation may require confidential information to be shared with and between creditors. For airlines with debt or equity securities that are listed or traded, parties 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 achieving 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.

Despite these disadvantages, bilateral negotiations may be preferable for some creditors, as it allows those 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 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.



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.

RANKED TIER 1 IN TRANSPORT FINANCE AND LEASING

LEGAL 500 UK, 2021

Coordinating Committees

Given the need to manage the complexity that results from an airline's different creditor constituencies and within said 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 lenders 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.

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 difficulty). 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 need to engage with multiple 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 is 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

While 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 has advised on more restructurings of maritime assets than any other law firm and has 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 the 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) 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 their aircraft are not leased the vast majority of their 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 or soft market that option may not be feasible, or at least not at a price that works for the lessor. These concerns, 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.

> "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, IT'S CAPITAL INVESTMENT IN THE AIRCRAFT."

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

For the first few months after the onset of the Covid pandemic, there was much discussion and focus on aircraft asset-backed securitisations ("ABS"), most portfolios of which comprise commercial passenger aircraft, and on the extent to which debt and equity investors would be affected by the significant reduction in lease revenues which are used to service the amounts owed to investors. This was understandable; the last six to seven years prior to the onset of the pandemic saw record amounts invested in aircraft ABS which were increasingly being tapped by aircraft lessors as a cost-effective and strategically important source of funding. This section takes a look at how investors in aircraft ABS have fared over the first 12 months of the pandemic, as well as some other developments.

Debt Investors

From the point of view of debt investors, aircraft ABS have performed reasonably well given the circumstances. While the senior series of many ABS have been either downgraded or put on Rating Watch Negative by the rating agencies, to our knowledge, no aircraft ABS has defaulted nor have there been more than two or three ABS where one or more drawings have been made under the liquidity facility. Debt investors have been timely paid the interest owed to them, although in many cases payment of principal has fallen behind the target amortisation profile. The success of aircraft ABS during the pandemic is not only down to the structural elements of the product which have helped keep them afloat; credit too must be given to the aircraft lessors who have expertly serviced their managed portfolios through careful lease restructurings, portfolio management and navigation through various airline bankruptcies.

In terms of secondary trading, over the past year average prices, for a time, plummeted to around 75% on Series A trades and 40% on Series B trades, although these have since recovered with many Series A notes now trading very close to par value.

> "THE WFW TEAM IS VERY DILIGENT, POSSESSES DEEP KNOWLEDGE AND HAS EXTENSIVE EXPERIENCE IN THEIR FIELD OF EXPERTISE WHICH IS TRANSLATED INTO THE PRODUCTION OF VERY ACCURATE DOCUMENTATION AND ADVICE."
>
> CHAMBERS GLOBAL, 2020

Equity Investors

The plight of the third-party equity investor in aircraft ABS has been very different. Most ABS, pre-pandemic, were issuing equity securities (the "E-Notes") in the aircraft in liquid form under Rule 144A/Reg. S in the same manner as the debt securities. This liquid form of equity allowed the E-Notes to be more widely marketed and investor interest soared. However, E-Notes are the most junior and therefore the 'first loss' tranche of the securities issued in an ABS and, consequently, distributions to equity investors have been significantly depressed impacting heavily on expected rates of return. DSCR breaches, which trigger cash sweeps and rapid amortization events, have meant that even where distributions would have otherwise been available, they have diverted to service debt obligations. Added to that, given the equity investors are the economic owners of the aircraft assets, decreases in aircraft values have further reduced the value of their capital investment. That said, as we noted in the first edition of this report, equity investors do not, or should not, have an absolute expectation for regular payments and may now be looking (albeit with few other options) to medium-to-long term recovery of both lease cash flows and aircraft values before collecting on expected returns.

The Comeback

The future of commercial aircraft ABS as both a financing product and a means of disposing of a portfolio of aircraft seems secure. Earlier this year in late January, Castlelake announced that it had financially closed on the first post-pandemic aircraft ABS (CLAS 2021-1), which was in Rule 144A or 'capital markets' format. This was both remarkable and unremarkable. It was remarkable in that it was the first such ABS, emerging largely unaltered in terms of its structure as compared to pre-pandemic ABS. But it was also unremarkable in that it demonstrated both that investor appetite in aircraft ABS remains high and that ABS have performed as they should have done and were designed to do during one of the most challenging global economic downturns in recent history (and one where the aviation sector has been disproportionately affected).

It is worth making a few observations on this first post-pandemic ABS, in particular the level of investor appetite and how unchanged its format is compared to those which closed most recently during pre-pandemic times. Provided that note tranches were rated favourably by the rating agencies, investors who have been looking for places to invest their capital flocked back to the aircraft ABS product. Broadly speaking, the rating of any aircraft ABS is computed by looking at three factors: (1) the expertise of the servicer, (2) the aircraft and lease portfolio (e.g. airline credits, diversity, age, remaining lease terms, etc.), and (3) the structural enhancements (e.g. the liquidity facility, financial tests and triggers, etc.).

Taking each of these in turn, Castlelake is a seasoned issuer with considerable expertise and experience in managing aircraft portfolios. This was perhaps the most important factor. However, while the aircraft portfolio itself was perhaps a little more conservative than recent pre-pandemic ABS (for example, the average lease remaining term was broadly aligned with the target repayment date, meaning that there was less reliance on needing to remarket aircraft during the term of the financing), the product itself contained few structural amendments. The DSCR test contained a shorter look back (presumably to ensure that future shocks to the market, like Covid-19, affecting a sudden drop in lease revenues could be addressed more quickly and effectively), and a new cashflow test marked against the lease cashflows that existed at closing. Notably, there has been no extension of the liquidity facility as some have speculated (whether in terms of the covered period or to cover liabilities other than senior series interest).

One last observation on the recent CLAS 2021-1 ABS is that there was no marketing of the E-Notes. That is not surprising given how hard equity investors have been hit.

As or shortly before this report went to press, Falko reported the financial closing of Regional 2021-1, the first post-pandemic ABS comprising a portfolio of exclusively regional aircraft assets. It was in 'loan format' rather than in 'capital markets format' and was financed by only one tranche of debt. One notable feature of the Falko-sponsored ABS is that the liquidity facility supported up to 12 months of interest on the debt, rather than the usual nine months. Regional 2021-1 also contained a number of other structural enhancements, mostly additional triggers for cash sweep events, but it seems to us that these could be attributed to the specifics of the transaction and the portfolio rather than a more pervasive change to the aircraft ABS product that will be replicated in future. Like the CLAS 2021-1 ABS, it appears that the E-Notes have been retained, at least initially, by Falko or funds managed by it.

What next?

We will likely see more ABS before the end of 2021. Not only has the product weathered the pandemic well, it continues to attract investors into the aviation sector. However, it could be a while before we see liquid equity investors return to the market!

STATE SUPPORT

More so than all previous shocks, the outbreak of Covid-19 challenges governments' willingness to support airlines.

In the first wave of the outbreak, many governments answered their own airlines' calls for help with bailouts, but these did not silence the demands when the second wave silenced the skies. European countries have taken opposite approaches. Many EU Member States have introduced schemes to support their airlines: Belgium, France, Denmark, Sweden, Germany, Austria, Italy, Croatia, Finland, Romania, Estonia, Latvia, Cyprus, Greece, Portugal and The Netherlands. The UK's approach throughout has been to refuse industry-wide support, asking carriers first to exhaust private means.

Less widespread, but nonetheless important, some EU Member States have also supported airports and tour operators, but this has been less common: Romania, Poland, Bulgaria, Belgium and Cyprus airports stand to benefit from authorised State Aid. The UK – an ex-Member State – introduced a scheme to support Scottish airports.

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, was 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.

This was true in the early months of the crisis and remains true now nearly one year later.

The European Union

The EU has a long-standing and increasingly sophisticated anti-state subsidy law, part of its competition rulebook, which regulates what EU Member States can do to support their aviation industries. The UK is no longer an EU Member State and EU law does not apply to the UK territory as of 31 December 2020 11pm UK time. However, the EU UK Trade and Co-operation Agreement of 30 December 2020, commits parties to maintain a "level playing field" and high levels of protection in several areas including State aid. This commits the UK to maintain an effective domestic subsidy control and enforcement closely aligned with the EU state aid system, which is linked to a binding dispute settlement mechanism including adoption of remedial measures. 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 (e.g. under the market economy investor principle), 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.

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 and to a lesser extent the 2014 Guidelines on State aid to airports and airlines. The Rescue and Restructuring Aid Guidelines 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. An EU 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". EU 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.

"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."

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 EU Member States may notify aid to the Commission under the "exceptional occurrence" framework 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 EU 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 EU 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 EU 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 was the first State aid measure to be notified by an EU Member State to mitigate Covid-19 damages in the aviation sector. It allowed 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. Denmark, Sweden, Germany, Austria, Italy, Croatia and France have all sought and been permitted to apply the "damages framework" aid to their airlines, whether by guaranteed loans, recapitalisation or grant aid. Timisoara Airport in Romania, Romanian regional airports, Polish airports and Scottish airports may all benefit from airport-related damages aid.

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 EU 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 EU Commission has obliged with very fast decisions on the notified aid schemes. Numerous EU Member States have obtained permission to grant airline aid under this framework: France, Finland, Portugal, Denmark, Germany, Cyprus, Sweden, Romania, Belgium, Denmark, Austria, Italy, Croatia, Finland, Estonia, Latvia, Greece and the Netherlands. 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".

State support for airlines has been controversial: both Ryanair and Wizz Air have lodged numerous actions at the General Court of the EU claiming that the grant of aid was anti-competitive and unlawful. Ryanair's appeals against the French and the Swedish State support schemes to airlines have been dismissed by the EU General Court on 17 February 2021. Its other appeals against several EU Member States' State aid support schemes to airlines are still pending before the EU General Court. With the industry still unable to re-start in a meaningful way, there are further calls for support.

The United States

On 27 March 2020, President Trump signed into law a substantial but temporary 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).

With the expiry of the aviation provisions of the CARES Act at the end of September 2020, the discussion shifted to whether a further temporary stimulus package could be agreed until the new Biden administration took office in January 2020. A second round of the stimulus package, the Consolidated Appropriation Act of 2021, was adopted on 21 December 2020 and includes further relief to commercial airlines.

AUTHORS

JIM BELL
Partner, Global Aviation
Co-Sector Head
Assets and Structured Finance

T: +44 20 7814 8228
jbell@wfw.com

STEPHEN PARKER
Partner
Restructuring and Insolvency

T: +44 20 7863 8908
sparker@wfw.com

PATRICK MOORE
Partner
Assets and Structured Finance

T: +44 20 3036 9832
pmoore@wfw.com

PETER O'HARE
Partner
Assets and Structured Finance

T: +44 20 7814 8421
po'hare@wfw.com

DOMINIC PEARSON
Partner
Assets and Structured Finance

T: +44 20 3314 6457
dpearson@wfw.com

SOLANGE LEANDRO
Partner
Regulatory, Public Law & Competition

T: 0207 814 8244
sleandro@wfw.com

AVIATION RESTRUCTURING WEBINAR

Our Aviation Restructuring webinar looks at trends in airline restructuring and strategies, a legal comparison of restructuring proceedings, and the lessor/creditor response and strategy. WFW partners were joined by leading restructuring experts at Seabury Capital and Deloitte.

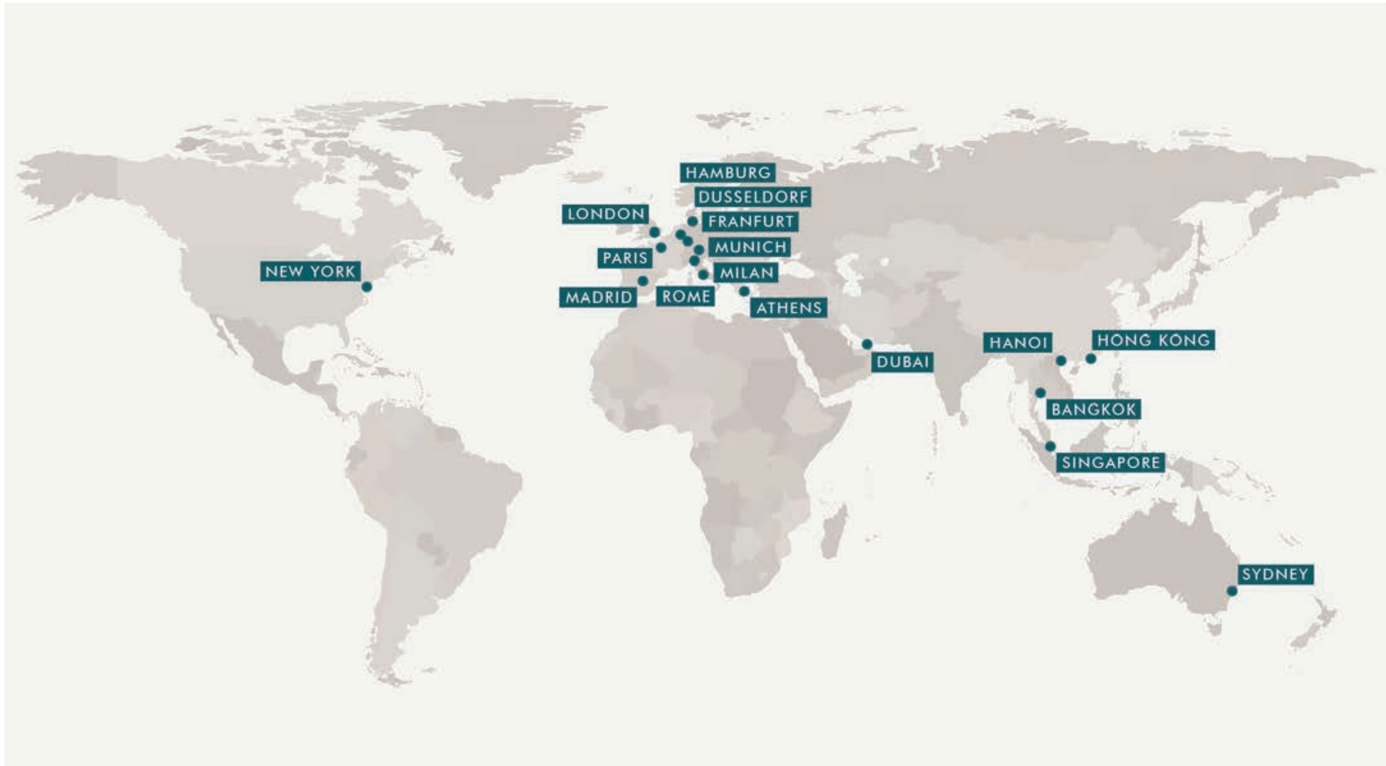
The webinar was part of our wider Transport Webinar Series, an eight-episode series of webinars covering the topics pertinent to theaviation, maritime and rail sectors.

Click here to watch >

A LEADING AVIATION PRACTICE

Our aviation team is at the forefront of the industry. With over 35 years' experience in the aviation sector, we have an industry-recognised practice that is able to provide specialist advice on a broad range of aviation matters.

Our strong sector focus means that we are able to combine technical excellence with deep industry knowledge across all services, including finance, capital markets, corporate, restructuring, dispute resolution and tax.



COMMERCIAL AIRCRAFT	HELICOPTERS
ENGINES	CORPORATE JETS
ALTERNATIVE ASSETS	SATELLITES

CLIENTS
BANKS AND FINANCIAL INSTITUTIONS
LESSORS
EXPORT CREDIT AGENCIES
AIRLINES
AIRPORTS
TOUR OPERATORS
ARRANGERS
PRIVATE EQUITY AND INVESTORS
MANUFACTURERS
OWNERS

ATHENS BANGKOK DUBAI DUSSELDORF FRANKFURT HAMBURG HANOI HONG KONG
LONDON MADRID MILAN MUNICH NEW YORK PARIS ROME SINGAPORE SYDNEY

wfw.com