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Aviation: Cramming Cape Town Creditors

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In summary

This article considers the extent to which the interpretation and effect of the Cape Town Treaty is impacting insolvencies and restructurings in the aviation industry, with a particular focus on the protections against creditor cramdown as provided under the Cape Town Treaty.

Discussion points

- The Cape Town Treaty: what it is and when it applies
- Alternative A insolvency regime under the Cape Town Treaty
- Insolvency-related events under the Cape Town Treaty
- Cape Town Treaty considerations in relation to the UK Corporate Insolvency and Governance Act 2020
- Approach of the courts in the Nordic Aviation Capital DAC and Virgin Atlantic Airways Ltd restructurings

Referenced in this article

- The Convention on International Interests in Mobile Equipment
- The Protocol to the Convention on Matters Specific to Aircraft Equipment
- Official Commentary, Fourth Edition (UNIDROIT April 2019), Roy Goode
- Chapter 11 of the US Bankruptcy Code
- The Companies Act 2006 (UK)
- The Companies Act 2004 (Ireland)
- The UK Corporate Insolvency and Governance Act 2020
- The Irish scheme of arrangement for Nordic Aviation Capital DAC, sanctioned by the High Court in Ireland on 21 July 2020
- Virgin Atlantic Airways Ltd, Re [2020] EWHC 2376 (Ch)
- Cape Town Convention Academic Project Annotation to the Official Commentary on the Cape Town Convention, dated 16 June 2020

Introduction

The global covid-19 pandemic has had a significant impact on the aviation industry, both in relation to the ability of airlines to meet obligations under leasing and financing contracts, as well as the ability of aircraft leasing companies to meet obligations owed to their creditors (in particular, under financing arrangements and purchase contracts with equipment manufacturers). This has resulted in a material increase in the number of insolvencies and restructurings within the industry.

The aviation industry is also notoriously symbiotic; the health of airlines depends on a robust leasing industry, which itself is dependent on healthy manufacturers, etc, such that pressure placed on any one aspect of the chain can have negative impacts on all participants. The pandemic and its particularly acute effect on the aviation industry necessarily forces participants to make short-term choices that may be adverse to their long-term interests.

While this cycle is only beginning to play out in commercial terms, from a legal perspective, a number of interesting issues have arisen as a result of these pressures. This article will focus on one issue in particular: the extent to which the interpretation and effect of the Cape Town Treaty is impacting restructurings. This issue may have a wide-ranging impact on the likelihood of aviation-related debtors (airlines and leasing companies) 'forum shopping' in England and Wales as they look for appropriate regimes to carry out restructurings (noting that during the pandemic, the United States has not yet lost its crown as the preferred safe harbour^[1] for restructuring within the aviation industry).

Cape Town Convention cramdown rights

What is the Cape Town Treaty?

The Convention on International Interests in Mobile Equipment (the Convention) and the Protocol to the Convention on Matters Specific to Aircraft Equipment (the Protocol), together the Cape Town Treaty, were signed in Cape Town, South Africa on 16 November 2001. They provide for the establishment and registration of international interests over aircraft objects by a debtor (ie, the lessee under a lease agreement, the grantor or chargor under a security agreement or mortgage, the conditional buyer under a title reservation agreement or the seller under a contract of sale) in favour of a creditor (ie, a chargee under a security agreement, a conditional seller under a title reservation agreement or a lessor under a leasing agreement) where the requirements set out in the Convention and the Protocol are met.

The primary objective of the Cape Town Treaty is to facilitate the asset-based financing and leasing of mobile equipment of high value or particular economic significance by providing an international regime for the enforcement, registration and protection of international interests in such equipment.^[2]

Creditors with the benefit of a registered international interest are entitled to remedies under the Cape Town Treaty in the event of a debtor default, as well as enhanced protections in the event of insolvency of the debtor company.

Applicability of the Cape Town Treaty

Central to the analysis of whether the Cape Town Treaty applies to a particular transaction is whether the state in question has implemented the Treaty and accordingly become a contracting state for the purposes of the Treaty. Implementation of the Treaty in a particular jurisdiction may be effected by a state ratifying, accepting, approving or acceding to the Convention and the Protocol, which is typically effected by the relevant state depositing a formal instrument to that effect with the International Institute for the Unification of Private International Law (UNIDROIT).^[3]

For the Cape Town Treaty to apply to a particular transaction, certain connecting factors must be met in relation to the transaction; at the time of the conclusion of the agreement creating or providing for the international interest:

- the debtor must be situated in a contracting state;^[4] or
- the airframe or helicopter must be registered in an aircraft register of a contracting state that is the state of registry.^[5]

The Cape Town Treaty also provides for certain additional formal requirements to be met for the Treaty to apply to a specific transaction. In particular, it only applies to airframes, aircraft engines and helicopters that constitute aircraft objects^[6] for the purposes of the Treaty, and the interest in relation to the aircraft object must meet certain conditions to constitute an international interest for the purposes of the Treaty.^[7]

As at the time of writing, the Cape Town Treaty has 82 contracting states,^[8] including many of the principal aircraft leasing and financing jurisdictions (including the United Kingdom, Ireland, China, Brazil and the United States).

Alternative A insolvency regime

One of the most substantive provisions of the Cape Town Treaty is article XI (remedies on insolvency) of the Protocol.^[9] Article XI provides for a contracting state to make a declaration pursuant to article XXX(3) of the Protocol, applying the provisions of one of two specific insolvency regimes to govern creditors' rights in relation to aircraft objects: Alternative A or Alternative B.

The Alternative A regime is functionally equivalent to the protections provided by section 1110 of the US Bankruptcy Code (section 1110) and, among other things, provides that upon the occurrence of an insolvency-related event (as defined in the Protocol), the insolvency administrator or the debtor either:

- cures all defaults (other than the default constituted by the opening of insolvency proceedings) and agrees to perform all future obligations under the agreement; or
- gives possession of the aircraft object to the creditor.

The insolvency administrator or the debtor must take the action required by the above cases no later than the earlier of the end of the waiting period or the date on which the creditor would be entitled to possession of the aircraft object if the relevant provision of article XI did not apply. Each contracting state is free to define its own waiting period, and many contracting states have adopted a 60-day waiting period to retain consistency with section 1110 (examples include Ireland, the United Kingdom and China).

The effect of this provision is that it provides creditors (be they lessors under lease agreements or finance parties under security agreements (Cape Town creditors)) with certainty by reference to a specific and binding time regarding when they will either obtain possession of the relevant aircraft object or obtain the curing of all past defaults and an agreement to perform all future obligations, in an insolvency scenario, as opposed to being subject to any judicial stay or moratorium in the relevant jurisdiction.

Another substantive provision contained in article XI is the cramdown provision in article XI(10), which has attracted close scrutiny in recent times. Article XI(10) provides that 'no obligations of the debtor under the agreement may be modified without the consent of the creditor.' This provision intends to provide significant protection for creditors in the event of an insolvency or restructuring of the debtor, as many insolvency regimes



in various jurisdictions would (absent article XI(10)) allow for the implementation of restructuring proposals without the consent of minority creditors.

Article XI(10) does not expressly state that it applies only upon the occurrence of an insolvency-related event in respect of a debtor; however, this seems to be the better interpretation of the intended effect of the provision (rather than it being read as a stand-alone provision) on the basis of the fact that it is consistent with the other substantive remedies under article XI (article XI(2) and (7)), and that, by its very nature, article XI intends to provide for remedies for a creditor in the event of a debtor insolvency.

A small segue: Cape Town and Chapter 11

The Alternative A Regime is functionally equivalent to the protections provided by section 1110 (allowing certain creditors to repossess aircraft equipment); however, section 1110 will not apply to non-domestic airlines or leasing companies. Where a foreign airline or a leasing company files for Chapter 11 protection in the US courts, the protection afforded by the Cape Town Treaty will depend on:

1. the extent to which protection applies in the home jurisdiction where the debtor's centre of main interests (COMI) are; and
2. whether the protection in point (i) is then recognised in the United States.

The question is complex and remains subject to debate; therefore, while similar conflicts of laws and recognition issues will apply in the case of an entity with a non-English COMI applying for an English scheme of arrangement, in cases where Cape Town has been elected on similar grounds as that between the home jurisdiction and England and Wales, the position could (pending clarification of the issues raised in this article) become comparatively more predictable and certain.

Back to Cape Town: what is an insolvency-related event?

If the premise that remedies under article XI become available upon an insolvency-related event is accepted (which, in the case of article XI(2), is inarguable as it is expressly stated and, in the case of article XI(10), it appears generally accepted by other market commentators), then being able to ascertain when an insolvency-related event has occurred is fundamental.

An insolvency-related event is defined for the purposes of the Protocol as meaning either:

- the commencement of insolvency proceedings; or
- the declared intention to suspend or actual suspension of payments by the debtor where the creditor's right to institute insolvency proceedings against the debtor or to exercise remedies under the Convention is prevented or suspended by law or state action.

Accordingly, what constitutes insolvency proceedings (and, as such, what would fall within the meaning of an insolvency-related event) must also be considered. Insolvency proceedings are defined in the Convention to mean bankruptcy, liquidation or other collective judicial or administrative proceedings, including interim proceedings, in which the assets and affairs of the debtor are subject to control or supervision by a court for the purposes of reorganisation or liquidation.

Many types of insolvency proceedings under many jurisdictions will fall within this definition and, accordingly, trigger the application of the Alternative A regime. However, for certain types of corporate reorganisation that are affected outside of a relevant jurisdiction's insolvency laws, the analysis is less straightforward and has been the subject of considerable

debate in recent years – in particular, whether the Cape Town Treaty protections afforded to Cape Town creditors will enable those creditors to avoid any attempt to vary the terms of their leases or debts by way of a cramdown under the recently introduced super scheme or restructuring plan introduced under Part 26A of the Companies Act 2006. One of the significant mechanics of a Part 26A restructuring plan is that, in certain circumstances, it provides the court with the power to bind dissenting creditors (such as lessors) in respect of the restructuring plan and effectively cram down an entire creditor class.

The UK Corporate Insolvency and Governance Act 2020

Whether the Cape Town Treaty applies to schemes of arrangement or similar reorganisation processes also came to light when the UK government was debating new corporate and insolvency legislation, which has now entered into force pursuant to the Corporate Insolvency and Governance Act 2020 (the Governance Act).

On 3 June 2020, the Corporate Insolvency and Governance Bill was debated by the UK House of Commons. An unexpected novelty introduced by the Bill was that the proposed new restructuring plan and the existing scheme of arrangement framework contained in Part 26A of the Companies Act 2006 would not be available in respect of creditors with aircraft-related interests. An aircraft-related interest is a registered interest within the meaning of the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015 (the Regulations), which is the United Kingdom's domestic legislation implementing the Cape Town Treaty and, importantly, Alternative A into national law. The net effect of these provisions, if enacted, would have been to deprive companies with aircraft assets in financial distress of a valuable tool to restructure outside of a formal insolvency process.

From a debtor's perspective, and from the perspective of creditors whose claims do not have the benefit of the protection of the Cape Town Treaty, this was a concerning development as it threatened to have a significant impact on the way restructurings of UK airlines and aircraft leasing companies could be effected now and in the future. Ahead of the 3 June 2020 session, the UK government tabled an amendment to the Bill, removing the provisions that would have excluded creditors with aircraft-related interests from the new restructuring plan and the existing scheme of arrangement framework. This amendment was passed – one of the few amendments to the Bill to have been adopted. The exclusion of aircraft-related interests in the original Bill may have been intended to reflect the cramdown provisions of article XI(10), which are incorporated into UK domestic legislation pursuant to Regulation 37(9) of the Regulations.

Given that the Alternative A provisions in the Cape Town Treaty (as incorporated into UK domestic legislation) apply, notwithstanding the provisions of the Governance Act, the amendment to the Bill does not mean that creditors with aircraft-related interests can necessarily have their interests affected by a scheme of arrangement or similar procedure without their consent, but rather it is left to an interpretation of whether the arrangements fall within the definition of insolvency-related event and, therefore, attract the protection of article XI(10).

While the intricacies of the Part 26A scheme are beyond the scope of this article, it is safe to say that it provides a potentially powerful tool for debtors to cram a whole class of creditors (eg, leasing creditors) without their consent as long as an economically 'in the money' creditor approves the plan, and the crammed down class is demonstrated to be no worse than in the 'relevant alternative' (ie, possibility liquidation or similar).

Might a scheme of arrangement be Cape Town exempt?

On 21 July 2020, the High Court of Ireland sanctioned a scheme of arrangement pursuant to Part 9, Chapter 1 of the Companies Act 2014 (the

NAC scheme) for Nordic Aviation Capital DAC (NAC), the world's largest regional aircraft lessor. The NAC scheme provided for, among other things, a nine-month deferral of principal payments and a 12-month deferral of maturity payments in respect of approximately US\$5billion of NAC's debt. Much of NAC's debt that was subject to the scheme benefitted from typical security arrangements, including the granting of Cape Town Treaty international interests over various aircraft objects in favour of a large number of scheme creditors.

Ireland has ratified the Cape Town Treaty and has made the relevant declarations to apply the terms of Alternative A. Accordingly, if a dissenting creditor were to successfully argue that the NAC scheme constituted an insolvency-related event for the purposes of the Cape Town Treaty, it may be able to successfully argue that article XI(10) prevented the NAC scheme from compromising or amending NAC's obligations to that creditor without the creditor's consent.

NAC submitted to the court (both in its written submissions in respect of the convening hearing and the later sanctions hearing) that the proposed scheme of arrangement did not constitute either insolvency proceedings or an insolvency-related event for the purposes of the Cape Town Treaty. Accordingly, it submitted that article XI(10) did not apply to the proposed scheme of arrangement and, therefore, the consent of each creditor with the benefit of an international interest was not required.

The arguments put forward were largely focused on the requirement that insolvency proceedings are collective proceedings in which the assets and affairs of the debtor are subject to control or supervision by a court. The company contended that a scheme of arrangement comprised a restructuring of only certain of a debtor's affairs (and was, therefore, not entirely akin to collective proceedings) and that the court merely supervises aspects regarding the scheme itself rather than its assets and affairs more generally. The company drew a distinction between other debtor-in-possession processes, such as Chapter 11 where court involvement is broader, and other English insolvency processes, such as a company voluntary arrangement where a court-appointed supervisor has an oversight role.^[10]

Ultimately the NAC scheme was unanimously approved by both classes of creditors (in value, 98 per cent of the unsecured creditors and 91 per cent of the secured creditors attended and voted in favour of the NAC scheme at the respective scheme meetings). While some secured creditors voted against the scheme, none sought to oppose its ratification and, therefore, its application to the non-consenting minority. In those circumstances, the court took the view that it was unnecessary for it to consider or make a ruling on the potential issues arising under the Cape Town Treaty. Justice David Barniville, in his written judgment, noted:

“ In those circumstances, I felt that it was not necessary and, indeed, might be inappropriate for me to embark upon a consideration of the issues arising under the Cape Town Convention and the Aircraft Protocol. I decided that it would be appropriate to leave over to a future determination of the potentially controversial issues which could arise in terms of the potential application of the Cape Town Convention and the Aircraft Protocol to schemes of arrangement under the 2014 Act.”

On 2 September 2020, the English High Court sanctioned a restructuring plan for Virgin Atlantic Airways Ltd (Virgin) under Part 26A of the Companies Act 2006, the provision incorporated into UK legislation pursuant to the Governance Act 2020. Virgin became the first company to use the new restructuring plan process to pursue a solvent recapitalisation of its business. Similarly to the NAC scheme, if a court were to find that a restructuring plan falls within the definition of insolvency-related event for the purposes of the Cape Town Treaty, the cramdown provisions would be prevented by the application of article XI(10) of the Cape Town Treaty in circumstances where an affected creditor has the benefit of an international

interest over any aircraft objects that form part of the restructuring arrangements.

However, prior to the sanction hearing, Virgin had secured the consent of all Cape Town creditors, and the scheme did not threaten to cram down any Cape Town creditor (the creditors that were threatened with cramdown were trade creditors). Accordingly, the question of whether a cram down of non-consenting creditors pursuant to a restructuring plan would be contrary to the provisions of the Cape Town Treaty was not at issue.

Annotation to the Official Commentary on the Cape Town Convention

In an attempt to clarify the types of restructuring or insolvency events to which article XI applies, the Cape Town Convention Academic Project (sponsored by the Aircraft Working Group) issued an Annotation to the Official Commentary on the Cape Town Convention on 16 June 2020 (the Annotation).

The Annotation confirms that arrangements fall within the definition of insolvency proceedings in the Cape Town Treaty where they are:

- formulated in an insolvency context, or by reason of actual or anticipated financial difficulties of the debtor company; and
- collective in that they are concluded on behalf of creditors generally or of classes of creditor that collectively represent a substantial part of the indebtedness.

The Annotation also confirms that a reorganisation arrangement, in which a court acts to facilitate a statutory process and where the court's approval is required for its implementation, constitutes insolvency proceedings where the assets and affairs of the debtor are subject to control or supervision by a court for the purposes of reorganisation.

Finally, addressing the cramdown provision in article XI(10) specifically, the Annotation provides that: 'in a reorganisation arrangement which falls within the definition of "insolvency proceedings" as interpreted in the Annotation, any modification of the debtor's obligations under the agreement without the consent of a creditor (so-called "cram down" provisions) is inconsistent with article XI(10) of the Protocol, where declared and implemented'.

The Official Commentary is not legally binding on national courts. Additionally, the Annotation does not have any official standing and does not constitute part of the Official Commentary. Notwithstanding this, it is likely that a court would give due consideration to both the Official Commentary and the views of the Cape Town Convention Academic Project when considering the applicability of provisions of the Cape Town Treaty, in the absence of existing judicial precedents.

Looking to a resolution?

Given that the Irish Court opted not to address the point in the NAC scheme, the applicability of article XI(10) of the Cape Town Treaty (and article XI more generally) in both Ireland and England and Wales awaits clarification from the respective courts.

At the time of writing, it is reported that Malaysia Airlines is considering using a restructuring plan under Part 26A of the Companies Act if its lessors do not agree to aircraft rental requests. The scheme may provide an English court a clear opportunity to address the scope of article XI, and the protection article XI(10) offers to dissenting creditors.

Ultimately, there may, however, be a simpler solution: if a scheme of arrangement offers Cape Town creditors the right to either (i) accept the compromise being offered or (ii) repossess (or foreclose upon) their aircraft,

then the question will be whether the arrangements proposed by the scheme can be crammed onto dissenters (even, under the Part 26A scheme, a whole class of lessors or creditors) if (ii) is not accepted. Given the rights that the Cape Town Treaty is intended to protect (ie, the protection of an interest in aircraft), the answer is, arguably, yes. That choice may well be, in today's markets, an unhappy one.

Notes

^[1] There have been several Chapter 11 filings in respect of airlines in 2020, in particular, South American airlines Avianca and Latam.

^[2] Paragraph 4.1, Official Commentary.

^[3] Article 47(3) and (4) of the Convention and article XXVI(3) and (4) of the Protocol.

^[4] Article 3(1) of the Convention.

^[5] Article IV(1) of the Protocol.

^[6] Defined in the Protocol as airframes, aircraft engines and helicopters (each of which are further defined in the Protocol). Article I of the Protocol.

^[7] These conditions are beyond the scope of this article (see paragraphs 4.55 to 4.60 and 4.73 to 4.84 of the Official Commentary for detailed analysis on the creation of international interests).

^[8] See <https://www.unidroit.org/status-2001capetown-aircraft> (last accessed October 2020).

^[9] Roy Goode notes that 'work in advance of the diplomatic Conference identified this provision as the single most significant provision economically' (paragraph 5.60, Official Commentary).

^[10] Nevertheless, there are many similarities between a scheme of arrangement and a company voluntary arrangement, and, in practice, the level of court oversight is similar. Interestingly, to meet the criteria for recognition under Chapter 15 of the US Bankruptcy Code, a scheme of arrangement must, among other things, be a 'foreign proceeding', the criteria for which includes a level of court oversight. English schemes of arrangement are regularly recognised in bankruptcy courts as such.

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