The Cape Town Convention and Aircraft Protocol’s Insolvency Regime: A Case Study of Alternative A

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Index

1. Why are effective remedies for aircraft required?
2. Development of Insolvency Laws
3. Development of US Section 1110
4. Canadian implementation of CTC
5. Case study
6. Resolution of case study
7. Key Conclusions
1. Why are effective remedies required for aircraft?

- Upon default, aircraft become very high value non-performing assets for financiers (represent loss of several hundred thousand to several million dollars per month per aircraft)

- May drop in value quickly (requiring substantial payments to restore value) if improperly maintained
1. Why are effective remedies required for aircraft? (cont’d)

- become ‘non-current’ almost immediately if daily maintenance and preservation not performed
1. Why are effective remedies required for aircraft? (cont’d)

- easy to strip and re-market high value components if left unattended
Depreciation of Transport Category Aircraft If no Maintenance Performed

*Note: these values represent the inspection tasks required to return an aircraft to service, and do not cover discrepancies that may be discovered.

Source: Blakes Aviation Group
2. Impact of insolvency law in aircraft financing

• Historically a repressive regime
• Move to ‘rescue’ culture
• Today – A balancing of equities
  – The ‘Context Theory’
  – Encourage business development
3. Development of US Section 1110

- Developed from protections afforded financiers of rail equipment
  - Response to numerous railroad bankruptcies
- Section 1110 – Key Drivers
  - Macroeconomic significance of airline industry
  - High cost of aircraft
  - Susceptibility of airlines to bankruptcy
  - Mobility of aircraft
  - Rapid depreciation of aircraft when not maintained or used
3. Development of US Section 1110 (cont’d)

- In General: Unless debtor cures outstanding defaults within 60 days of a Chapter 11 filing and agrees to perform all future obligations, a lessor or other financing party can repossess equipment

- Answer to automatic and indefinite stay
3. Development of US Section 1110 (cont’d)

- Practical Effects of Section 1110

  - Forces airline to decide within 60 days of filing which equipment to keep (at least until rejection)
  
  - Airline can only protect itself by curing and meeting requirements of existing documentation or negotiating Section 1110(b) agreements or other forbearance agreements
3. Development of US Section 1110 (cont’d)

- Section 1110 has shaped the aircraft finance market in the United States
  - Rating agency requirement for most favorable rating upgrade
  - Bankruptcy proceedings have become predictable and efficient with both debtors and creditors relying on established procedures to address fleet restructurings and aircraft returns
3. Development of US Section 1110 (cont’d)

- Not just a pricing issue (without Section 1110 protection, many transactions would not occur)

- 1110 minimizes occurrence of “hostile” stays – extensions beyond 60 days are now consensual (with consensual terms and conditions, such as rent rates), rather than unilaterally imposed by airlines in bankruptcy

- Note – actual length of stays under 1110, including consensual extensions beyond 60 days, are greatly impacted by market conditions
## Alternative A - Comparison with Section 1110

<table>
<thead>
<tr>
<th>Alternative A</th>
<th>Section 1110</th>
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<tbody>
<tr>
<td><strong>Applies to ANY debtor</strong></td>
<td><strong>Debtor - air carriers</strong></td>
</tr>
<tr>
<td><strong>Limited to aircraft objects and includes all data, manuals and</strong></td>
<td><strong>Covers airframes, engines, propellers, appliances, spare parts and</strong></td>
</tr>
<tr>
<td><strong>records relating to the object</strong></td>
<td><strong>Includes only those records which are required to be returned</strong></td>
</tr>
<tr>
<td><strong>Mandatory return of equipment following termination of</strong></td>
<td><strong>Provides relief from automatic stay following termination</strong></td>
</tr>
<tr>
<td><strong>waiting period</strong></td>
<td><strong>of waiting period</strong></td>
</tr>
<tr>
<td><strong>Applies to any international interest</strong></td>
<td><strong>Applies to a lease, security or conditional sale agreement,</strong></td>
</tr>
<tr>
<td><strong>International Interest must be registered</strong></td>
<td><strong>No perfection required</strong></td>
</tr>
<tr>
<td><strong>If no cure (or extension), insolvency administrator must</strong></td>
<td><strong>If no cure (or extension), relief from automatic stay</strong></td>
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<tr>
<td><strong>give possession to creditor</strong></td>
<td><strong>If no cure (or extension), relief from automatic stay</strong></td>
</tr>
<tr>
<td><strong>Waiting period - for most jurisdictions, 60 days</strong></td>
<td><strong>Waiting period - 60 days</strong></td>
</tr>
<tr>
<td><strong>Automatic obligation to preserve aircraft and maintain it</strong></td>
<td><strong>Must seek adequate protection outside of Section 1110 in order to preserve</strong></td>
</tr>
<tr>
<td><strong>and its value in accordance with the agreement</strong></td>
<td><strong>aircraft</strong></td>
</tr>
<tr>
<td><strong>Cure obligation - all defaults (excluding opening of</strong></td>
<td><strong>Cure obligation - all defaults other than 365(b)(2) defaults</strong></td>
</tr>
<tr>
<td><strong>insolvency proceeding)</strong></td>
<td><strong>(which includes defaults relating to financial condition)</strong></td>
</tr>
<tr>
<td><strong>Aviation authority - obligated to deregister in 5 days</strong></td>
<td><strong>No comparable provision</strong></td>
</tr>
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4. Canadian implementation of CTC

• Federal CTC Act became law (partially) on February 24, 2005

• Government of Québec implemented the CTC and Protocol by adopting, in 2007, the Québec CTC Act:

  (i) Official Commentary may be used to interpret the Convention and the Protocol, and

  (ii) Québec Government may make regulations to carry out the provisions of the Convention and the Protocol

• CTC and Protocol became law in Canada and Québec on April 1, 2013
4. Canadian implementation of CTC (cont’d)
4. Canadian implementation of CTC (cont’d)

- Canada ratified CTC with all OECD Qualifying Declarations, including self help, relief pending final determination and the IDERA, so Canadian airlines entitled to OECD export financing discounts and best available rating in capital markets deals for their aircraft.
4. Canadian implementation of CTC (cont’d)

• Primarily due to Canada’s implementation of Alternative A, Air Canada was able to save $100M+ in three EETCs closed in 2013 and 2015.
5. Case study

- Lease of 2 x Airliners plus 1 x Engine to Airline situated in Quebec, Canada
- Cape Town/Alternative A applicable in Canada/Quebec
- Leases Registered under IR; IDERA Deposited with Aviation Authority
- Airline in Default under Leases
- Aircraft 2 in possession of MRO performing services
- Airline filed for Bankruptcy Protection in Canada – obtained 12 month Stay against Creditors
5. Case study (cont’d)

- Lessor is “Critical Supplier” of Airframes and Engine under Canadian insolvency law (Court can compel Lessor to supply the Airframes/Engine to the Airline on the terms and conditions that the Court considers appropriate)
- Lease Rentals well above Current Market Pricing
- Lessor refused to re-negotiate leases with Airline/Administrator
- Airline/Administrator could not Cure past Defaults or Agree to perform all Obligations in future
5. Case study (cont’d)

- Airline/Administrator wished to retain Aircraft and Engines at Reduced FMV Rent so as to continue Airline in business in “public interest”

- Administrator could only perform basic Maintenance on Aircraft and Engines and wished to sell off high-value Parts replacing them with airworthy but lower value Parts

- MRO wished to retain possession of Aircraft 2 under Mechanics’ Lien notwithstanding Alternative A
5. Case study (cont’d)

- Lessor
- Lessee Airline / Administrator
  - Aircraft 1
    - Engine
  - Aircraft 2
  - MRO
- Transport Canada
- Court
- Aircraft/Engine Leases
- IDERA Filing
- Bankruptcy Stay / Application of Alternative A
- Mechanic’s Lien
- Hangar 3
- Hangar 4

Airline Located in Québec, Canada

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6. Resolution of case study

1. Although Lessor may be “critical supplier” under Canada bankruptcy law, *CTC Act* (Canada) and *CTC Act* (Quebec), implementing CTC in Canada and Québec in priority to other law, take priority over other Canadian bankruptcy law, and Alternative A would be held to apply. As such, Lessor is not compelled to supply the Aircraft on terms which the Court dictates; rather, it is entitled to Alternative A.

2. Lessor entitled to return of the aircraft and engine, within 60 calendar days, provided that Airline (i) maintains the collateral pursuant to the requirements of the Leases, and (ii) preserves the value of that collateral; unless Airline cures all defaults and agrees to perform all future obligations under the Leases.

3. Failure of Lessor to demand compliance with Alternative A is irrelevant – Alternative A rights are automatic. Agreement to perform future obligations should take form of commercial amendment to the Leases approved by the Bankruptcy Court.
6. Resolution of case study (cont’d)

4. Lessor entitled to have Aircraft 1 deregistered pursuant to IDERA and to physically export Aircraft 1, provided that it obtains required ferry permits pursuant to applicable safety laws

5. MRO entitled to retain Aircraft 2 (if Lessor was in privity with the MRO). MRO can maintain possession until paid in full, at which point it must be returned to Lessor

6. Aircraft 2 could be deregistered pursuant to IDERA, but cannot be physically exported until MRO claim bonded off or paid in full

7. Once MRO claim dealt with, all applicable authorities obligated under IDERA to cooperate with physical export of Aircraft 2
7. Key Conclusions

- U.S. 1110 is critical part of ability of U.S. airlines to raise lowest possible cost financing, particularly in capital markets or when in financial distress.

- Alternative A is an effective international improvement on highly efficient U.S. Section 1110.

- Alternative A is critical – probably the most critical – aspect of the benefits available under Cape Town.

- If implemented properly in a Contracting State, and complied with properly in that State, Alternative A establishes new law where there is none, and takes priority over any national law that conflicts with its terms.

- The benefits of Alternative A are automatic and require no affirmative steps by a Creditor.

- Alternative A and the IDERA are obligations of the Debtor and the applicable Contracting State.
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