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AVIATION | INSOLVENCY AND RESTRUCTURING ADVISORY

Aircraft Lessors Should Prepare for UK Restructuring Processes

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KEY POINTS

- The use by Malaysia Airlines' subsidiary, MAB Leasing Ltd. (incorporated in Malaysia) ("**MABL**"), in 2021, of an English Scheme of Arrangement (a "**Scheme**") to compromise its aircraft lease obligations proved that US Chapter 11 is not the only route to a globally recognised compromise of airline leases.
- Airline lessors should now prepare themselves for Schemes (and possibly also other English restructuring processes) as an alternative to Chapter 11.

Background

MABL was a wholly-owned subsidiary of Malaysia Aviation Group Berhad ("**MAGB**"). MAGB, together with its subsidiaries (the "**Group**"), operated Malaysia's national air carrier, the ultimate shareholder of which was Khazanah Nasional Berhad ("**KNB**") (Malaysia's sovereign wealth fund). As with many other airlines around the globe, the COVID-19 pandemic wreaked financial devastation. By late 2020, the Group was seeking a comprehensive restructuring of its financial indebtedness (the "**Group Restructuring**").

MABL's role in the Group was to lease aircraft and engines under various operating and finance leases with third party lessors. It sub-leased the aircraft to various entities in the Group, and sub-leased the operating leases to Malaysia Airlines Berhad ("**MAB**").

The operating leases were governed by English law and subject to the jurisdiction of the English courts. The lessors' rights under the operating leases were secured by way of a security assignment with respect to the corresponding sub-lease from MABL to MAB, and MABL's obligations were guaranteed by MAGB. Evidence established that the security and guarantee were of minimal value since, in a liquidation of MAB and MAGB – which was accepted as the counter-factual if the Group Restructuring failed – lessors would have received minimal recovery.

The Group Restructuring involved a wholesale balance sheet restructuring, including (i) arrangements to defer principal payments and reduce interest payments under certain of the Group's finance leases, as well as certain Malaysian law credit facilities and hedging agreements entered into by MAB; (ii) arrangements to amend certain of MABL's aircraft leases (on terms similar to those proposed under the Scheme, but which were implemented bilaterally with the relevant lessors); (iii) arrangements to amend the Group's engine lease agreements and

maintenance and service contracts to align with market rates, the Group's cashflow requirements and its revised long-term business plan; (iv) various arrangements with entities related to the Government of Malaysia; and (v) a substantial equity injection by KNB and the capitalisation of existing shareholder loans advanced by KNB.

Regarding the restructuring of MABL's operating leases, it undertook bilateral negotiations, but only succeeded in securing agreement from a relatively modest portion of its lessors. To encourage agreement from the remaining 44 lessors (the "**Scheme Creditors**") in respect of 52 aircraft, MABL proposed the Scheme. The Scheme was inter-conditional with the wider Group Restructuring.

Schemes of Arrangement and Restructuring Plans in the UK

Schemes of Arrangement

For those unfamiliar, Schemes are a statutory procedure under Part 26 of the Companies Act 2006 (UK) ("**Companies Act**"). It enables a debtor company to reach a binding compromise or arrangement with its members or creditors (or any class of them). The debtor company does not file for insolvency: it is not, in this sense, an insolvency proceeding under the Insolvency Act 1986 (UK).

In the context of a financial restructuring, the debtor company invites a class (or classes) of creditors to consider and vote on a proposal for compromise of indebtedness. If a majority in number and 75 percent in value in attendance vote in favour, the proposal will, subject to court sanction, be imposed on the entire class, even if they did not vote or voted against (known as "**intra-class cramdown**").

The role of the court is fairly light touch. Firstly, at a so-called convening hearing, the court determines whether to allow the company to convene the creditor meeting(s) to vote on the scheme. At this stage, the court primarily considers matters of jurisdiction and class composition. Next, if and when the creditors vote in favour of the Scheme, there will be a second hearing at which the court determines whether to sanction the Scheme. There is an opportunity at this hearing for dissenting creditors to object on grounds such as fairness.

Restructuring Plans

In 2020, a new statutory process for facilitating compromise of indebtedness came into law in the guise of Restructuring Plans under Part 26A of the Companies Act.

There are three principal respects in which the Restructuring Plan differs to a Scheme:

- Firstly, there is no majority in number threshold for voting purposes; only 75 percent in value.
- Secondly, it is only available to a company to assist it with its "financial difficulties."
- Thirdly, it facilities "cross class cramdown", not dissimilar to Chapter 11 of the US Bankruptcy Code. The court may sanction a Restructuring Plan even if not duly voted by all classes, provided two conditions are satisfied. Firstly, none of the members of the dissenting class would be worse off than in the "relevant alternative" (being the most likely to occur in relation to the company if the Restructuring Plan were not sanctioned). Secondly, the Restructuring Plan has been approved by at least one class who would receive payment or have a genuine economic interest in the company in the "relevant alternative." This differs from the "absolute priority" test in a US Chapter 11 for applying cross class cramdown.

Restructuring Plans have thus been coined "Chapter 11 Lite."

Terms of the MABL Scheme

In the MABL Scheme, each Scheme Creditor was offered two principal options: (1) to continue to lease the aircraft to MABL at a revised rent, adjusted in line with market terms (with additional optionality to receive a higher rent in return for a contingent deferral, and regarding lease extensions) with all other material terms remaining unchanged; or (2) to terminate the operating lease and take back the aircraft and receive a one-off payment exceeding the upper end of the expected return in a liquidation of MABL.

Cape Town Convention and Insolvency Arrangements

One question that arose was whether the Scheme was impacted by the Cape Town Convention.

The Operating Leases were subject to the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015 (SI 2015/912) (UK) (the "**UK Cape Town Regulations**"). The UK Cape Town Regulations ratified certain provisions of the Cape Town Convention and associated Protocol to the Cape Town Convention on matters specific to Aircraft Equipment.

The UK Cape Town Regulations provide for the consequences of an "insolvency-related event" occurring in respect of a party to a regulated agreement, and the rights and remedies available to the creditor in those circumstances.

It is principally because of experts' concerns surrounding Schemes being an "insolvency-related event" that it took until 2021 for a Scheme to be put to the test in respect of agreements regulated by the UK Cape Town Regulations. The concern, in particular, was that if a Scheme did constitute an "insolvency-proceeding", the cramdown feature would likely be in contravention of the right of each lessor to consent to a proposal to amend its lease terms.

In short, the consequence of an "insolvency-related event" occurring in respect of a party is two-fold: (1) no obligation of the debtor under the agreement may be modified without the consent of the creditor; and (2) a lessor is entitled to terminate the lease, claim repossession and receive a termination fee by way of damages.

An "insolvency-related event" means "(i) the commencement of insolvency proceedings or (ii) 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 UK Cape Town Regulations is prevented or suspended by law or State action." "Insolvency proceedings" means "liquidation, bankruptcy, sequestration or other collective judicial or administrative insolvency proceedings, including interim proceedings, in which the assets and affairs of the debtor are subject to control or supervision by a court (or liquidation committee)."

What Are Some of the Questions a Lessor Should Be Asking?

Does a Scheme Constitute an "Insolvency Proceeding" Under the UK Cape Town Regulations?

Although the court did not settle the question, it referred to MABL counsel's "powerful arguments" that a Scheme was not an "insolvency proceeding." The principal arguments are that Schemes are a creature of English corporate law, not insolvency law and, unlike an administration or liquidation under the Insolvency Act 1986 (UK), a Scheme does not result in moratorium on creditor action – the directors stay in office and the company continues in operations as normal.

There were two reasons the court did not need to decide the point. Firstly, 100 percent of the lessors agreed on the terms, and therefore cramdown was not in issue. Secondly, the terms of the Scheme included an option for a dissenting lessor to terminate its lease, claim repossession and receive a termination fee by way of damages in excess of the *de minimis* dividend it would have received in a liquidation. (The court accepted MABL's evidence that, absent the Scheme, a liquidation would have been the realistic alternative.)

The question is therefore still open. Some commentators have suggested that including a termination option, such as that in MABL's Scheme, makes the point moot. However, that may not necessarily be the case. It might be argued that a lessor should be able to at least be issued shares in the restructured company, as in most Chapter 11 cases. The argument would be that, if the lessor is left with only a *de minimis* termination fee calculated by reference to its dividend on a liquidation, then this unfairly compels the lessor to agree to the restructuring – and so is a back-door cramdown.

As for Restructuring Plans, they have already been held to fall within a definition of "bankruptcy proceedings" set forth in a treaty to which the UK is a party called the Lugano Convention – primarily due to the "financial difficulty" threshold mentioned above. This threshold is absent in Schemes. The Lugano Convention definition is not dissimilar to the "insolvency proceeding" definition in the UK Cape Town Regulation. There may therefore be additional arguments that a Restructuring Plan is an "insolvency proceeding" for the purposes of the UK Cape Town Regulations.

Which Lessors Should Have English Processes in Their Purview?

In short, if a lease is governed by English law and subject to the jurisdiction of the English courts, lessors should consider their leases susceptible to a compromise by way of a Scheme or a Restructuring Plan, at least for the purposes of jurisdiction.

English courts accept jurisdiction for foreign companies routinely, on bases not dissimilar to the US courts for a Chapter 11 filing. There simply needs to be a "connection" to the UK. This can be satisfied by the presence of one of a number of factors (e.g., if the governing law of the lease is English law, if a critical mass of creditors is located in the UK or if a co-obligor is incorporated in the UK). In MABL, the leases were governed by English law and subject to English court jurisdiction, and this was accepted as sufficient for the English court to exercise jurisdiction.

There is another factor that the English court requires: evidence that the Scheme will be likely to take effect in the jurisdiction(s) where it needs to. This requirement is a practical one – the English court will not "act in vain." In MABL, evidence of Malaysian counsel was adduced confirming that the Scheme would be recognised in Malaysia.

Why is an English Process an Attractive Solution to an Airline?

Here are the top five reasons:

- A variation of contractual rights under a Scheme prevents a lessor of an English law-governed lease from invoking the so-called "Rule in Gibbs" as a defence to a compromise process under a foreign law (such as a process under Malaysian law, for example). The Rule in Gibbs, which dates back to the 1890s and is still good law, provides that an English law debt may be varied or discharged only by an English law process (unless the creditor submits to the foreign process). In this case, it means that, had the Malaysian court purported to compromise the operating leases, a lessor could have sought an injunction from the English court preventing it taking effect in the UK, and thus facilitate an action against MABL's assets in the UK.
- As with a Chapter 11, the airline directors stay in control and the company can continue in operations, but unlike Chapter 11, there is no court supervision of the company for the duration of the Scheme process.
- Schemes are more flexible, cheaper and speedier than a Chapter 11, insofar as the debtor's board chooses which class(es) of creditors to include in the proposal for compromise, and "out of the money" creditors have limited rights to exercise "nuisance value." This is in contrast to Chapter 11, where representation of the unsecured creditor committee is alive and well, whether or not "out of the money."
- Protracted valuation disputes (e.g., regarding market value of the leases and liquidation value of the company) are rare absent credible evidence challenging the debtor's case. To argue against the debtor's valuation, a stakeholder must become a party to the proceedings and apply for discovery in the usual way.

- The losing party risks being ordered to pay not only its own costs, but also the costs of the winning parties. Taking a litigious position against the debtor is therefore not a "free option."

There are some noteworthy similarities with Chapter 11: (1) third party obligors' claims (such as guarantors) can be released without needing to be made party to the Scheme; and (2) schemes are routinely recognised globally. (For European companies, Brexit has not changed this.)

How Did the English Court Arrive at the Decision to Agree With the Debtor That All Aircraft Lessors Should Be Included in the Same Class?

Class constitution is decided according to stakeholders' legal (as opposed to collateral) rights against the debtor, both going into and coming out of the Scheme. Stakeholders vote in the same class if their rights are "*not so dissimilar as to make it impossible for them to consult together with a view to their common interest.*"

The court held that, despite the wide range of haircuts offered to lessors depending on the vintage of the aircraft, they should be put in the same class because there was far more uniting them than dividing them.

How Can a Lessor Prepare Itself for a Scheme?

For as long as the issue remains unsettled, it is open for lessors to argue that a Scheme constitutes an "insolvency proceeding" and, insofar as it purports to impose a variation on lessors, is in contravention of the UK Cape Town Regulations.

Separately, in circumstances where the debtor includes a "termination option" in the package of compromise options (as MABL did), there may be an argument that the statutory right to pursue damages on termination is illusory.

What a lessor should do is engage as early as possible with the airline to put its case forward as to valuation and preferred restructuring options. To the extent practical, lessors should group together to discuss their options as a class.

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