

Features of the Hong Kong Airlines Restructuring Plan

October 4, 2022

KEY POINTS

- Hong Kong Airlines (HKA) has announced that it is seeking to implement a restructuring of its aircraft lease obligations and other liabilities by court action in the UK and Hong Kong.
- The plan proposes to give aircraft lessors a right to an upfront cash recovery – of about 5 percent of their claims (or in the case of lessors of aircraft being retained, the right to elect equity in the restructured HKA) – and potential future payouts starting in 2028 tied to the future earnings of the airline.
- It is important that requests by lessors for additional information about the plan and any objections are raised promptly and preferably well in advance of the Convening Hearing scheduled for October 25. As has been made clear in recent cases, active participation in the court hearings will be important to influencing the court’s discretion.

Overview

On September 27, HKA distributed a “Practice Statement Letter” to most of its aircraft lessors, perpetual noteholders and other unsecured creditors (together the “Plan Creditors”). The Practice Statement Letter describes a restructuring plan proposed by HKA for those creditors under Part 26A of the Companies Act 2006 of the UK. The restructuring plan, if adopted, would put in place a compromise of HKA’s liabilities to the Plan Creditors (including any Plan Creditors who did not consent to or opposed the plan).

Initial observations and considerations

Lessors should regularly review the [website for the restructuring plan](#), referred to in the Practice Statement Letter, for further information. The following considerations arise from the Practice Statement Letter:

- The stated recovery levels may be optimistic given that the plan is currently unclear as to how the amount of cash available for distribution was calculated and as to how HKA calculated the aggregate dollar amount of claims of aircraft lessors and other unsecured creditors.
 - The plan does not specify the rate of future payouts tied to future earnings of the airline.
 - The plan does not impair the existing claims of intercompany creditors or related parties.
 - The plan does not cover secured creditors of HKA, in particular HKA’s largest lender (including with respect to its aircraft finance leases to HKA). They receive the benefit of separately negotiated terms.
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- The plan does not impair “Other Excluded Claims” (stated to be about 28 percent of HKA’s total indebtedness) or explain what this term comprises.
- The plan states that it has the approval of 73.2 percent of creditors (suggesting the plan has close to the required 75 percent approval of Plan Creditors), but this seems to be misleading. The 73.2 percent actually represents the approval of all creditors of HKA. The 75 percent threshold represents the required percentage of creditors of each class of creditors covered by the restructuring plan (which does not include secured creditors or related creditors or holders of other excluded claims).

Process

Convening Hearing

The Practice Statement Letter recites that an initial court hearing will be held on or about October 25 before the Chancellor of the High Court of Justice of England and Wales (the Court) in London, which HKA creditors may attend. At the hearing, creditors will have the opportunity to raise before the Court any objections or other concerns over the Plan Creditor classes and other procedural matters relating to the restructuring plan (but not otherwise going to the merits or fairness of the plan). If the Court is satisfied at this hearing that the restructuring plan has a prospect of being approved by the creditors and the proposed classes of creditors have been correctly constituted, the Court will then order plan meetings for the classes of creditors to be convened.

Steps Following the Convening Hearing

Provided the Court grants the convening order HKA will:

- convene plan meetings (expected to be held on or about November 25) by notifying the respective Plan Creditors in accordance with the directions of the Court of the time and date and means of attending the plan meetings.
- make additional restructuring plan documents available on the plan website to the plan creditors, including the voting and proxy form the creditors will have to complete in order to vote at or appoint a proxy to vote at the plan meeting.

After the plan meetings, provided the requisite majorities of Plan Creditors vote in favor of the plan, HKA will apply at the “Sanction Hearing” for an order sanctioning (i.e., approving) the restructuring plan. Plan Creditors may attend and make objections. The Court will consider whether requisite majorities were obtained, whether the creditor classes were fairly represented by those who attended the plan meetings, and whether the restructuring plan is a fair plan that a creditor could reasonably approve.

Requisite Approval

The restructuring plan will take effect and be binding on all creditors to whom it applies if the plan is approved by at least 75 percent by value of the Plan Creditors present and voting in person or by proxy at each meeting of Plan Creditors convened to consider the restructuring plan, and the plan is then sanctioned by the Court at a hearing scheduled for this purpose.

Dissenting Class

The Court may sanction a restructuring plan even if the Requisite Approval is not obtained from a class of Plan Creditors at a meeting provided that:

- the Court is satisfied that none of the members of the Dissenting Class would be worse off than they would be under the relevant alternative to the plan.
- the Requisite Approval for the plan has been obtained from a class of creditors that would receive a payment or otherwise have an economic interest in the company under that alternative.

The Plan Creditors

The creditors proposed to be subject to the restructuring plan consist of:

- **Unsecured Creditors.** Generally, a creditor with an unsecured claim against HKA, and any secured creditor to the extent any portion of its claim is unsecured (such as an aircraft lessor holding a security deposit). This class of creditors includes aircraft lessors (except as provided below for Critical Lessors) but apparently not for any aircraft being subleased by HKA or certain bank-financed leased aircraft.
- **Critical Lessors.** Generally, any financier or lessor with a claim related to the lease of one or more aircraft to HKA that are intended to be retained by HKA on completion of the restructuring. Such aircraft are identified in the Practice Statement Letter. A person may be both an Unsecured Creditor and a Critical Lessor.
- **Perpetual Noteholders.** A holder of the “Perpetual Notes” (7.125 percent senior perpetual securities guaranteed by HKA).

New Equity Injection

It is contemplated that as part of the restructuring, new ordinary shares of HKA representing at least 94 percent of the issued shares of HKA at the restructuring effective date will be issued to a “New Investor.” The New Investor is identified only as a special purpose entity to consist of a current indirect minority shareholder of HKA and other (unidentified) joint venture partners. The New Investor will receive the shares in exchange for a new equity investment of three billion Hong Kong dollars (HK\$) (approximately \$382 million US dollars). The equity investment is a condition to the implementation of the restructuring.

Not All Indebtedness Is Subject to the Restructuring Plan

As further described in the Practice Statement Letter, approximately HK\$ 30 billion in HKA indebtedness, including aircraft lessor claims, will be subject to the restructuring plan. Approximately HK\$ 19 billion in claims, consisting of secured liabilities, claims of excluded creditors (including related parties), and approximately HK\$ 14 billion in “Other Excluded Claims” (not defined), are not subject to the restructuring plan.

Restructured Fleet

The current HKA fleet consists of 53 aircraft. The bank that is described as HKA's largest creditor, with whom HKA reports it has been separately negotiating, is the lender to 13 special purpose borrower subsidiaries of HKA, which in turn used the proceeds of their loans to purchase 13 new aircraft and lease them to HKA with Beijing Capital Airlines as co-lessee. Under the restructuring plan, HKA plans to retain six of such aircraft. HKA plans to retain 14 other leased aircraft, bringing the total number of aircraft that HKA intends to retain to 20. The 14 are leased from three lessors under operating leases. For the remaining 26 aircraft, HKA will retire or return them to the lessor or in the case of an aircraft under sublease, cause the lease to be novated from HKA to the sublessee. (However, it is not clear if the novation will only occur consensually, or if HKA intends it to occur by order of the Court under the restructuring plan. In the latter case, the affected lessors ought to be treated as Plan Creditors.)

Background to the Restructuring

HKA describes how its condition started to deteriorate in 2018 and was exacerbated by the COVID-19 pandemic and social and political unrest in Hong Kong. HKA reports that when it applies in early 2023 for renewal of its air transport license, which expires March 2023, it must demonstrate financial viability. Absent the implementation of the restructuring plan, HKA is unlikely to demonstrate financial viability, resulting in the revocation of HKA's air transport license and the winding up of HKA, resulting in recoveries for plan creditors likely lower than what they will recover under the restructuring plan. Starting in December 2021, HKA commenced restructuring negotiations with its larger creditors, including in particular, the bank that is HKA's largest creditor, which held approximately 49 percent of HKA's indebtedness. There is a winding-up petition against HKA pending in the Hong Kong courts filed by its lessor Stellar Aircraft Holding 1 Limited. The petition has been adjourned several

times most recently to October 31. HKA has received letters of support from creditors (not necessarily Plan Creditors) holding 73.2 percent of HKA's indebtedness, confirming in principle, their support for the restructuring plan in general terms.

Bilateral Discussions

HKA has had bilateral discussions with certain creditors, in particular certain secured creditors, which may be the subject of bilateral settlement agreements outside the restructuring plan. The aircraft intended to be retained are intended to have lower rents going forward.

Hong Kong Scheme

Concurrently a scheme of arrangement is being pursued in Hong Kong in order to effectively compromise the Hong Kong law governed and other non-English law governed claims to which the UK restructuring plan applies. The Hong Kong scheme and the UK restructuring plan will have the same restructuring terms as far as aircraft lessors are concerned. Creditors may not have a double recovery under the two plans.

Recovery for Lessors

Under the plan, the Unsecured Creditors will receive:

- an upfront payment out of a pool of approximately HK\$ 960 million estimated to represent a recovery of about 5 percent of their claims.
- subsequent cash distributions (at rates that are not yet specified) if HKA meets its annual Pro-forma EBITDA targets (as specified on page 46 of the Letter). These targets are for the years 2027 through 2035.

Under the plan, Critical Lessors will receive:

- to the extent they elect the cash option, an upfront payment out of a pool of approximately HK\$ 120 million estimated to represent a recovery of about 5 percent of their claims.
- subsequent cash distributions (at rates that are not yet specified) if HKA meets its annual Pro-forma EBITDA targets (whether they elect the cash option or equity option).
- to the extent they elect the equity option, their pro rata share of the conversion shares.

Critical Lessors May Elect to Have Aircraft Returned

With the Cape Town Convention in mind, the plan permits Critical Lessors who do not agree to amended terms to their leases, including an extension of the term and amended rental and maintenance reserve payments, to elect to have those aircraft returned to them and have their claims treated as Unsecured Claims.

Proofs of Claim

Instructions for filing proofs of claim are expected to be provided to creditors following the Convening Hearing.

Conclusions

HKA's restructuring plan promises a low short-term cash recovery to aircraft lessors and vague promises of additional payouts that do not start until well into the future, while giving preferential treatment to certain creditors and leaving intercompany and related company claims intact. Lessors have ample grounds to question and object to provisions of the restructuring plan. Active participation in the upcoming Court hearings will be important to influencing the Court's discretion.

CONTACTS

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