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*Airline Reorganization Under the U.S. Bankruptcy Code*

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## Airline Reorganization under the U.S. Bankruptcy Code

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### Summary

On August 11, 2002, U.S. Airways filed petitions for reorganization under the United States Bankruptcy Code. Generally, a filing under Chapter 11 of the Bankruptcy Code allows a company to continue operating while providing the company with an opportunity to reorganize its finances. Considering that much of the property utilized by an airline in its daily operations is leased, leases of real property - terminals and gates - and leases of aircraft equipment can weigh heavily in the reorganization. Several provisions of the Bankruptcy Code specifically relate to filings by air carriers and dictate how their leased property is treated under reorganization. This report will provide a brief overview of the provisions of the U.S. Bankruptcy Code that specifically relate to the reorganization of an airline's finances under the United States Bankruptcy Code.

### Background

In 1978, Congress enacted the Airline Deregulation Act with the goal of returning the airline industry to "competitive capitalism with many competing airlines, where none could control the market and where all would have to actively participate in price competition."<sup>1</sup> Prior to the enactment of the Deregulation Act, airlines were heavily regulated by the federal government. The government regulated everything from ticket prices, to routes, to the number of airlines allowed to operate. "The regulatory scheme tended to favor the status quo and discourage competition, and for the airlines lucky enough to be in existence, regulation provided a fairly comfortable operating environment."<sup>2</sup>

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<sup>1</sup> Mark C. Mathiesen, *Bankruptcy of Airlines: Causes, Complaints, and Changes*, 61 J. Air L. & Com. 1017, 1021(1996), citations omitted. See Airline Deregulation Act of 1978, Pub. L. 95-504, 92 Stat. 1705, codified in scattered sections of Title 49 U.S.C.

<sup>2</sup> 62 J. Air L. & Com. at 1022.

The Deregulation Act caused numerous changes in the airline industry, and resulted in the introduction of over 100 new airlines in the first six years of deregulation.<sup>3</sup> As competition increased, many airlines were unable to compete and ultimately failed. Changes in the industry brought on by deregulation, as well as unrelated economic concerns, led many airlines to seek protection under Chapter 11 of the United States Bankruptcy Code.<sup>4</sup>

## Chapter 11 of the U.S. Bankruptcy Code

Chapter 11 of the United States Bankruptcy Code governs the reorganization of an organization's finances.<sup>5</sup> By filing under Chapter 11, a company is able to stay in business while being afforded an opportunity to reorganize its finances. Provisions of Chapter 11 may help the company terminate unprofitable leases of property and equipment, while ensuring that the company continues to operate and an attempt is made to cure defaults. Generally, the goals of a successful reorganization are to provide "continued employment to the debtor's workforce, treat[] creditors in an even-handed manner, and attempt[] to ensure a fair return to stockholders on their investment."<sup>6</sup>

There appears to be an ongoing debate within the industry as to whether allowing an airline to continue operations under Chapter 11 provides the airline with an unfair advantage over financially stronger competitors.<sup>7</sup> As noted above, one of the express purposes of Chapter 11 is to rehabilitate insolvent debtors. Those airlines not in bankruptcy argue that allowing airlines in Chapter 11 to defer debt payments, cut labor costs, and lower operating costs over a long period of time creates an unfair advantage.<sup>8</sup> However, airlines operating in Chapter 11 argue that there are major disadvantages associated with bankruptcy, including the need to make cash payments on certain debts and consumer resistance to flying with a company operating in bankruptcy.<sup>9</sup>

## Provisions Specific to Airline Reorganization

The Bankruptcy Code includes several provisions specific to bankruptcies by airlines. Generally, the provisions provide protections for entities that finance acquisitions by airlines in the event of a bankruptcy filing. These protections were originally enacted to encourage new financing in key industries, such as air transportation.<sup>10</sup> Due to the expenses associated with acquiring the equipment and

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 1023.

<sup>5</sup> For a detailed discussion of Chapter 11, see CRS Report 97-1057, *A Bankruptcy Primer: Liquidation and Reorganization under the U.S. Bankruptcy Code*, by Robin Jeweler.

<sup>6</sup> 62 J. Air L. & Com. at 1025.

<sup>7</sup> *Id.* at 1019.

<sup>8</sup> *Id.*, citing H.R. Rep. 103-22 (1993), reprinted at 1993 U.S.C.C.A.N. 83.

<sup>9</sup> *Id.*

<sup>10</sup> Jason J. Kilborn, *Thou Canst Not Fly High With Borrowed Wings: Airline Finance and* (continued...)

property necessary to run an airline, air carriers often seek financing of their acquisitions through secured borrowing and leasing, and “given the magnitude of these transactions, the financiers of aircraft acquisitions seek – indeed, sometimes demand – maximum protection for their investment, particularly protection from the worst-case scenario of an air carrier bankruptcy.”<sup>11</sup>

**Leases of Terminals and Gates.** Section 365 of the Bankruptcy Code allows a debtor to choose between assuming or rejecting certain executory contracts<sup>12</sup> and unexpired leases.<sup>13</sup> Several subsections of section 365 specifically relate to air carriers and leases of aircraft terminals or aircraft gates.<sup>14</sup> Generally, section 365 requires the debtor to “either reaffirm and continue to fulfill its obligations under the leases to retain possession of the leased property, or reject each lease in its entirety and surrender possession of the leased property to the lessor.”<sup>15</sup> The debtor is given the authority, subject to the court’s approval and with certain exceptions, to assume or reject any executory contract or unexpired lease.<sup>16</sup> However, the debtor may not assume a lease if the debtor has defaulted under that lease unless the debtor cures, or provides adequate assurance that he or she will promptly cure, such default; compensates, or provides adequate assurance that he or she will promptly compensate, a party other than the debtor, for any actual pecuniary loss to such party resulting from the default; and provides adequate assurance of future performance under the contract or lease.<sup>17</sup>

With respect to contracts or leases of aircraft terminals or gates, if the debtor leases more than one terminal or gate, the debtor may not assume or assign any contract or lease unless all such leases are assumed by or assigned to the same person.<sup>18</sup> The airport operator may consent to the assignment of less than all such leases.<sup>19</sup>

Generally, for non-airline debtors filing under Chapter 11, a debtor may assume or reject a lease at any time before the confirmation of a plan. However, the court, on the

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<sup>10</sup> (...continued)

*Bankruptcy Code Section 1110*, 8 Geo. Mason L. Rev. 41, 51(1999), citing H.R. Rep. No 85-944 (1957); H.R. Rep. No. 95-595, at 239, reprinted at 1978 U.S.C.C.A.N. 6198.

<sup>11</sup> *Id* at 42.

<sup>12</sup> An executory contract is a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that failure of either to complete performance would constitute a material breach excusing performance by the other party. *Black’s Law Dictionary*, 6<sup>th</sup> ed (1990).

<sup>13</sup> 11 U.S.C. 365. For purposes of a Chapter 11 filing, the debtor usually performs the duties of the trustee. Where the Code references “trustee,” this report uses the term “debtor” to imply that the duties discussed are generally performed by the debtor.

<sup>14</sup> 11 U.S.C. 365(d)(5), (8), and (9).

<sup>15</sup> 8 Geo. Mason L. Rev. at 55-56.

<sup>16</sup> 11 U.S.C. 365(a).

<sup>17</sup> 11 U.S.C. 365(b)(1).

<sup>18</sup> 11 U.S.C. 365(c)(4).

<sup>19</sup> *Id*.

request of any party to the lease, may order the debtor to determine within a specified period of time whether to assume or reject the lease.<sup>20</sup> If the debtor does not assume or reject the lease within 60 days after the date of the order for relief, or within such additional time as the court, for cause,<sup>21</sup> within such 60-day period, fixes, then such lease is deemed rejected, and the debtor must surrender the property to the lessor.<sup>22</sup>

With regard to leases of aircraft terminals or gates, the law imposes additional obligations. If the debtor fails to assume or reject an unexpired lease of an aircraft terminal or aircraft gate prior to the occurrence of a termination event,<sup>23</sup> then, at the option of the airport operator, the lease is deemed rejected five days after the occurrence of the termination event. At that time, the debtor is required to immediately surrender possession of the premises to the airport operator. The airport operator must provide the airline adequate opportunity to remove the fixtures and equipment that are the property of the airline.<sup>24</sup>

**Leases of Aircraft Equipment.** Section 1110 places greater limitations on a debtor airline's ability to assume or reject security agreements, leases and contracts related to aircraft equipment when it files for bankruptcy.<sup>25</sup> Subject to certain exceptions, a party with a security interest in certain aircraft equipment,<sup>26</sup> or a lessor of such equipment, may take possession of the equipment in compliance with a security agreement, lease, or conditional sale contract, and enforce any of its other rights or remedies under the agreement, lease, or contract, to sell, lease, or otherwise retain or dispose of the

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<sup>20</sup> 11 U.S.C. 365(d)(1).

<sup>21</sup> The burden of proof for establishing cause for an extension by an affected air carrier lies with the debtor. 11 U.S.C. 365(d)(8). For purposes of determining "cause" with respect to an unexpired lease of an airport terminal or gate between an air carrier and an airport operator, the court shall consider, among other relevant factors, whether substantial harm will result to the airport operator or airline passengers as a result of the extension. In determining whether there would be substantial harm, the court shall consider, among other relevant factors, the level of actual use of the terminals or gates which are the subject of the lease, the public interest in actual use of such terminals or gates, the effect of the extension on the debtor's ability to successfully reorganize, and whether the debtor is capable of continuing to comply with its obligations under section 365. 11 U.S.C. 365(d)(9).

<sup>22</sup> 11 U.S.C. 365(d)(4).

<sup>23</sup> A termination event is defined as the entry under section 301 or 302 of the Bankruptcy Code of an order for relief under chapter 7 of the Bankruptcy Code; the conversion of a case under any chapter of the Bankruptcy Code to a case under chapter 7 of the Bankruptcy Code; or the granting of relief from the stay provided under section 362(a) of the Bankruptcy Code with respect to aircraft, aircraft engines, propellers, appliances, or spare parts, except for property of the debtor found by the court not to be necessary to an effective organization. 11 U.S.C. 365(d)(6).

<sup>24</sup> 11 U.S.C. 365(d)(5).

<sup>25</sup> 11 U.S.C. 1110.

<sup>26</sup> Equipment means an aircraft, aircraft engine, propeller, appliance, or spare part, as defined in 49 U.S.C. 40102. 11 U.S.C. 1110(a)(3)(A)(i).

equipment.<sup>27</sup> However, the right of repossession may be subject to an automatic stay<sup>28</sup> if, within 60 days after the order for relief, the debtor, subject to the approval of the court, agrees to perform all obligations of the debtor under the agreement, lease or contract; and any default is cured in compliance with the terms of the agreement, lease, or contract within a specified period of time.<sup>29</sup> The parties may agree to extend the 60 day period, subject to approval by the court.<sup>30</sup>

Despite the ability of the debtor to assume the debts discussed above, the secured party, lessor, or vendor may make a written demand to take possession of the equipment at any time after the date of the order for relief, if such a demand is allowable under the initial agreement between the parties.<sup>31</sup> Upon demand, the debtor is required to immediately surrender and return the property to the requesting party. After the equipment is returned to the requesting party, any security agreement, lease or conditional sale contract relating to the equipment, shall be deemed rejected if such security agreement or conditional sale contract is an executory contract.<sup>32</sup>

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<sup>27</sup> 11 U.S.C. 1110(a)(1).

<sup>28</sup> 11 U.S.C. 362.

<sup>29</sup> 11 U.S.C. 1110(a)(2).

<sup>30</sup> 11 U.S.C. 1110(b).

<sup>31</sup> 11 U.S.C. 1110(c)(1).

<sup>32</sup> 11 U.S.C. 1110(c)(2).