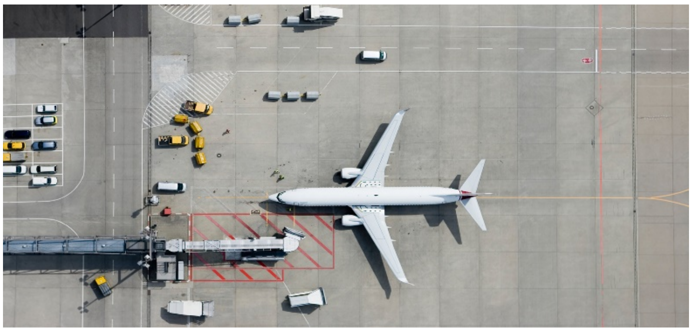
Airline Insolvency Review

Return to sender



UK taxpayers paid over £60 million to repatriate around 110,000 passengers stranded abroad following the failure of Monarch in October 2017. The UK Government commissioned the Airline Insolvency Review to assess the existing protections available to passengers in the event of a future airline insolvency and make recommendations to ensure taxpayers no longer foot the repatriation bill. The review has now published its final report. It remains to be seen which of the recommendations (if any) will be implemented but some of them have the potential for far reaching changes in the sector.

Existing protections

The final report's assessment is that the existing protections are incomplete. Only around 80% of UK-originating passengers have some form of protection from financial loss on an airline failure by one or more of:

- protection under the Air Travel Organiser's Licence (ATOL) scheme. Broadly speaking, UK firms selling air packages, flight plus trips and some flight only bookings must hold an ATOL and if the firm fails, the Civil Aviation Authority (the "**CAA**") draws on Air Travel Trust funds to cover repatriation;

- a claim against credit card issuers who are jointly and severally liable for a breach of contract under the Consumer Credit Act 1974 (the "**CCA 1974**");

- a travel insurance policy (potentially packaged with other financial products), of which around 50% provide cover for an airline failure; and

- reversal of a transaction by a debit card issuer where services have not been provided.

The outcomes also differ with the various protections. For example, ATOL protection results in repatriation organised by the CAA. Protection under the CCA 1974 covers claims above £100 for both losses from the original flight and consequential loss. By contrast, the debit card protection covers loss from the original flight but not consequential loss.

The report's passenger survey found that passengers' greatest concern is the risk of being stranded on an airline failure and consequently that passengers are willing to pay more for tickets to guarantee repatriation. As a result, the final report focuses on how best to secure repatriation.

The alternative – that passengers take the risk of incomplete protections on an airline failure and bear that in mind when deciding which airline to book with – flies in the face of the policy decision in Monarch for the taxpayer to pay for repatriation.

The Flight Protection Scheme

The principal recommendation is a repatriation scheme, known as the "Flight Protection Scheme" to ensure repatriation for all UK-originating air passengers.

The proposed Flight Protection Scheme is essentially a single mechanism to ensure that the best repatriation option can be deployed for a particular airline failure. The options that may be deployed depending on the particular facts are:

- **self-repatriation**: passengers book and pay for repatriation flights. This is currently the default approach where there is no ATOL protection;

- **assisted repatriation**: as above but with a more active role played by a co-ordinating body. For example, the body could work with airlines to increase the number of flights, size of aircraft and, by agreeing a code of conduct on rescue fares, improving the availability of rescue fares and operate a central information and booking facility for affected passengers;
- **organised charter**: where aircraft are chartered from third party airlines specifically to repatriate customers of the insolvent airline. This was the approach deployed on Monarch's failure; and
- **keep the fleet flying**: where the fleet of the failed airline continues flying for a short period to repatriate.

What reforms are required to facilitate each option?

Currently, when an airline fails in the UK it is highly unlikely that it will continue to fly following the appointment of a liquidator or administrator. There are a number of reasons for this. First, insolvency practitioners (and their firms) will be concerned at the risk of liability or reputational damage should an accident occur on their watch. The report cites that in 1989 administrators traded Paramount Airways but it is far from certain that a similar approach would be taken today. Second, the officeholder would require access to significant funds to continue to fly, for example, to maintain key insurance cover, retain essential management and staff and ensure that essential suppliers continue to supply and creditors do not seek to assert liens over or detain or repossess aircraft required for the continued trading (including for example overseas airports seeking to recover unpaid airport charges).

The review therefore proposes a special administration regime for airlines. The key elements being:

- a primary purpose of an airline special administration is to repatriate stranded passengers. Therefore even though repatriation may not be in the interests of creditors of the airline, the special administrator would nonetheless be obliged to use available funds until repatriation is concluded. Repatriation will presumably be deemed concluded when all passengers can be repatriated via the suite of repatriation options, rather than the special administrators repatriating <u>all</u> passengers where assisted repatriation is more suitable for some of the stranded passengers;
- the Secretary of State for Transport would control the identity of the special administrator and be able to prevent alternative insolvency proceedings being commenced in the UK. This is common in existing special administration regimes for other sectors. The final report envisages that there would be a pre-approved list of insolvency practitioners with the requisite skills to oversee repatriation;
- an enhanced moratorium to prevent creditors taking action for a 14 day period at the start of the special administration, including to prevent key suppliers such as aircraft lessors and fuel suppliers from terminating contracts or demanding ransom payments. The key challenge is ensuring this is respected in other jurisdictions which, in reality, may require the special administrator to pay overseas creditors threatening action;
- arrangements to ensure funding is available to enable the special administrator to achieve the purpose of the special administration; and
- the Secretary of State would have an express power to provide a grant, loan or indemnity to the special administrators to alleviate concerns over their personal liability. It may nonetheless still prove difficult for insolvency practitioners' firms to be comfortable with the reputational risks should an accident occur during a special administration.

Whilst less fundamental, there are issues with other repatriation options. In particular, a myriad of practical issues will need to be dealt with to have a truly co-ordinated assisted repatriation process. Developing an efficient, passenger-facing solution that could be deployed on short notice on an airline failure would be a significant logistical challenge.

Funding the Flight Protection Scheme

The key driver behind the review is that the taxpayer should not fund the scheme.

The report proposes each airline is responsible for an amount of funding calculated by reference to that airline's repatriation exposure. Details would need to be resolved (including where repatriation costs are already covered in part by existing ATOL protections), but the principle is that the co-ordinating body would map each airline's repatriation exposure based on a pre-agreed and publicly available formula. Each airline would then be responsible for posting security products (such as letters of credit) for a percentage of its repatriation exposure. Such percentage would be determined by the co-ordinating body but the report suggests it would cover 60 to 70 percent of the exposure to avoid the cost of procuring the security product overburdening the industry.

Costs beyond this protected amount would be met from a centrally managed fund (likely separate from the Air Travel Trust) capitalised by an airline levy calculated by reference to UK originating seats sold. Indications are that the target amount of the fund would be £35 million and would be built up by a 15p levy per departing UK passenger for the first five years, falling to 6p thereafter.

The co-ordinating body would then use the cash in the fund to take out insurance to protect against excess loss. The insurance would be placed so far as practicable in the market with the government providing cover on commercial terms where this is not possible.

Impact on airlines

An immediate consequence for airlines if the recommendations are implemented will be meeting obligations to fund the Flight Protection Scheme – which the report proposes would be implemented as a condition of the UK operating licence or route licence for overseas airlines.

However at a time of stress on the industry airlines will be keen to ensure that the extent to which an increased financial burden on them and/or their passengers is minimised.

A levy can in theory be passed on to passengers. The cost of providing the security product is however likely to fluctuate with an airline's financial robustness so it may be difficult to calculate the amount to pass on to passengers. If an airline's lenders require cash collateral for any letters of credit then this would affect cash flow.

Airlines may also see their funding costs increase generally (including as a result of greater leverage once any letter of credit facilities are factored in) if their lenders or bondholders believe that their returns in an insolvency scenario will be less than anticipated. Financial creditors may assume for example that on an insolvency any cash in the business will first be applied to the costs of a special administration - including an expensive 14 day repatriation exercise.

In theory, if repatriation is assured for passengers, merchant acquirers should face fewer claims from passengers for bookings made via credit or debit card. This could lead to the release of a percentage of trapped cash to airlines that would otherwise be held back to cover merchant acquirers' exposure. In practice however, it may be difficult to model claims accurately – particularly if repatriation does not ensure that repatriation flights will return at the same time as scheduled bookings. Merchant acquirers may still therefore continue to withhold cash from a struggling airline at a time when cash flow is often most critical.

The report also proposes two small but important changes to the UK's regulatory framework. UK airlines would be required to develop "repatriation plans" setting out information required to repatriate passengers. This requires airlines to spend resources planning for their own failure. Airlines would also have to satisfy certain minimum financial requirements and provide the CAA with greater visibility of their financial position. The report suggests that as part of the requirements for holding an Airline Operator Licence the board of each UK airline would need to provide the CAA with "an annual certificate of financial fitness for the next 12 months". Given the current climate for directors of business that fail, boards may require a significant amount of analysis in order to ensure they can demonstrate that they discharged their duties in issuing such a certificate to a Parliamentary committee or the Insolvency Service in the event the business subsequently fails.

The report proposes that the CAA takes on the role as co-ordinating body. This would result in a significantly increased scope for the CAA and it would require a proper period to prepare for any increased functions. Whilst the air operating licence regime currently requires an analysis of the financial health of an airline, the changes would also change the tone of the CAA's relationship with UK airlines as, ultimately, the CAA would be responsible for ensuring there is no call on the taxpayer in the event of a Monarch-scale failure in future. The result of this may be that the CAA is required to take an even more active approach to assessing the financial health of airlines than it currently does.

Impact on lessors

The key question for lessors is how a special administration may impact their existing position.

One concern for lessors will be that there is no adverse effect on their existing rights under the Cape Town Convention (as implemented in the UK pursuant to the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015). In particular, the UK has adopted the "Alternative A" insolvency regime whereby (notwithstanding any moratorium) a lessor can take steps to repossess an aircraft at the end of a 60 day waiting period following the commencement of airline insolvency proceedings (or the declared intention to suspend or actual suspension of payments by the airline where the lessor's right to institute insolvency proceedings or exercise remedies against the airline is prevented or suspended by applicable law), provided that, at the end of the waiting period, the officeholder has not cured all defaults under the lease (other than a default caused solely by the fact of the airline's insolvency) or has not agreed to perform all continuing obligations under the lease. The lessor's right of repossession at the end of the 60 day waiting period overrides the statutory administration moratorium under the Insolvency Act 1986 which can in any event be lifted with the consent of the special administrator or permission of the Court. The short, time-limited period (intended to be 14 days or less in most cases) for the "keep the fleet flying" repatriation option would therefore initially appear compatible with the longer waiting period under the Cape Town Convention.

Jurisdictional risk will also be an important consideration for a lessor where its aircraft is to be used in a "keep the fleet flying" scenario. Currently, if an airline ceases flying immediately on an administration or liquidation appointment, usually timed at a point when all (or most) aircraft are in the UK, there is a high degree of certainty that the lessor will ultimately be able to recover the asset promptly (provided that the lessor is willing to discharge any liens asserted over the aircraft by third parties). In contrast, where a special administrator continues flying to repatriate, there is an increased risk of the lessor's aircraft being trapped in other (potentially non creditor-friendly) jurisdictions, especially in the case of airlines with a large international route network. However, this risk may be mitigated to some extent if the jurisdictions in question are contracting states under the Cape Town Convention, meaning the lessor's rights thereunder should be recognised by those jurisdictions (although, at present, the Cape Town Convention remains untested in most contracting states). In theory, the special administrator may have an obligation to ensure that does not happen (for example, by paying all airport charges) but this would give overseas creditors in particular a straightforward route to "ransom" the special administration during repatriation as a way to recover the full amount of their claims – potentially materially increasing the cost of the special administration.

Another concern for a lessor will be that its aircraft is properly maintained by the insolvent airline during the special administration period. This is already a requirement under the "Alternative A" insolvency regime, whereby an airline insolvency official is required to preserve an aircraft and maintain it (and its value) in accordance with the terms of the lease during the 60 day waiting period. In addition, the lessor is entitled to apply for any other forms of interim relief available under English law during the waiting period. However, the report's recommendations also include some additional protections for lessors which go beyond their existing rights under the Cape Town Convention, for example:

- the right to receive payments under the lease during repatriation;
- the right to require redelivery of the aircraft to an airfield of their choice; and
- the special administrator's obligation to discharge any liens asserted in respect of the aircraft, e.g. those imposed by the CAA or Eurocontrol, airport authorities or maintenance providers.

Although some lessors may welcome these additional protections, given the increased jurisdictional risk associated with a repatriation others may prefer for their aircraft to remain grounded in the UK or another favourable jurisdiction whilst they make arrangements to remarket the aircraft to other prospective lessees.

It may be that lessors will ultimately be comfortable that the proposals do not materially affect their insolvency analysis – for example, at present they have no certainty that all aircraft will be in the UK or another favourable jurisdiction at the time of any administration or liquidation appointment. It is however important that lessors are aware of the potential issues that could arise under a new special administration regime.

Conclusion

The report raises a number of potentially significant changes. We need to see which will be taken forward and a number of significant details will need to be developed if this progresses. As things stand, it appears clear that the government's keenness to avoid a repeat of the policy decision taken in Monarch to repatriate stranded passengers at the taxpayer's cost will lead to structural changes that are capable of having a wide-ranging effect.

Contacts

Kevin Pullen
Partner
+44 207 466 2976
Kevin.Pullen@hsf.com

John Chetwood
Partner
+44 207 466 7548
John.Chetwood@hsf.com

John Whiteoak
Partner
+44 207 466 2010
John.Whiteoak@hsf.com

Rex Rosales
Partner
+44 207 466 2586
Rex.Rosales@hsf.com

Kristen Roberts
Partner
+44 207 466 2807
Kristen.Roberts@hsf.com

Neil Blake
Partner
+44 207 466 2755
Neil.Blake@hsf.com

Kim Dietzel
Partner
+44 207 466 2387
Kim.Dietzel@hsf.com

Robert Moore
Partner
+44 207 466 2918
Robert.Moore@hsf.com