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AirAsia X Restructuring: Scheme of Arrangement is an Insolvency-Related Event under Cape Town Convention

Kwan Will Sen and Joyce Lim write about the judgment involving AirAsia X's restructuring and its significance under the Cape Town Convention.

Case Summary

The Malaysian High Court handed down a significant judgment, ***AirAsia X Bhd v BOC Aviation Ltd & Ors* [2021] 10 MLJ 942**, in relation to AirAsia X Berhad ("**AAX**")'s application for leave to convene creditors' meeting for purposes of considering and approving a scheme of arrangement ("**Leave Application**").

It analysed and interpreted certain provisions under the Convention on the International Interests in Mobile Equipment ("**the Convention**") and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment ("**the Protocol**"), in particular that of Article XI(10) of the Protocol.

The Convention and the Protocol were implemented and came into force in Malaysia on 1 March 2006 pursuant to the local legislation of International Interests in Mobile Equipment (Aircraft) Act 2006), and where Malaysia opted for Alternative A in relation to the insolvency regime to govern creditors' rights in relation to aircraft objects.

The Convention is an international treaty designed to facilitate asset-based financing and leasing transactions by establishing clear rules to govern the transactions. The Convention serves to protect the rights and interests of all interested parties through the creation of an international registry.

The Court discussed and provided its views on these two questions:

1. Whether a scheme of arrangement is an 'insolvency-related event' under Article XI(10) of the Protocol; and

2. Whether Article XI(10) means that the debtor's obligations to make payments under the lease agreement cannot be subject to the 'cram down' provisions under a scheme of arrangement.

It answered the first question in the affirmative. As for the second question, this is also in the affirmative, to the extent where the lease agreements are not terminated.

This is the first Court in the world which has provided a detailed analysis of Article XI(10) of the Convention and the Protocol (albeit this being a provisional view and subject to further arguments at the sanction stage of the scheme, if at all).

Background Facts

As of 30 June 2020, the total estimated debts and liabilities owed by AAX to its scheme creditors were approximately RM 64.15 billion. AAX intends to restructure its debts, with a debt forgiveness of 99.7% haircut to all of the scheme creditors, leaving a pool of RM 200 million to be distributed for purposes of recovery. A total of 15 parties consisting mainly aircraft lessors applied to intervene in the ex-parte proceedings, to oppose AAX's Leave Application.

BOC Aviation, Macquarie and the Asia Pacific Aviation Leasing Group entities led the arguments on whether the debts owed by AAX to the lessors can be restructured or otherwise without their consent, due to Article XI(10) of the Protocol.

Article XI(10) of the Protocol provides that "*no obligation of the debtor under the agreement may be modified without the consent of the creditor*". As AAX's proposed scheme of arrangement is not consensual and permits a "cram down" of non-consenting creditors such as the lessors, we argued that this is in contravention of Article XI(10) of the Protocol.

In distilling the arguments, the Court summarised the issues in the form of the two questions highlighted above, as discussed further below:

Scheme of Arrangement is an 'Insolvency-Related Event' under Article XI(10) of the Protocol

Justice Ong Chee Kwan of the High Court found that a scheme of arrangement is an 'insolvency-related event' under Article XI(10) of the Protocol.

With this, Article XI(10) is applicable in the context of a scheme of arrangement.

The Court's reasoning is as follows:

1. The Official Commentary on the Convention does not address the issue as to whether a scheme of arrangement is an 'insolvency proceeding'. However, the Court gave due consideration to the views of Professor Sir Roy Goode (despite it being in his personal, instead of official capacity), in the following:

    - Exchange of letters on 12 June 2020 between the Cape Town Convention Academic Project (as sponsored by the Aircraft Working Group ("**AWG**")) and Professor Sir Roy Goode. Professor Sir Roy Goode confirmed that a scheme of arrangement or restructuring plan fall within the definition of 'insolvency proceedings' for the purposes of the Convention; and
    - The resulting Annotation to the Official Commentary on the Convention dated 16 June 2020 ("**Annotation**"), which confirms the position as described above.

2. The Court considered the opinions of two sets of experts, namely that of Professor Jennifer Payne on the one hand, and Professors Louise Gullifer and Riz Mokal on the other hand. The Court favoured the latter Professors' position, and said as follows:

    - Professor Jennifer Payne's interpretation of the phrase 'insolvency proceedings' under Article 1(l) of the Convention, specifically on the words "in which the assets and affairs of the debtor are subject to control or supervision by a court", are too narrow and restrictive.

    - The Court opined that in relation to Article 1(l), all that is required is that the proceedings being a collective proceedings is such that it involves assets and affairs of the debtor being subject to the control or supervision of the Court. Further, the fact that the scheme must receive sanction from the Court and where AAX's creditors must comply with directions from the Court on the implementation of the scheme, meets the requirement of 'control or supervision by a court'. The Court disagreed that it is merely 'to facilitate the compromise or arrangement put forward by the parties' as suggested by Professor Jennifer Payne.

- Professors Louise Gullifer and Riz Mokal's views are preferred, in that the element for control or supervision by a court within the relevant proceedings must be for purposes of those proceedings (i.e. insolvency proceedings). The level of court supervision or control is whatever that is appropriate to the proceedings, so long as the debtor's assets or affairs are not under the control solely of the debtor itself or its creditors. Their views on the element of supervision and control by a court fortified the Court's views as described above.

3. The High Court considered the cases of ***Re Nordic Aviation IEHC*** **[2020] 445** ("***Nordic Aviation***"), ***Virgin Atlantic Airways Limited*** **[2020] EWHC 2191** ("***Virgin Atlantic***"), and the decision of ***MAB Leasing Limited*** **[2021] EWHC 152 (Ch)** which allowed the convening of a creditors' meeting. The Court noted that these decisions came close to determining the issue of whether a scheme of arrangement or restructuring plan is an 'insolvency-related event' for the purposes of the Protocol. However, in the end, the question was not decided upon as the creditors had approved the scheme of arrangement and the restructuring plan.

Debtor's Obligations to Pay Cannot be Subject to 'Cram Down' Provisions under a Scheme of Arrangement

Having found that Article XI(10) of the Protocol applies to schemes of arrangement, the question is therefore whether a debtor's obligation to pay can be subject to 'cram down' provisions under such a scheme.

AAX's counsel had advanced the argument that Article XI(10) of the Protocol only covers in rem rights, and does not extend to in personam rights (such as a lessor's debts). The Court rejected this view, as doing so is to read into the Articles words which are simply not within the provision.

Instead, the Court cross-referred to Articles XI(7), (10) and (11) and held that Alternative A of the Protocol provides the following protection to a creditor, namely, in the event the debtor chooses not to terminate the agreement when an insolvency-related event has occurred or the creditor does not exercise its right to repossess the aircraft, the obligations under the agreement including the obligation to pay the rentals cannot be modified by the debtor unless with the consent of the creditor.

In respect of AAX and its proposed scheme of arrangement, the Court however found that AAX does not require the consent of the lessors in respect of the 'cram down' provision under the scheme in the form of a 99.7% hair-cut of their claims, for these reasons:

1. AAX's proposed scheme provides for termination of the lease agreements, which under Article XI(II) of the Protocol, AAX is entitled to do. With termination, the lessors would be left with the remedies of repossession, which are not interfered by the proposed scheme. The issue of modification of obligation to pay rentals therefore does not arise.

2. The proposed scheme is intended to compromise a lessor's claim for damages against AAX (arising from termination of its lease agreement). This does not then relate to Article XI(10) of Alternative A of the Protocol.

It is to be seen, and arguable that Article XI(10) of the Protocol may apply, in the event of there being no termination of the lease agreement. In which case, any scheme which provides for a modification of the debtor's obligations under the lease agreement (especially on obligations to pay rentals) may run foul of this provision.

Lastly, the Court made clear that the fact that no obligations under a lease agreement can be modified without the consent of the creditors does not necessarily mean that the creditor will veto a scheme of arrangement presented by the debtor, for two reasons:

1. A debtor is entitled to terminate the lease agreement (as intended to be done by AAX).

2. Commercially, it may serve the interest of the creditor to engage into negotiation with the debtor on the proposed terms under a scheme of arrangement, rather than insisting on the obligations under the agreement as the resulting modification to the obligations would mean a continuation of the lease agreement (as what transpired in ***Nordic Aviation*** and ***Virgin Atlantic***).

Comments

This decision by the High Court of Malaysia is welcomed. It provides clarity in the ongoing debate on the application of Article X1(10) of the Protocol, pending the publication of the next edition of the Official Commentary to the Convention and the Protocol.

With potentially more airline restructuring in the pipeline, it is hoped that the High Court of Malaysia's decision will assist and promote a greater understanding of the relevant provisions under the Convention and the Protocol.

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Both Will Sen and Joyce represented a number of scheme creditors in the AirAsia X Berhad scheme of arrangement proceedings. They advanced arguments on the Cape Town Convention during the hearing of this matter.