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THE BANKRUPTCY PEGASUS: STALKING HORSE AGREEMENTS IN AVIATION

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The Covid-19 pandemic has had a significant impact on the aviation industry, with regular international travel being halted for prolonged periods since March 2020. This has led to payment defaults and insolvencies for airlines and other market participants who have struggled to continue operations and meet their debt and rental obligations. However, the market turmoil has piqued the interest of savvy investors who see an opportunity to exploit depressed aircraft values and demand in the secondary market.

In particular, investing in assets, which have become available as a result of the insolvency of a lessor or airline could prove to be fertile ground for both existing aviation market players and new entrants alike. This article will briefly discuss one interesting mechanism through which investors have already sought to take advantage of the current market environment, stalking horse agreements.

STALKING HORSE AGREEMENTS

Whilst relatively uncommon in the context of European restructurings and distressed sales, stalking horse agreements are relatively commonplace in the context of Chapter 11 bankruptcies in the US. They are often filed in order to facilitate so-called “363 sales” of a business’s assets, in accordance with section 363 of the Bankruptcy Code, in the quest to recover money owed to the creditors of the bankrupt company. The debtor and the bankruptcy court will consider stalking bid proposals from third parties willing to purchase all or part of the debtor’s assets. A stalking horse bid will act as a reserve bid, setting a minimum bid level for any competing bidders. Given the distressed nature of 363 sales in the US, the stalking bid will usually value the assets below current market value, but the court and the debtor will be mindful of the fact that a stalking horse bid may represent a competitive price in the current market circumstances and the fact that a stalking horse bid and subsequent auction process guarantees that the assets will be sold and may instigate interest from other bidders. In these circumstances, a stalking horse will negotiate with the debtor-in bankruptcy the conditions of its stalking horse bid and the parameters of an auction process, which could result

in other bidders defeating that stalking horse bid. The benefits of such a 363 sale for the stalking horse bidder/eventual buyer include:

- the assets are sold to the eventual buyer free and clear of any liens;
- the costs incurred during the due diligence and asset purchase negotiations are often recoverable by the stalking horse bidder, through an expense reimbursement or payment of a break-up fee; and
- the stalking horse bidder is often heavily involved in structuring the auction process, meaning that the rules and procedures are often beneficial to the stalking horse bidder who can influence auction timeframes and rules, such as minimum overbid requirements for competing bids, increasing the likelihood that the stalking horse bidder will prevail in the auction process.

STALKING HORSE AGREEMENTS IN THE AVIATION INDUSTRY

Since early 2020, we have seen many aviation businesses endure tough times and undergo various insolvency or restructuring arrangements, which has led to lessors defaulting on debt repayments and airlines defaulting on rent payments and/or rejecting aircraft leases altogether. In such scenarios, unless new debt or lease terms can be agreed between the defaulting party and its creditors, aircraft assets need to be remarketed and disposed of, in order for creditors to retrieve some value for their initial investment. The extent of the market downturn means that aircraft values are currently depressed and demand for them is low compared with pre-pandemic levels, which means that the proceeds from any disposal of aircraft assets are less likely to be high enough to cover the outstanding debt amounts owed to creditors of the aircraft owning entities in question. In an attempt to stimulate market interest in purchasing their aircraft assets and to guarantee that the aircraft assets will be sold at a pre-agreed minimum price, certain debtors have been entering into stalking horse agreements with potential buyers (the stalking horse bidders), where such buyer agrees to purchase the aircraft assets at an agreed price if they are not sold at a subsequent auction. The stalking horse bidder will have conditions attached to its stalking horse bid, such as a minimum threshold for any bid which defeats the stalking horse bid and some kind of financial compensation in the event that the stalking horse bidder is ultimately unsuccessful in purchasing the aircraft assets.

Two high profile examples of this type of stalking horse bid agreement in the aviation industry can be found in VMO Aircraft Leasing's (VMO) stalking horse arrangement for the ten Boeing 737-800 owned by Norwegian Air Shuttle's (NAS) enhanced equipment trust certificates (EETC) issuance and the 17 aircraft associated with LATAM's EETC issuance. In both scenarios, investors reportedly utilised the standard EETC terms in order to take control of the process for disposing of the aircraft collateral and initiate an auction process in which such investors were the stalking horse bidders.

Based on reports, the stalking horse agreements we have seen in the aviation industry since the onset of the Covid 19 pandemic include:

- significant “break-up fees”, in the tens of millions of US Dollars, payable to the stalking horse bidder if it is outbid in the eventual auction;
- stalking horse bids for entire aircraft portfolios, typically sufficient to repay at least the majority of principal and interest owed to the senior noteholders/lenders, reimburse the costs incurred by and fees due to the administrative agents and to repay amounts owed to the liquidity facility providers. However, the stalking bids typically have not been sufficient to repay amounts owed to subordinated noteholders/lenders;
- requirements that competing bidders in the eventual auction process meet certain conditions such as: signing a confidentiality agreement; providing evidence of their ability to execute the transaction; and a minimum overbid increment in the case of more than one qualified bidder;
- in one particular EETC deal , a stalking horse bid (made by a controlling Class A majority creditor) which values the aircraft at least 30% below certain third-party appraisers' current market values of the portfolio aircraft; and
- in another case, a stipulation that any competing bid must be for all of the aircraft in the portfolio and that qualifying bids must be at least $60 million higher than the stalking horse bid, inclusive of a break-up fee.

Whilst unusual for UK and European restructurings and distressed aircraft disposals, this type of mechanism for acquiring distressed company assets is quite common in US “363 sale” scenarios.

Private equity and other alternative credit providers may be tempted to exploit the downturn in the aviation industry to acquire assets at discounted prices, using stalking horse arrangements, which have been successfully utilised by them in other sectors.

CONSEQUENCES FOR CREDITORS OF THE INSOLVENT DEBTOR

It has been reported that in both the NAS EETC and LATAM EETC stalking horse arrangements the stalking horse bids were sufficient to discharge at least the majority of the senior outstanding debt but not the outstanding subordinated debt. This has led some observers to question the propriety of such a mechanism, given that the stalking horse bidders introduced a relatively novel and aggressive set of rules and procedures compared with usual commercial aircraft auction processes.

Some observers have speculated that potential investors from the aviation finance community have been deterred from bidding in these types of auctions, which they see as being designed to ensure that the stalking horse bid would ultimately succeed, due to the minimum bid and break-up fee

requirements, as well as the tight timeframe during a depressed market where potential bidders would have been less confident about placing the aircraft with operators. Hudson Structured Capital Management and other subordinated B Noteholders under the NAS EETC issuance have launched legal proceedings in the New York courts against Wilmington Trust and Ares Management. The principal complaint in that lawsuit is that auction process was a "sham" process designed to ensure that VMO's (an affiliate of Ares' parent company) stalking horse bid was successful. It is claimed that VMO's purchase of the aircraft at a discount resulted in losses for the subordinated noteholders, whose outstanding debts were reportedly not discharged by the sale proceeds.

The counter argument to complaints about these stalking horse agreements is that subordinated debt is by its nature a riskier investment and is priced accordingly, with subordinated debt investors being well aware that they will potentially suffer losses in the event of a debtor insolvency and distressed collateral sale. One could also point to the fact that in the context of these EETC transactions, the stalking horse bidder simply availed itself of the standard EETC provisions which facilitate trading of subordinated certificates on the secondary market and entitle majority subordinated certificate holders to buy out the senior certificate holders.

It is too early to say whether or not these examples foreshadow a genuine emerging trend in the aviation industry when it comes to airline insolvencies and distressed asset sales, but it is an intriguing prospect. Investors in subordinated debt instruments in particular would be well advised to keep a keen eye on how this develops and whether they believe any such emerging trend will have any impact on how they analyse the concomitant risks going forward, given that stalking horse bids on the lower side and auction processes which deter competing bids could result in substantial or even total losses on subordinated outstanding debt recoveries. What is for sure is that the stalking horse mechanism and depressed aircraft asset values provides an intriguing opportunity for alternative credit providers to gain entry into an industry which usually garners solid returns for its investors and which many hope will return to normal health in the not-too-distant future.

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MEET THE TEAM

Anton Chambers

London

anton.chambers@bclplaw.com
+44 (0) 20 3400 4366

Marc Trottier

London

marc.trottier@bclplaw.com
+44 (0) 20 3400 4072

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