ALLEN & OVERY

UK Corporate Insolvency and Governance Act 2020

What the aviation industry needs to know about the ban on *ipso facto* clauses.

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The Corporate Insolvency and Governance Act (the **Act**) which entered into force on 26 June 2020 represents the most significant insolvency reforms in the UK for a generation.

In addition to some temporary measures addressing the economic fallout from Covid-19, the Act introduces permanent reforms in three key areas: (1) the introduction of a new statutory moratorium (**Moratorium**); (2) a ban on the operation of termination clauses in supply contracts triggered by insolvency proceedings (or so called *ipso facto* clauses); and (3) the introduction of a new pre-insolvency rescue and reorganisation procedure (the **Restructuring Plan**). Our detailed analysis of the various measures introduced by the Act can be accessed here.

In a three part series of bulletins, we analyse the implications of each of these permanent measures for the aviation industry. This second bulletin co-authored by partners Jennifer Marshall and Paul Nelson and, associate Harini Viswanathan focusses on the implications of the ban on the operation of *ipso facto* clauses for airlines, lessors, suppliers and financiers.

1. What are ipso facto clauses?

Contracts for the supply of goods and services commonly contain a termination clause (also known as an *ipso facto* clause) which permits a party to that contract to terminate solely on the basis of an insolvency event affecting the other party. Often, if a company needs a continued supply of a particular good or service then the supplier will hold the company to ransom and will threaten to terminate unless their pre-insolvency arrears are paid and the terms of continued supply are made more favourable. This is detrimental to corporate rescue and to address this, the Act has introduced (subject to certain exceptions), a ban on the operation of *ipso facto* clauses.

2. What does the ban on the operation of ipso facto clauses do?

The ban on the operation of *ipso facto* clauses will prevent suppliers of goods and services from terminating, varying or exercising any right under a contract due to its counterparty entering into a "relevant insolvency procedure". As such, the supplier will be forced to continue to supply the company on the same terms and will not be guaranteed payment of arrears. Notably, the Act also prevents suppliers from doing 'any other thing' upon a company becoming subject to a "relevant insolvency procedure". The 'any other thing' language is extremely broad. It means that any other contractual rights triggered by or exercisable upon the commencement of a "relevant insolvency procedure" permanently cease to have effect except with company or office-holder consent, or a hardship order. This includes provisions such as the ability to charge default interest, acceleration of unpaid payments, or any other contractual consequence. By way of example, this could mean that if there is a guarantee in the supplier's favour, the supplier would be prevented from making any claim under such guarantee as a result of the airline's insolvency and will instead need to rely on a non-insolvency related event of default such as non-payment.

There are significant carve-outs (including by entity type and contract type) to the ban on the operation of *ipso facto* clauses. These exceptions are of particular relevance to the aviation industry (please see paragraph 4 below).

3. What does a company entering into a "relevant insolvency procedure" mean for these purposes?

A relevant insolvency procedure includes: (a) a Moratorium coming into force; (b) the company entering administration; (c) an administrative receiver of the company being appointed; (d) a company voluntary arrangement taking effect in relation to the company; (e) the company going into liquidation or a provisional liquidator being appointed; or (f) a convening order being made by the court in respect of a Restructuring Plan. Notably, this ban does not apply to schemes of arrangement under Part 26 of the Companies Act 2006.

4. Are there any exceptions to the ban on the operation of ipso facto clauses?

Yes. The ban on the operation of *ipso facto* clauses does not:

a) apply where either the insolvent party or counterparty is an Excluded Entity as set out in the Act. The list of Excluded Entities is a long one and includes among others: (a) banks; (b) parties to a capital market arrangement involving debt of at least £10 million (depending on the structure of the financing arrangements, an aircraft lessor or an airline that has funded itself by raising debt in the capital markets may be caught by this exclusion); and (c) insurance companies[1]. For other types of entities that do not fall within these definitions (including, for example, special purpose vehicles (commonly used in many aviation financing structures) or hedge funds), the question will be whether there is an exclusion for the particular contract (see sub-paragraph b) below);

b) apply to financial contracts including loan agreements, financial leasing, swap agreements and derivatives and capital market arrangements. There is also a carve-out for any set-off or netting arrangement. This means that lenders will be permitted to draw-stop facilities, accelerate loans, charge default interest, exercise contractual set-off rights and otherwise exercise their contractual rights associated with an event of default under a facility. As the ban on the operation of *ipso facto* clauses does not apply to financial leasing, these provisions will not apply to aircraft funders or lessors under finance leases or funding arrangements;

c) affect the International Interests in Aircraft Equipment (Cape Town Conventions) Regulations 2015 (**CTC Regulations 2015**).[2] The CTC Regulations 2015 allow parties the contractual freedom to include *ipso facto* clauses[3] and pursuant to this exception, such clauses are not subject to the general ban on the operation of *ipso facto* clauses. The ability of a Cape Town Creditor (creditor with registered interests within the meaning of the CTC Regulations 2015) to repossess its aircraft objects upon termination is governed by Regulation 37 of the CTC Regulations 2015. For a detailed analysis of a Cape Town Creditor's ability to repossess its aircraft objects during a Moratorium please see paragraph 8 of our first bulletin in this series available here. The principles discussed therein apply analogously to repossession of an aircraft object in any other insolvency related event (eg administration, liquidation etc.); or

1 The ban on the operation of *ipso facto* clauses does not apply to companies/suppliers that carry on the regulated activity of effecting or carrying out contracts of insurance and which are not an exempt person (as defined in section 417 of the Financial Services and Markets Act 2000) in relation to that activity.

2 Paragraph 21 of Part 4 of Schedule 4ZZA of the Insolvency Act 1986 (inserted by the Act) states that, "Nothing in section 233B affects the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015 (S.I. 2015/912)."

3 Regulation 18 of the CTC Regulations 2015 allows parties to agree what events constitute defaults.

d) apply to small company suppliers where their counterparty became subject to an insolvency procedure before 30 March 2021[4], with this date being subject to possible extension. The Act states that a supplier is small if, in its most recent financial year, at least two of the following conditions were met: (i) the supplier's turnover was not more than £10.2 million; (ii) the supplier's balance sheet total was not more than £5.1 million; and (iii) the number of the supplier's employees was not more than 50. This temporary exemption is unlikely to apply to most suppliers in the aviation industry.

5. Are operating leases carved out from the ban on the operation of ipso facto clauses?

Unlike finance leases, operating leases are not expressly carved out from the ban on the operation of *ipso facto* clauses and we do not consider that operating leases would fall within the exclusion for financial leasing. The pertinent question therefore is whether such a lease is a contract for the "supply of goods and services". A lease of an aircraft would come under the Supply of Goods and Services Act 1982 as far as implied terms which suggests that it would. Furthermore, it could be argued that many of the excluded contracts (such as financial leases) do not readily fall within this expression but it could be that the list of excluded financial contracts has been drafted broadly for the avoidance of any doubt. In any event, the company is incentivised to continue paying rent under an operating lease agreement for the duration of the relevant insolvency procedure (see paragraph 8 below). There is no equivalent obligation to pay any pre-insolvency outstanding rent (see paragraph 7 below) although such debts may have priority under certain circumstances (see paragraph 8a) below).

If operating lease agreements are considered to constitute a contract for the supply of goods and services, they will be subject to the ban on the operation of *ipso facto* clauses unless any of the exceptions listed above apply. It is likely to be the case that lessors will benefit from the exception available to Cape Town Creditors – see paragraph 4c) above). If the relevant operating lease agreement is not governed by the CTC Regulations 2015, lessors will need to look to other provisions in their operating lease agreements in order to exercise termination rights triggered by the airline entering into a relevant insolvency procedure which could include:

a) termination on the basis of an event of default that occurs prior to the airline's entry into a relevant insolvency procedure - typically, aircraft leasing agreements provide for rights of termination in relation to events that may occur prior to a formal insolvency procedure including the airline: (i) being unable or admitting its inability to pay its debts as they fall due; (ii) suspending or threatening to suspend making payments on any of its debts; or (iii) due to actual or anticipated financial difficulties, commencing negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness. Such provisions could be relied upon to terminate the operating lease agreement before any formal insolvency process has commenced. Notably, if the supplier had a right to terminate the contract or supply before the company became subject to an insolvency procedure but did not exercise that right, the supplier will temporarily lose that right once the insolvency procedure has commenced i.e. the supplier may not terminate for that reason during the insolvency period; and/or

b) termination on the basis of an event of default that occurs post the airline's entry into a relevant insolvency procedure - if an event of default occurs post insolvency, lessors can still exercise termination rights at that point. This is because suppliers retain the right to terminate or "do any other thing" with respect to any non-insolvency related events contained in the supply contract, provided that the contractual right to terminate did not arise pre-insolvency and was not exercised.

6. What are the options for suppliers who are subject to the ban on ipso facto clauses?

Apart from the specific exceptions noted in the paragraphs above, the restrictions on *ipso facto* clauses will apply to all other suppliers to the company (eg fuel suppliers[5]). Such suppliers are still able to terminate their supply contracts if: (a) the relevant office-holder (ie the administrator, administrative receiver, liquidator or provisional liquidator) consents to the termination; (b) the company consents to the termination; or (c) the court is satisfied

[4] The end date for this temporary measure was extended from 30 September 2020 to 30 March 2021 by the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) Regulations 2020 which comes into force on 29 September 2020.

[5] Fuel payments are of course only an issue if aircraft are operating during the relevant insolvency procedure (moratorium, administration etc.).

that the continuation of the contract would cause the supplier "hardship" and grants permission for the termination of the contract. There is no definition of the term "hardship" in the Act and so we expect that there will be considerable litigation on this point. Notably, certain suppliers of services to an airline also have rights to detain aircraft in case of non-payment – see paragraph 9 below. It is unclear how this ban will apply in respect of group supply agreements and what rights a supplier would have against other (solvent) group companies.

The Act does not include any equivalent of section 365 of the US Bankruptcy Code which provides the trustee or debtor in possession in a US Chapter 11 process with a 3 month election window in which they can choose whether to assume, reject or assign supplier contracts. Suppliers are required to supply goods and services until the company/office holder (as applicable) indicates that continued supplies are not required. As the CAA has historically grounded flights on an airline's entry into formal insolvency proceedings (eg administration or liquidation), it is imperative that discussions about continued supplies are had as promptly as soon as practicable to avoid any unnecessary supplies and associated charges.

7. Will a supplier get paid for pre-insolvency debts?

A supplier is prohibited from making it a condition of any future supply of goods and services that any pre-insolvency outstanding charges are paid. This seems to be the case regardless of whether there is an ongoing supply contract or a series of contracts for "spot" deliveries. Therefore at a general level, although the company may choose to pay the supplier, there is no obligation to do so. It is pertinent to note that the consequence of non-payment in certain instances (eg non-payment of Eurocontrol charges) will result in a lien over the entire fleet of the airline (including a potential sale of those aircraft with the permission of the court if the non-payment is not resolved) - see paragraph 9 below.

8. Will a supplier get paid for continued supplies?

As a general principle, the debtor ought to make payments for the continued supply that it is receiving.

a) If the company is in a Moratorium, non-payment for goods and services supplied during the Moratorium period will operate to end the Moratorium and therefore, the debtor company is incentivised to continue paying for goods and services. If the company enters into a winding-up or administration process within 12 weeks following the end of the Moratorium, any debts that did not have the benefit of a payment holiday in the Moratorium but which are unpaid (including unpaid debts in respect of goods or services supplied during the Moratorium) will have priority over all other debts (except fixed charges), ie they will come ahead of preferential creditors, the prescribed part and floating charge holders.

b) Where the company is in administration, liquidation, provisional liquidation or administrative receivership, the office-holder should ensure that these amounts are paid as expenses of the procedure (ie ranking ahead of pre-insolvency unsecured and floating charge claims). If the company ceases to pay for goods during the insolvency procedure, this would usually give rise to a termination right, which could be exercised by the supplier; it is therefore in the interests of the debtor company to continue paying for the supplies that it requires.

9. Detention and sale rights of certain suppliers

Certain suppliers have the ability to detain (and in some instances sell) the aircraft for non-payment of charges including:

a) the UK Civil Aviation Authority (**CAA**): if an operator does not pay its air navigation charges[6], the CAA can: (i) detain an aircraft that is physically located at an airport in the UK pending payment of the outstanding amounts; and (ii) if such amounts are not paid within 56 days of the date of detention, with the leave of the court, sell the aircraft to pay off the route charges. In terms of detention and sale, the CAA has two separate rights namely: (i) the right to detain and sell an aircraft for any air navigation charges accrued in the past in relation to that particular aircraft, whoever was operating it at the time

[6] This includes charges payable for the supply of services by the UK National Air Traffic Services, the Danish and Icelandic authorities and Eurocontrol.

(**Tail Lien**); (ii) the right to detain and sell any aircraft in an operator's fleet for any outstanding route charges accrued in respect of any aircraft in that operator's fleet (the **Fleet lien**). The Fleet Lien will cease to apply in circumstances where the operator is no longer in possession of the aircraft;

b) airport authorities: where default is made in the payment of airport charges (eg parking charges), airport authorities may: (i) detain the aircraft in respect of which such default is made pending payment of the outstanding amounts; and (ii) if such amounts are not paid within 56 days of the date of detention, with the leave of the court, sell the aircraft to pay off the route charges. As in the case above, the airport authority can exercise both a Tail Lien and a Fleet Lien; and

c) possessory lien in respect of work done on the aircraft: any repairer of an aircraft may exercise a lien over the aircraft for the cost of work done on the aircraft.

We do not consider that the *ipso facto* prohibitions would, *per se*, prevent the exercise of the detention and sale rights discussed in this paragraph as these rights are triggered by the non-payment of charges as opposed to constituting rights available on a party's entry into an insolvency procedure. Accordingly, we would consider that these rights are outside the scope of the ban on the operation of *ipso facto* clauses. It is a separate question as to whether such sale and detention rights would be prevented by the stay that arises in a Moratorium or an administration (and how the CTC Regulations 2015 would affect this position).

Conclusion

The ban on the operation of *ipso facto* clauses introduced by the Act encourages the rescue of distressed airlines by ensuring that suppliers are not able to terminate or vary their contracts solely on the basis of the airline entering into a relevant insolvency procedure. The nature of the exceptions to the ban (exclusions include rights under finance leases and insurance contracts and rights of Cape Town Creditors) somewhat limits its applicability to the aviation industry.

In response to these reforms, suppliers may likely amend their supply contracts to add to the number of non-insolvency related events which will trigger termination or amendment of contractual terms. They may also need to enter into negotiations with their credit insurance providers as most credit insurance policies will: (i) include an insolvency of a counterparty as a "loss event" (which will automatically terminate cover for future supplies); and (ii) contain allocation of money clauses such that any monies received from the insolvent company after the loss event will be applied against the oldest debt.

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