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## Who's flying the plane?



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# American Airlines: Who's flying the plane?

American Airlines' Chapter 11 filing on 29 November 2011 may signal the reality that a formal insolvency proceeding is part of the airline industry business cycle



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American Airlines' Chapter 11 filing on November 29, 2011 may signal the reality that a formal insolvency proceeding is part of the airline industry business cycle. The U.S. airline industry has experienced substantial consolidation and many carriers have reorganized in Chapter 11. The U.S.'s largest carriers, United/Continental, Delta/Northwest, and American Airlines, each filed for Chapter 11 at least once. Southwest Airlines is the only major U.S. carrier that has not filed for Chapter 11 protection. Typically a primary motivator for an airline bankruptcy is to cut defined benefit pension plans ("Pension Plans") for employees and/or to reject or modify collective bargaining agreements. Although jet fuel spot prices have risen 110% from January 2001 to December 2006, and 133% from January 2007 to July 2008, there is little airlines can do to reduce cost of this essential commodity, other than pass along those price increases to the passengers in the form of various surcharges.

In American Airlines' case, it has reported \$4 billion of aggregate net operating losses in 2008, 2009 and 2010 and another \$2 billion for fiscal year 2011. Moreover, citing an \$800 million cost disadvantage to other U.S. carriers, American Airlines' stated goal is to reduce operating costs by \$2 billion per year. Of that number, American Airlines seeks to save \$1.25 billion by terminating its Pension Plans. It has

four Pension Plans, for pilots, flight attendants, agents, and ground crew, covering almost 130,000 employees and retirees. The Pension Benefit Guaranty Corporation ("PBGC") estimated that the combined assets in the Pension Plans are \$8.3 billion as of American Airlines' filing date and the combined liabilities are \$18.5 billion, leaving the Pension Plans "underfunded" by approximately \$10.2 billion. By comparison the Chapter 11 "underfunding" for the Pension Plans of other major airlines was as follows:

**United Airlines** - \$7.4 billion - 2005  
**US Airways** - \$2.7 billion - 2003/05  
**Delta Airlines** - \$1.6 billion - 2006

American Airlines' pension bust would be the largest in U.S. History.

The PBGC has publicly opposed American Airlines' proposed termination of its Pension Plans. The PBGC is a quasi-governmental U.S. agency (analogous to the FDIC) created to guaranty the benefits granted in Pension Plans to employee and retirees of U.S. corporations who sponsor such plans. In cases of underfunding, if a Pension Plan is terminated, the PBGC is obligated to honor most of the obligations owed under the Pension Plan. Unfortunately, the PBGC currently estimates its deficit, prior to American Airlines, at \$23 billion. Ultimately, the PBGC is backed by the full faith and credit of the U.S. Government. A termination of American Airlines' Pension Plans would increase the PBGC deficit by

50%, a burden which may be eased by increasing the premiums on other Pension Plans, but which is ultimately borne by the American taxpayer. The PBGC has brought political pressure to bear in its effort to oppose terminations of the American Airlines' Pension Plans. Specifically, George Miller, a Democratic member of the U.S. House of Representatives from California, and ranking member of the House Committee on Education and the Workforce issued a public letter to Joshua Gotbaum, Chairman of the PBGC, to do everything in its power to avoid the pension plan termination by American Airlines. There has been historical perception that the PBGC has generally "rolled over" and accepted corporate Pension Plan terminations.

Clearly the stakes are high for American Airlines, the airline industry in general, and the U.S. government and the American taxpayer. This presages a legal battle over American Airlines' ability to terminate its Pension Plans, which will play out in the United States Bankruptcy Court. Under the Employee Retirement Income Security Act of 1974 (ERISA), an employer seeking reorganization in Chapter 11 bankruptcy may petition the bankruptcy court for termination of a Pension Plan. The debtor is required to show that unless the Pension Plan is terminated, it will be unable to pay all its debts pursuant to a reorganization plan and will be unable to continue in business



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outside the Chapter 11 reorganisation process. However, if the termination would violate the terms and conditions of an existing collective bargaining agreement, a debtor seeking a distress termination may also need to obtain the bankruptcy court's approval to unilaterally reject or modify the collective bargaining agreement pursuant to section 1113 of the Bankruptcy Code. Section 1113 requires that the debtor make a proposal to the union "which provides for those necessary modifications in the employees benefits and protections that are necessary to permit the reorganisation of the debtor and assures that all creditors, the debtor and all affected parties are treated fairly and equitably". If history repeats itself, American Airlines will likely be able to terminate most or all of its Pension Plans, thus reducing its financial obligations by \$1.25 billion per year. In fact, American Airlines filed a motion to reject its collective bargaining agreements on March 27, 2012, but no hearing on the motion has occurred at this time. Many view this motion as the "velvet hammer" to prompt a favorable resolution for American Airlines.

Assuming American Airlines is successful in its goals, what's next for American Airlines? On February 9, 2012, Reuters reported that American Airlines' creditors' committee wants a merger explored, contrary to American Airlines' management's goal to stay independent. The members of

American Airlines' creditors' committee include the PBGC, American Airlines' labor unions, the banks representing American Airlines' bondholders and Boeing. Both Delta and US Airways have announced they have engaged financial advisors to explore acquisitions of or mergers with American Airlines. Many industry analysts believe a Delta merger is unlikely given potentially insurmountable antitrust hurdles and over-lapping U.S. east coast routes. Most analysts have not ruled out a US Airways combination but do not believe it would be the dream alliance such as the United and Continental combination created. However, US Airways has been a champion of industry consolidation and has managed to post a \$447 million profit in 2010. With growing political pressure and creditor support for a merger, American Airlines may be forced to consolidate by combining with another airline. Recently, American Airlines' CEO, Tom Horton, has indicated a sale or merger may indeed be a business strategy for American Airlines' future.

Whether American Airlines is able to succeed in staying independent or forced to consolidate will again be played out in Bankruptcy Court and may hinge on who controls the bankruptcy process. A key component will be determining who may propose and file a plan of reorganisation, which is the court-approved contract to pay creditors that allows a Chapter 11 debtor to emerge from

bankruptcy protection. In Chapter 11, American Airlines retains the exclusive right to propose a plan of reorganisation and to solicit votes in favor of such plan for a period of 120 days for a plan, and another 60 days to gain acceptance of its plan. In a case of the size and complexity of American Airlines, it is likely the Bankruptcy Court will exercise its discretion to extend that right to 18 months. Very often in Chapter 11 cases, creditors, through the officially appointed committee of creditors, will support extensions of such a debtor's exclusivity provided the debtor is making progress. In this case, "progress" will be measured by reductions in operating costs and a satisfactory business strategy to successfully emerge from Chapter 11 and deliver value to creditors, perhaps through an acquisition or merger. We anticipate that the Bankruptcy Court will extend American Airlines' exclusivity until as late as September, 2013.

It is also likely that creditors including the bondholders, the PBGC and vendors will own a significant stake in a reorganized American Airlines, or in the surviving entity in any American Airlines merger. This is because under the provisions of the U.S. Bankruptcy Code, the "absolute priority rule" prohibits any junior class of creditors from receiving value on account of its claims or interests unless and until all superior classes are satisfied in full. Clearly, the current American Airlines equity is "out of the money" and thus the new equity will be distributed in part

to American Airlines' existing unsecured creditors on account of their debt claims.

American Airlines' Chapter 11 will be perhaps the most important case since the U.S. auto manufacturer cases. The PBGC is positioned to backstop American Airlines as "too big to fail" but the cost will be enormous ... to American Airlines, to its creditors, to its employees and retirees, to the airline industry and ultimately to the American taxpayer. This chapter of American Airlines' history will play out in 2012 and 2013. The future of the global airline industry will unfold over many years.

In an era of above \$100 per barrel oil prices, exacerbated by continued unrest in the Middle-East, lagging economies in the U.S., EU and Asia, constricted lending conditions and potentially rising interest rates in global capital markets, U.S. and global carriers must find ways to gain operating efficiencies and maximize revenue opportunities. Many believe that growth in emerging markets will be critical to enhancing profitability. At some point, global consolidation, beyond current global "alliances", may need to play a role in the industry's future. However, many carriers are state-owned, and "open skies agreements" limit foreign investment to 25%, both hurdles to global consolidation. Perhaps American Airlines' Chapter 11 proceeding will spur a global debate about the future of the global airline industry.