

Case Update – Applying a Scheme of Arrangement to an Airline in Malaysia

The High Court in Malaysia has recently, on 19 February 2021, granted leave to AirAsia X Berhad, a long-haul low-cost airline based in Malaysia, and a sister company of AirAsia (“**AirAsia X**”), pursuant to the provision of s.366(1) of the Companies Act Malaysia (“**Act**”), to *inter alia*, convene meetings of certain classes of AirAsia X’s creditors, to consider and approve a scheme of compromise or arrangements to be proposed by AirAsia X.

AirAsia X first filed its application in October 2020, and there has been a long-drawn process – with 15 Interveners, many Court dates (via Zoom due to the current Movement Control Order in Malaysia) and extensive affidavits and submissions from all Parties therein.

Being an application for a Scheme of Arrangement (“**Scheme**”) by an airline, it is important to note that some of the key issues here may not arise if other non-airline companies seek to put in place a Scheme of their own.

In summary, the commercial terms of the proposed Scheme are that the total estimated debts and liabilities of RM64.15bil be reduced and will instead see the Scheme Creditors sharing a general pool of RM200mil, amounting to a haircut of 99.7%.

Further, after the final Court Sanction Order (once AirAsia X obtains the Court’s sanction at the material time) is obtained and lodged with the Registrar of Companies, all existing contracts between AAX and its Leasing Subsidiaries with the Scheme Creditors will terminate, with the termination being backdated to 30 June 2020.

The Lessors, who made up the bulk of the Interveners, raised various common objections. However, Malaysia Airports Berhad’s subsidiary, Malaysia Airports (Sepang) Sdn Bhd (“**MASSB**”) raised a few additional objections in addition to the issues raised by the Lessors.

The Convening Stage

The Honourable Ong Chee Kwan, the Judicial Commissioner presiding over this case, determined that the Court is to only generally deal with jurisdictional issues at the Convening Stage, and that issues with discretionary or value judgment shall be left to the Sanction Stage.

The following issues go towards the jurisdiction of the Court:

- (i) Where the proposed Scheme does not meet the definition of a “*compromise or arrangement*” or where the Company is hopelessly insolvent, the Court will refuse to permit the proposed Scheme to proceed;
- (ii) The Company is responsible for proposing the Scheme and classifying the Creditors;
- (iii) Issues pertaining to the constitution or composition of the classes should be taken at the Convening Stage. However, decisions taken at the Convening Stage are not final and that the Court is not bound by such decisions following the rationale in *Re Apcoa*;
- (iv) “The 2-stage Test”: The appropriate comparator is what would the alternative be if the scheme does not proceed – where the appropriate comparator is the insolvent liquidation of the Company, the Court will look at the creditors’ legal rights *inter se* where the Company is in liquidation and compare that with the rights of the creditors *inter se* under the Scheme. If there is a difference between the creditors’ relative positions, the Court assesses whether the difference is such as to render the creditors’ rights “*so dissimilar that they cannot sensibly consult together with a view to their common interest*”
- (v) It is incumbent upon the Company to adduce evidence of sufficient quality, and the Company has a duty of full and frank disclosure of all relevant facts and matters to the Court, including the classification of creditors.

The Scheme is a “Compromise or Arrangement” under s.366(1) of the Companies Act

The Court noted that the Act does not define “*compromise*” or “*arrangement*”. A broad and expansive interpretation should be given to these words, and “*arrangement*” must deal with an arrangement between the Company and its creditors *inter se* as debtor and creditor. The Court held that *the fact that the Scheme provides only a marginally better position to the Scheme Creditors than the alternative of*

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liquidation still constitutes a variation or modifications of the Company's obligations to the Creditors and it is for the Scheme Creditors to decide whether to accept and approve the Scheme.

AirAsia X is not hopelessly insolvent

AirAsia X contended that under the Scheme, AirAsia X will be completely debt free post-Scheme, with no liabilities and with fresh capital to meet its operations. AirAsia X's proforma balance sheets shows a solvent company post-Scheme, and AirAsia X anticipates profitability once the Covid-19 pandemic is over.

The Court held that it does not have a role nor the expertise to make any commercial assessment on the financial viability of AirAsia X post-Scheme, given that no independent or expert report was submitted to the Court. As such, the Scheme Creditors who are in the airline industry are best placed to determine the viability or otherwise of AirAsia X post-Scheme.

The Proposed Debt Restructuring is bona fide and is not an abuse of process

Although AirAsia X has not been able to explain its earlier classifications (there were three revisions to the Proposed Debt Restructuring Scheme with the Third Revised Scheme being the latest revision to be deliberated on), the Court found no evidence of actual dishonesty nor was the classification of creditors in the Third Revised Scheme arbitrary or capricious.

The Court noted that 94.5% of Secured Class A creditors (as they were then classified) were not insisting on the liquidation of the Company, but also that these creditors were not supporting the existing Scheme. The Court therefore took the view that it would be more beneficial for the Scheme Creditors and AirAsia X to have further discussions and negotiations, rather than to dismiss AirAsia X's application and having AirAsia X re-file again which would have wasted time and incurred more costs for all parties.

Classification of Creditors

By far, most of the submissions and arguments centred around the issue of the classification of creditors. The Lessors objected to being classified as "*Secured Creditors*". A few of the Lessors had also objected to being in the same class as Airbus and the airport and other authorities. It is notable that the arguments on classification appear to be fairly specific to the aviation / airline industry and ought to be read in the light of the particular facts and circumstances of this case.

AirAsia X argued that the Security Deposits and Maintenance Reserves paid by AirAsia X to the Lessors pursuant to the Company's Lease Agreements, justified the Lessors being classified as Secured Creditors. The Court noted however, having reviewed the various leases, that AirAsia X has no proprietary rights once these payments are paid over to the Lessors; and that generally, the Lessors may commingle such payments with the Lessors' own funds.

Further, the Court held that the Lessors are not "*Secured Creditors*" as they do not come within the definition of Secured Creditors pursuant to s.2 of the Insolvency Act 1967.

Similarly, AirAsia X having paid pre-delivery payments to Airbus pursuant to the Aircraft Purchase Agreements, does not make Airbus a Secured Creditor.

Does the Cape Town Convention prevent AirAsia X from restructuring the debt without the Lessors' consent?

Issues relating to the applicability or otherwise of the Cape Town Convention, although raised, were not previously decided in the UK Courts – In a first for Malaysia, having considered all arguments raised at the Convening stage, including certain expert opinions, the Malaysian Court held that the Scheme is an "insolvency-related event" under Article XI of the Protocol under the Cape Town Convention ("**Protocol**") – relying on the facts that (i) the Scheme is formulated in the context of an Insolvency Procedure; (ii) the Scheme is also an arrangement that is collective in that it is "*concluded on behalf of creditors generally or such classes of creditors as collectively represent a substantial part of the indebtedness*"; and (iii) the Court's approval is required for its implementation.

In addition, the phrase "*(no) obligations (of the debtor) under the agreement*" as stated in Article XI (10) of the Protocol includes the obligation of the debtor to pay the rentals under the agreement. Reading Article XI (7), (10) and (11) together, the Court concluded that *in the event the debtor chooses not to terminate the agreement when an insolvency-related event has occurred or the creditor does not*

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exercise its right to repossess the aircraft, the obligations under the agreement including the obligations to pay the rentals cannot be modified by the debtor unless with the consent of the creditor.

However the Court then went on to state that the proposed Scheme, or rather the AirAsia X proposed haircut, is seeking to compromise the Lessors' claims for damages and is unrelated to Article XI (10) of the Protocol and in this instance, AirAsia X does not require the consent of the Lessors in respect of the proposed 99.7% haircut on the Lessors' claims.

Should the Lessors and Airbus be in separate classes?

The Court held that Airbus' type of debt (which constitutes more than 75% of the AAX's entire debt in value) was an unsecured debt and would be placed in the same class as the other Unsecured Creditors.

Applying the 2-stage Test, the Court concluded that in a liquidation scenario, Airbus and the Lessors would be Unsecured Creditors; and there is very little likelihood of any significant recovery of their losses.

By contrast, under the Scheme, Airbus' debts are contingent debts which appear to allow Airbus to be in a better position than the Lessors as they may be able to recoup some losses from renegotiated or fresh sale of Aircraft contracts – AirAsia X will necessarily still need aircraft to operate post-Scheme. Comparing the Airbus position against the Lessors who would lose 99.7% of their accrued debts show that the rights of Airbus and the Lessors *are so dissimilar that they cannot sensibly consult together with a view to their common interest*. Airbus also holds almost 77.5% of the total debts, which gives Airbus a stronger bargaining position in the negotiations of fresh contracts with AirAsia X.

What about other Malaysian carriers?

In a different approach, Malaysia Aviation Group (MAG), the parent company of Malaysia Airlines Bhd, had sought for and has, during a sanction hearing on the 22 February 2021, obtained the approval of the High Court of England and Wales, that will allow Malaysia Airlines to start on its restructuring plan. The restructuring includes deferrals of principal repayments as well as reduced interest payments on various facilities.

Conclusion

The Court's decision reflects an attempt at balancing various factors – permitting AirAsia X the opportunity to rehabilitate itself; ensuring that creditors with similar / common interests are classified accordingly to avoid minority creditors cram down; and giving credence to the Creditors' expressed support for AirAsia X not to be wound up (which is one possible scenario in the event AirAsia X was not able to proceed with the application for a Scheme of Arrangement).

Although AirAsia X was given leave to convene separate meetings of the Class A Creditors (ie Secured Creditors) and Class B Creditors (ie Unsecured Creditors), the Court made further directions: (i) The Lessors are to be treated as Unsecured Creditors and be placed in Class B; and (ii) Airbus is to be treated as an Unsecured Creditor but to be in a separate class from the other Unsecured Creditors in Class B.

On the face of it, the Court's decision will give both AirAsia X and its creditors some time and space to negotiate for a Scheme that is more acceptable to all parties concerned, with perhaps a more robust business plan.

Should you have any queries in relation to the aforementioned case or any other related matters, please contact our partner Datin Shelina Razaly Wahi at email shelina@abdullahchan.my or mobile: +6012-3271973.

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