

Chapter 11 of the U.S.
Bankruptcy Code:
The Case of US Airways



U·S AIRWAYS

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Brief History

- 1903 – Wright Brother’s first mechanically powered flight
- 1919 – The Convention for the Regulation of Aerial Navigation created the International Commission for Air Navigation (“C.I.N.A.”) as a permanent body under the League of Nations. United States not a party.
- 1929 – The United States became a signatory to the Convention for the Unification of Certain Rules Regarding International Air Transport, better known as the “Warsaw Convention.”

- 1938 – Establishment of the Civil Aeronautics Board that decided which airlines could serve which cities and set the price (not prices) that they could charge for each route.
 - Prices tended to be high, and to increase over time, because the CAB permitted increased costs to be passed along in higher fares – which did not provide strong incentives for airlines to seek out ways to reduce costs.
- **1939 – All American Aviation brings the first airmail service to many small western Pennsylvania and Ohio Valley communities.**

- 1944 – Convention on International Civil Aviation, better known as the “Chicago Convention.”
 - Established the first two of the “Freedoms of the Air” – the right of innocent passage and the right to land for technical purposes without letting off or taking on passengers, *e.g.*, for refueling.
 - Established the International Civil Aviation Organization (“ICAO”), as an agency of the United Nations, and successor to C.I.N.A. under the League of Nations.
 - They were, however, unable to come to any resolutions regarding airline rates, acceptable levels of capacity, tariffs, and other commercial rules for scheduled operations. Instead, they decided that the countries would decide these issues among themselves.

Freedoms of the Air

- *First freedom* – The right to fly over another country without landing.
- *Second freedom* – The right to make a landing for technical reasons (e.g., refueling) in another country without picking up/setting down revenue traffic.
- *Third freedom* – The right to carry revenue traffic from your own country (A) to the country (B) of your treaty partner.
- *Forth freedom* – The right to carry traffic from country B back to your own country A.
- *Fifth freedom* – The right of an airline from Country A to carry revenue traffic between country B and other countries such as C or D. (This freedom cannot be used unless countries C or D also agree).

- 1945 – Forty-five airlines met in Havana, Cuba and founded the International Air Transport Association (IATA) that was later established by an act of the Canadian Parliament. Its stated purposes are:
 - To promote safe, regular and economical air transport for the benefit of the peoples of the world, to foster air commerce, and to study the problems connected therewith;
 - To provide means for collaboration among air transport enterprises engaged directly or indirectly in international air transport service;
 - To cooperate with the International Civil Aviation Organization and other international organizations.

- 1946 – Bermuda I – Treaty between the United States and Britain that became the model for the rest of the world.
 - The United States still advocated a free market system, but was now more willing to have some regulation on pricing control.
 - Britain also did not want to jeopardize \$3.75 billion in credit that it had negotiated with the Truman Administration that still required Congressional approval.
 - Britain stood its ground and obtained major concessions from the United States. Specifically the United States and Britain granted each other all five freedoms, with limitations on the fifth.
 - Britain, and the United States in response, restricted domestic operation of foreign airlines.
 - Created no machinery to establish economic regulations, but “delegated” that function to IATA, subject to each government’s approval. The Civil Aeronautics Board (CAB) gave such approval shortly after that, subject to annual review, and in 1955 replaced the annual review with a permanent, but still conditional, approval of IATA’s tariff coordination activities. Moreover, this approval granted IATA immunity from American antitrust statutes.

- **1948 - Piedmont Airlines begins operations.**
- **1949 - All American Aviation becomes All American Airways and makes the transition from airmail to passenger service.**
- **1949 - Pacific Southwest Airlines begins operations with service in California.**
- **1949 – Collective bargaining agreement with mechanics entered.**
- **1953 – All American Airways name changed to Allegheny Airlines.**

- **1957 – Collective bargaining agreement with pilots entered.**
- **1958 – Collective bargaining agreement with flight attendants entered.**
- **1968 - Allegheny merges with Indianapolis-based Lake Central Airlines.**
- June 1971 – Southwest Airlines begins operating.
- **1972 – Allegheny acquires Utica, N.Y. based Mohawk Airlines.**

- 1977 – Treaty between the United States and Britain that became the new model for the rest of the world.
 - Liberalized capacity.
 - Allowed competition on fares
 - Still limited the United States’ Fifth Freedom via London.
- 1978 - Airline Deregulation Act of 1978
 - Deregulated airline industry and virtually eliminating CAB’s power to set minimum fares and led to eventual phase out of CAB.
 - Similar to the Railroad Revitalization and Regulatory Reform Act of 1976 that deregulated the railroad industry and limiting the Interstate Commerce Commission’s (ICC) power to set minimum rates) and the Motor Carrier Deregulation Act of 1980 that severely reduced the Interstate Commerce Commission’s pricing and service regulations.
 - Economists from the Brookings Institution and George Mason University estimated that consumers saved \$19.4 billion per year through 1998 from competition arising from deregulation.

- **1979 – Allegheny changed its name to USAir.**
- **1988 – PSA is merged into USAir.**
- **1989 – Piedmont is merged into USAir.**
- 1990 – Lower cost carriers carried 10.4% of passengers. They compete with USAir on 4 of its 50 largest markets.
- **1992 – USAir begins management of Trump Shuttle (formerly Eastern).**

- **1993 – USAir and British Airways enter an investment/alliance plan. USAir gives up its London route authority. British Airways purchases 24.6% of USAir.**
- **1996 – British Airways pursues alliance with American Airlines. USAir challenges this.**
- **1997 – USAir changes its name to US Airways. Relationship with British Airways ends.**
- **1998 – Shuttle Acquired.**
- **December 17, 1999 – JetBlue Airways commences operations.**
- **2000 – Merger with United Airlines announced.**

- **August 24, 2001 – Merger effort officially terminated with formal objection from the U.S. Justice Department.**

September 11, 2001 – . . .

- September 22, 2001 – Air Transportation Safety and System Stabilization Act becomes law.
 - Air Transportation Stabilization Board
 - Immediate grant of funds
- **September 25, 2001 – US Airways began furloughing and eliminating employees. No agreement reached with labor on cost reductions.**
- November 19, 2001 – Aviation and Transportation Security Act becomes law.
 - Federalization of Aviation Security
 - New Aviation Security Fees on Passengers and Carrier

- **August 12, 2002 – Filed under Chapter 11 of the U.S. Bankruptcy Code.**
 - Reduced labor costs.
 - Reduced number of employees – net over 10,000 from 9/11.
 - Reduced fleet and eliminated several fleet types.
 - Eliminated unneeded facilities.
- **March 31, 2003 – Emerged from Chapter 11.**
 - Obtained \$1 billion loan guaranteed to 90% by ATSB.

This Year – 2004

- Labor costs remain the highest in the industry.
- Fuel costs rose far more than ever anticipated. Due to prior Chapter 11 proceeding, there was no hedging.
- Low Cost Carriers carry more than 30% of all passengers. Now compete with US Airways in 33 of 50 largest markets.
- May 9, 2004 – Southwest Airlines began operating from Philadelphia – deviating from its prior modus operandi. Has firm orders and options to almost double its fleet to 800 aircraft.

- June 2004 – Independence Air begins competing with US Airways in markets that previously represented 35% of US Airways’ revenue. Currently has 30 aircraft and firm orders for 87 more.
- 2004 – JetBlue started service from LaGuardia Airport (it previously only operated from John F. Kennedy Airport). Currently has 60 aircraft, firm orders for 223 and options for 150 more.
- Proportion of domestic passengers using “Premium Tickets” (First, Business and Unrestricted Coach class) has fallen from 39.7% in 1998 to 4.6% in 2004.
- September 12, 2004 – Filed under Chapter 11 for second time.

Chapter 11 of the U.S. Bankruptcy Code

- Article I, Section 8, clause 4 of the U.S. Constitution provides that Congress has the power “To establish a uniform rule of naturalization, and uniform laws on the subject of bankruptcies throughout the United States.”
- The first US bankruptcy law was enacted in 1800 and lasted less than two years; another was passed in 1841 and lasted about the same amount of time. A third was passed right after the Civil War, but lasted just a few years. Finally, in 1898 a bankruptcy code was passed and the United States has had one ever since. The current code was adopted in 1978, although it has been regularly amended.

- There are several flavors of “bankruptcy.”
 - Chapter 7 – “straight” liquidation
 - Chapter 9 – municipal bankruptcies
 - Chapter 11 – business reorganizations (some individuals use, also)
 - Chapter 12 – family farms
 - Chapter 13 – individual reorganizations (“payouts” for natural persons)
- We will be focusing on Chapter 11, but it should always be kept in mind that a Chapter 11 case can be converted to a Chapter 7 case (§ 1112).
- It is helpful to think of Chapter 11 as a “singularity” - the ordinary rules of law and business simply change.

- The Automatic Stay (§ 362)
 - Pre-petition debts are suspended.
 - Pre-petition litigation is suspended.
 - Suits based on pre-petition conduct remain pre-petition claims.
 - Pre-petition breaches of contract or those arising from the filing itself are not actionable, *i.e.*, are not a basis to suspend performance of a contract.

- Exceptions to the automatic stay:
 - Commencement of criminal proceedings (§362(b)(1)).
 - Actions to establish paternity or alimony/child support, or to collect alimony/child support from non-estate property. (§362(b)(2)).
 - Perfection of purchase money security interest under state law (§362(b)(3)).
 - Actions concerning a government's enforcement of its police or regulatory power. (§362(b)(4)).
 - An audit by a government agency for tax liability, notice of tax deficiency, or demand for tax returns. (§362(b)(9)).
 - Act of a lessor to regain property on a terminated nonresidential lease. (§362(b)(10)).

- **Violations of the Automatic Stay**
 - Willful violation – the court can award attorney fees to the estate, as it is a contempt of court.
 - Nonwillful violation – The action is void or voidable
- Problem with un-counseled creditors and attorneys who claim “expertise” and “experience” in bankruptcy.

- **When the Automatic Stay can be lifted**
 - The stay can be lifted after notice and a hearing if there is not “adequate protection” for the creditors.
 - Secured Creditors can lift the stay “for cause,” meaning his interest in the collateral is in jeopardy. (§ 362(d)(1)).
 - Protection can be shown by either making periodic cash payments to the creditor, or by giving additional/substitute liens, or by giving “other protection.” (§361).
 - Unsecured creditors (and secured creditors as well) can get the stay lifted if the debtor has no equity in the property, **and** the property is not necessary for an effective reorganization.
 - Many creditors try use this as an excuse for performance.

- How do operations continue?
 - The business continues to operate “in the ordinary course” (§ 363(b)).
- Trustee in Bankruptcy (TIB) v. Debtor in Possession (DIP).
 - The DIP has the same duties as the TIB, i.e., to act on the behalf of the creditors (note that this creates a natural tension between management’s ordinary duty to the stockholders). He also has the same powers.
- There is no court approval needed for routine transactions (§ 363(c)(1)).
 - But there are limits on things that can be done with property subject to a security interest. (§ 363(e)).
 - Creditors sometimes argue this as a tactic.

- Ability to assume, assume and assign, or reject “executory contracts.” (§ 365).
 - Special rules for commercial real estate – have sixty days (may be extended).
 - Special rules for aircraft (not generally extended).
 - The business judgment rule applies to assumption/rejection decision.
 - Offers opportunity to negotiate with creditors.
- Upon assumption the debtor must cure all breaches (or give “adequate assurance that it will”).
 - Ability to assign (can be useful for real property leases).
- Upon rejection, all claims under the agreement become “general unsecured.”
 - No further duties.
- Agreements with foreign entities.
 - Not addressed in the code.

- Labor-Management Relations – Can collective bargaining agreements be “rejected.”
 - The courts ultimately ruled that the answer was yes. Congress then added some barriers.
 - § 1113(c) – specifically deals with collective bargaining agreements; court can approve rejection of the contract if certain prerequisites are met.
 - § 1113(e) – temporary specifically to collective bargaining agreements as directed by the court.
 - § 1114 sets out guidelines for handling pensions
 - Does not eliminate the union, but rather just its contract.
 - Courts have established a nine part test.

Nine Part Test To Reject Labor Contracts & Pension Plans

1. The debtor made a proposal to modify the collective bargaining agreement/retiree benefits.
2. The proposal was based on the most complete and reliable information available at the time of the proposal.
3. The proposed modifications are necessary to permit reorganization of the debtor.
4. The proposed modifications assured that all creditors, the debtor, and all other affected parties were treated fairly and equitably.
5. The debtor provided to the authorized representative (*i.e.*, the union or committee of retirees) such relevant information as is necessary to evaluate the proposal.
6. The debtor met at reasonable times with the authorized representative between the time of the proposal and the time of the hearing on the proposal.
7. The debtor conferred with the authorized representative in good faith at these meetings.
8. The authorized representative refused to accept the debtor's proposal without good cause.
9. The balance of equities clearly favors rejection of the agreement.

In re American Provision Co., 44 B.R. 907, 909 (Bk.D.Minn 1984).