STEPHENSON HARWOOD

Wei Tu China Association
罗夏信-伟途 联营

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ASIA-PACIFIC RESTRUCTURING REVIEW

AIRLINE RESTRUCTURINGS IN ASIA-PACIFIC: A CREDITORS' PERSPECTIVE

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AIRLINE RESTRUCTURINGS IN ASIA-PACIFIC: A CREDITORS' PERSPECTIVE

SUMMARY

IN SUMMARY

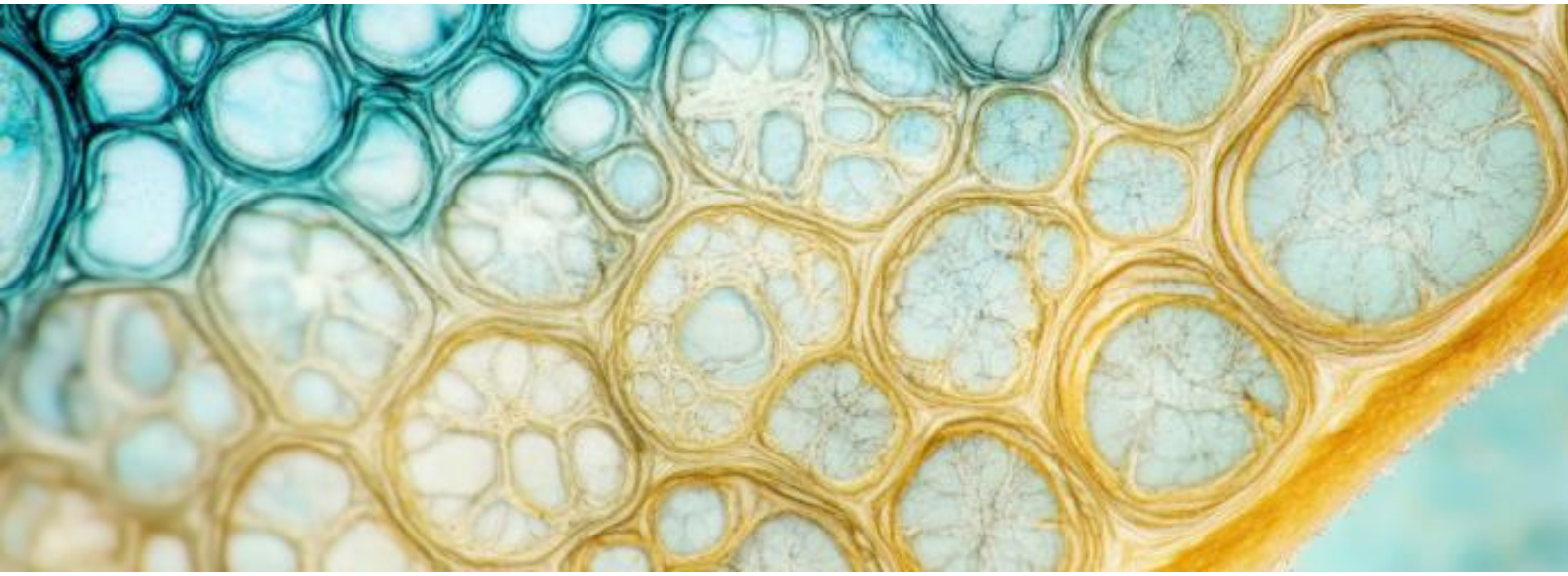
In this article, the authors discuss the lessons they learnt in advising aircraft lessors and financiers in the insolvency restructuring or liquidation of various airlines in seven jurisdictions in the Asia-Pacific region since the covid-19 pandemic.

DISCUSSION POINTS

- Tension between international treaties on aviation finance and local insolvency protection laws and attempts to resolve it in judicial practice and
- Whether aircraft lessors should be classified as secured or unsecured creditors for approving the lessee's restructuring scheme
- Problems in repossessing aircraft from an insolvent airline and possible solutions
- Application of security deposits by aircraft lessors
- Treatment of guarantees in the primary debtor's insolvency restructuring

REFERENCED IN THIS ARTICLE

- The Convention on International Interests in Mobile Equipment (2001)
- The Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment (2001)
- ***Re Nordic Aviation***
- ***Re MAB Leasing Ltd***
- ***AirAsia X Bhd v BOC Aviation Ltd & Ors***
- The Protection of Interests in Aircraft Objects Act, 2025 of India



INTRODUCTION

Airlines were hard hit by the outbreak of the covid-19 pandemic and its aftermath. Without strong government support as their peers in some other parts of the world enjoyed, many airlines, including flag carriers in Asia-Pacific (APAC), resorted to insolvent restructuring in one form or another.[1] Since the beginning of the pandemic, the authors have been lead legal counsel to some aircraft lessors and financiers (the creditors) in the insolvent restructurings or liquidations of seven airlines situated in different jurisdictions in APAC.[2] While local laws vary, the authors believe that there are common themes that are worth taking note of.

Compared to the cases in other industries, airline insolvent restructuring is special in that:

- aircraft are not only big-ticket assets, but also critical equipment on which the continued operation and survival of the airlines depend;
- aircraft by their nature can be in any part of the world at any given time; and
- aircraft leasing and financing is mostly an international business governed by international treaties, which impact local insolvent restructuring or liquidation processes.

In this article, we discuss, first, the tension between the Convention on International Interests in Mobile Equipment (the Cape Town Convention) and local insolvency restructuring law and practices; second, the classification of aircraft lessors for creditor approval purposes during a restructuring exercise; third, the repossession of leased or mortgaged aircraft by creditors; and fourth, other legal issues.[3]

IMPACTS OF THE CAPE TOWN CONVENTION

Since coming into existence in 2001, the Cape Town Convention and its Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment (the Aircraft Protocol) (collectively, the CTC) have been ratified by about 85 jurisdictions and the European Union, including most countries in APAC.[4] Besides establishing an internet-based International Registry for transactions creating 'international interests' (which are essentially ownership, security and some 'non-consensual' interests) in aircraft equipment, they aim at, among other things, standardising the rights of creditors and the repossession of leased or financed 'aircraft objects'[5] in the event of the default or insolvency of their operators.[6] One of the important creations of the CTC is the instrument of the irrevocable deregistration and export request authorisation

[1] Mainland China is a notable exception, as it benefited from a huge domestic aviation market relatively unaffected by cross-border lockdown. Other than the Hainan Airlines Group that has undergone an insolvency restructuring, Chinese airlines were able to pay rents and service their debts for their aircraft during the pandemic.

[2] These include Australia, Hong Kong, India, Indonesia, Malaysia, Thailand and South Korea.

[3] The authors are English law counsel, who have been supported by local law counsel in the relevant jurisdictions. The discussion of local law and practices in this article is entirely based on our experience in the transactions. There is no pretence that we are representing the latest statuses of the relevant local laws and practices.

[4] Notable exceptions in Asia Pacific include, among others, the Hong Kong Special Administrative Region, Japan, the Philippines, South Korea, Taiwan and Thailand. The Convention on International Interests in Mobile Equipment (Cape Town Convention) and the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment (Aircraft Protocol) (collectively, the CTC) apply if either the 'debtor' as defined in the CTC is situated, or the airframe is registered, in a CTC jurisdiction. For this article, the difference between those two nexuses is not important because the airframe is usually registered in the airline debtor's home country.

[5] Which are essentially airframes, aircraft engines and helicopters.

[6] Article 10 and 13, the Cape Town Convention.

(IDERA). An IDERA is an irrevocable power of attorney granted by the operator to the creditor in advance. It authorises the creditor to deregister an aircraft object from, and export it out of, the operator's home country without the operator's assistance in a default scenario.[7]

The idea of speedy repossession of aircraft creates tension if the operator airline is undergoing insolvency protection and restructuring, which in many countries entails a moratorium on enforcement of legal rights against the company. As most aircraft of most airlines are either leased or mortgaged, an airline stripped of its aircraft can hardly be rehabilitated.

The compromise[8] mandated by the CTC is that a contracting state must give possession of the aircraft to their lessors or financiers after a 'waiting period' that it committed to when it acceded to the CTC, even if the moratorium period under local law has not expired.[9] Such waiting period is often 60 days commencing from the 'occurrence of an insolvency-related event', which is defined to mean either the commencement of insolvency proceedings or a moratorium.[10] During the waiting period, the airline may continue to use the aircraft but must maintain their value and condition according to the original lease or loan agreements.[11]

When the waiting period expires, the airline may retain the aircraft only if it has cured all defaults[12] and undertakes to perform all future obligations under the original lease or loan agreements[13]. In reality, an airline that has just encountered an insolvency-related event will be unable to do that, so it must seek a substantial writing down of past dues and a reduction of future obligations if it chooses to retain the aircraft. However, a difficult question of interpretation exists as article XI(10) (Alternative A) of the Aircraft Protocol mandates that no obligations of the debtor airline under the lease or loan agreement may be modified without the consent of the creditor in the debtor's insolvency process. That appears to be at odds with insolvency restructuring laws, which in most countries require any dissenting creditor to be bound by the restructuring scheme and 'haircuts' approved in the creditors' meeting and sanctioned by the court, as otherwise a minority creditor could hold the debtor hostage and sabotage the restructuring efforts.

Such tension led courts in Ireland[14] and England[15], for example, to cast doubts, as ***orbiter dicta***, on whether article XI(10) applies in an insolvency restructuring. Such doubts appear to be prompted by practical necessity rather than logic as there is nothing in the CTC that suggests that article XI(10) may be disapplied.

Fortunately, the Malaysian court came to the rescue in its judgment in ***AirAsia X Bhd v BOC Aviation Ltd & Ors***.[16] The airline in this case proposed a scheme of arrangement under Malaysian law, and the court was called on to consider the applicability of the CTC, of which Malaysia is a contracting state. The court upheld the view that the CTC applies not only to rights ***in rem*** relating to the aircraft objects but

[7] Articles IX (1) and X (2) and (6), the Cape Town Convention.

[8] While an international interest is effective if, prior to the commencement of insolvency proceedings, that interest was registered in conformity with the CTC, it does not affect any rules of procedure relating to the enforcement of rights to property that is under the control or supervision of the insolvency administrator (article 30, the Cape Town Convention).

[9] 'Alternative A' under article XI, the Aircraft Protocol. Article XI provides for Alternative A and Alternative B regarding the remedies of a creditor on the debtor's insolvency for a contracting state to choose from. All CTC jurisdictions that the authors have encountered so far have opted for Alternative A.

[10] Article I(2)(m), the Aircraft Protocol.

[11] Article XI (5)(a) and (6), Alternative A, the Aircraft Protocol.

[12] Other than any default by reason of the occurrence of the insolvency proceedings per se.

[13] Article XI (7) and (9), Alternative A, the Aircraft Protocol.

[14] ***Re Nordic Aviation***, IEHC [2020] 445.

[15] For example, Zacaroli J's judgement in ***Re MAB Leasing Ltd*** [2021] EWHC 152 (CH).

[16] Judgment delivered by Ong Gee Kwan, Judicial Commissioner (as he then was), in the High Court of Malaya, Kuala Lumpur, Commercial Division on 19 February 2021.

also rights ***in personam*** relating to the rentals as they are 'associated rights' protected by the CTC. The future rental amounts therefore cannot be reduced unilaterally against a dissenting lessor according to article XI(10). However, the court held that there was no such unilateral variation in the circumstances as the airline terminated all pre-existing aircraft lease agreements and entered new ones with those lessors who agreed to the new rental arrangements. In other words, the lessors were not deprived of their aircraft on an ongoing basis against their will.

In regard to the past rental dues, the Malaysian court held that any dissenting lessor must also be bound by the haircuts under the approved and sanctioned restructuring scheme. The court made the fine distinction that article XI(10) is concerned about the 'obligation of the debtor under the agreement' (presumably referring to the rents payable going forward) only but not the damages payable by the debtor for a default. Although such distinction may be artificial,[17] the Malaysian court has apparently done its best in maintaining the logical integrity of the CTC while achieving the practical aims of an insolvent restructuring. In any event, as the court pointed out, a dissenting lessor benefited from the approved restructuring scheme as the recovery rate would be less if the airline were to be wound up instead (so the dissenting lessor should be bound for fairness). The authors submit that the Malaysian judgment is a helpful one although it is not entirely without difficulties.

Yet the problem in some other CTC contracting states is not that of its interpretation but of its implementation. In some APAC countries without an independent or efficient legal system, the CTC and the IDERAs may be honoured in the breach by reasons such as the relevant contracting state having procrastinated in enacting national law to implement its international obligations under the CTC or a court imposing an artificial requirement that an IDERA may only be exercised after the lessor has successfully obtained a final and unappealable judgment against the airline in the chosen venue of dispute resolution. Criticisms coming from the international community,[18] however, have incentivised countries like India to enact new laws in recognition of the supremacy of the CTC over conflicting local insolvency laws after the covid-19 pandemic.[19]

Overall, despite the challenges, the CTC has helped to strike a healthy balance between parochial interests in revitalising airlines in difficulties and the legitimate interests of international creditors. In some countries that have not acceded to the CTC,[20] we were advised that the airline can retain the aircraft against an unwilling lessor pursuant to an insolvent restructuring scheme. That is markedly different from the CTC position and potentially disturbing from the creditors' perspective.

CLASSIFICATION OF CREDITORS

It is common for creditors of a company to be divided into different classes with the insolvent restructuring scheme of the company having to be approved by each class. Whether or not there is cross-class cramdown (which allows a dissenting class to be ignored if certain conditions are met) under local insolvency law, it is often in the interest of creditors to find themselves in a smaller class where they have a bigger say relatively. That might put them in a better bargaining position when they negotiate the terms of the proposed scheme with the airline or its insolvency administrator.

A rather common classification in different jurisdictions is simply to divide all creditors into either secured creditors or unsecured creditors. While financiers with aircraft mortgages are clearly

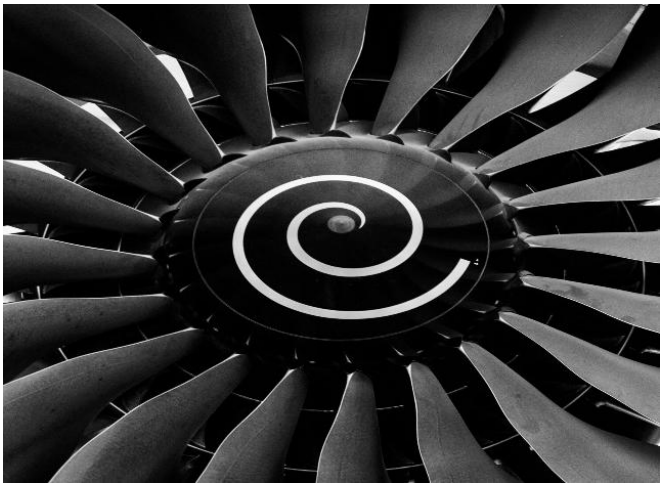
[17] The authors submit that, if such distinction was intended by the drafters of the CTC, then article XI(10) would be obsolete because article XI(2) of Alternative A already provides that the creditor is entitled to the possession of the aircraft upon the expiry of the waiting period, so naturally future rentals cannot be modified against its will in any event.

[18] The Aviation Working Group, for example, publishes a ranking of the implementation of the CTC in contracting states.

[19] ***The Protection of Interests in Aircraft Objects Act 2025***.

[20] Such as Thailand.

secured creditors, the case of aircraft lessors is debatable. Whether it is an operating lease or a finance lease, the lessor is the owner of the aircraft



but do not have any security interest in it, so a lessor is not a secured creditor per se.[21] However, it might be argued that a lessor is a secured creditor on either or both of the following grounds, although its security interests are in something other than the aircraft.

First, an aircraft lessor often holds a cash security deposit (SD) under the lease agreement. The lease agreement will invariably provide that, upon receipt from the lessee, the SD will become the unencumbered property of the lessor that may be commingled with the lessor's general corporate fund, with the lessor being subject to a merely contractual obligation to return an amount equal to any unapplied SD to the lessee when the lease expires. Does that make the lessor an owner of the SD but without any security interest in it? The answer may depend on how the SD provision in the lease agreement was drafted.

English law (by which most cross-border aircraft lease agreements are governed) may easily construe that a charge has been created if the SD provision employs wording like 'the Lessor may apply the SD towards remedying a default of the Lessee' — wording that is not uncommon in an aircraft lease agreement. The lessor is then arguably a secured creditor of the airline, although its security takes the form of the SD rather than the aircraft. The counterargument to that is that such a charge might have become void as the lease agreement creating the charge has not been filed in the companies registry of the jurisdiction of incorporation of the airline lessee within the legal time limit, as it is not the industry norm to file the lease agreement with a companies registry. Another complexity is that the SD might have been depleted completely after being applied towards remedying non-payment by the lessee, and the lessee does not have the means to replenish it as required under the lease agreement. All in all, whether a lessor is a secured creditor on account of the SD is a complicated and uncertain issue.

Second, an aircraft lessor invariably has in its favour some true security documents other than the lease agreement. In Indonesia, for example, local counsel advised that an overseas aircraft lessor may be considered to be a secured creditor of an insolvent airline because the latter has granted an assignment of the insurance proceeds of the aircraft to the lessor by way of security. The fact that the collateral is of no value as no total loss or insured damage of the aircraft has occurred is irrelevant, we were told. It would be interesting to see how this issue is considered in other jurisdictions.

As a side note, besides lessors and financiers, another important type of creditors of an airline are aircraft manufacturers, in respect of the balance of purchase prices payable for aircraft ordered by the airline. Given the high value of aircraft and the fact that the airline may have ordered tens or even hundreds of aircraft, the amount involved may be much higher than that owed to lessors and financiers, or indeed any other type of creditors. As such, to avoid the manufacturers outvoting all other creditors in the same class, in the case of ***AirAsia* X**,

[21] On the other hand, the lessor's financier may have an aircraft mortgage, but it is a secured creditor of the lessor, not of the airline.

for example, the Malaysian court sensibly put Airbus in a class of its own.

REPOSSESSION OF AIRCRAFT

An aircraft can happen to be in an outstation or a repair and maintenance facility overseas when the airline operating it becomes subject to an insolvency moratorium. It may be desirable for the creditor to repossess the aircraft if the moratorium does not yet have extraterritorial effects so that it can re-lease or dispose of the aircraft instead of being stuck with the airline's restructuring procedure. One should then check whether the insolvency administrator has already applied for recognition of the moratorium in the relevant jurisdictions and, if not, apply in those jurisdictions for either an interlocutory injunction against the airline removing the aircraft from such jurisdictions or an order of repossession of the aircraft. If both the home country of the airline and the relevant overseas jurisdictions[22] are OTC contracting states, the overseas jurisdictions are obliged to cooperate with both the insolvency administrator in implementing the waiting period,[23] and the creditors in exercising their IDERAs to repossess their aircraft after the waiting period expires.[24]

Relatedly, in some jurisdictions, the application for an interlocutory injunction must be accompanied by the payment of substantial security into the court to compensate the debtor if the applicant loses in the main litigation eventually. In the Philippines, for example, the applicant must procure an expensive 'replevin bond' in the value of the aircraft. In such cases, the creditor may consider applying for an interlocutory injunction in England as the chosen forum in the lease or loan agreement instead and then seeking recognition of it in the jurisdiction in which the aircraft is situated.

Regardless of whether the aircraft is in the airline's home country or situated overseas, repossession may be hindered by various forms of possessory liens. In most jurisdictions, repair facilities, tax authorities, airport operators and even fuel suppliers will have such liens on the aircraft, its engines, its manuals and records (which are essential and costly to reconstruct) and even fuel in its fuselage for unpaid fees, charges and taxes. Such a 'non-consensual right or interest is recognised by the CTC.[25] In particular, a government entity or a private provider of public services such as an airport operator may arrest or detain an aircraft object for payment of amounts owed to such entity or provider 'directly relating to those services in respect of that object or another object'.[26]

By referring to 'another object, the OTC recognises that a creditor's aircraft may be arrested and detained for amounts owed not only for services provided to its aircraft, but also, at least in theory, for those provided to other aircraft within the airline's fleet if local law so dictates. This is unfortunately an unavoidable risk in aircraft leasing and financing, as the creditor must pay off the dues to secure the release of its aircraft. As the airline is in financial difficulties, it is possible that the creditor may only reclaim a percentage of such expenses by proving its claims in the insolvency proceedings of the airline. Such a risk may be partially mitigated by, among other things, the lessor having a sufficient security deposit or the financier avoiding too high a 'loan to value ratio'. It is also beneficial if the airline can voluntarily reposition the aircraft to a location where no entity has any possessory lien on the aircraft before it is surrendered to the creditor.

Difficulties in repossession may also be caused by the fact that an airline will swap the engines and parts between different aircraft within its fleet (and sometimes even with other airlines) or take them off-wing for maintenance. It is worth mentioning that, in some jurisdictions, an engine may be

[22] Assuming that they have made a declaration pursuant to article XXX(1) of the Aircraft Protocol.

[23] Article XII (2), the Aircraft Protocol.

[24] Article XIII (4), the Aircraft Protocol.

[25] Article 39(1)(a), the Cape Town Convention.

[26] Article 39(1)(b), the Cape Town Convention.

considered to have become an inalienable part of the airframe to which it is temporarily installed, thereby extinguishing its original ownership and security interest. Although the OTC position is that ownership and security interest in an engine will not be affected by its installation on or removal from an aircraft,[27] it is prudent to obtain written confirmation from the other creditors of the airline that they will not assert any right on the creditor's engines by reason of their installation on the other creditors' airframes,[28] unless counsel in the airline's home country confirms that there is no such risk under its laws.

FINAL THOUGHTS

Airline insolvent restructuring is complicated and requires input from different lawyers with respective experiences in aviation finance, restructuring and insolvency and litigation, as well as strong local law support.

While this article cannot provide a comprehensive overview of all relevant topics, the authors will mention two more points in passing.

First, a lessor should seek local law advice, as a matter of strategy, as to whether it should apply the SD against outstanding rents and notify the airline in writing about such application to avoid the liquidator of the airline seeking to claw back unapplied SD on the pretence that the SD is part of the bankruptcy estate that must be distributed among all creditors, or whether it should instead retain the SD and demand payments of rents from the airline to maximise the lessor's provable claims in the eventual liquidation of the airline.

Second, sometimes a creditor may have obtained a guarantee from the airline's parent company or shareholder. If the guarantor is not undergoing an insolvent restructuring or liquidation process in parallel, the creditor should consider the difficult legal issues involved. For example, by the creditor voting in favour of the proposed restructuring scheme of the airline (which scheme will involve the creditor forgoing part of its debt claims against the airline), will the guarantor be released by law from its obligations under the guarantee? On the other hand, if creditors can still claim under the guarantees, will the guarantor be able to exercise any right of subrogation and claim indemnity from the airline, thereby defeating the restructuring efforts? Because of these issues, a restructuring scheme usually requires creditors to release the guarantees, but there may be situations where it would be difficult to do so during the restructuring process of the airline by reason of the guarantor being a foreign company or the guarantees being governed by another law, among other things.

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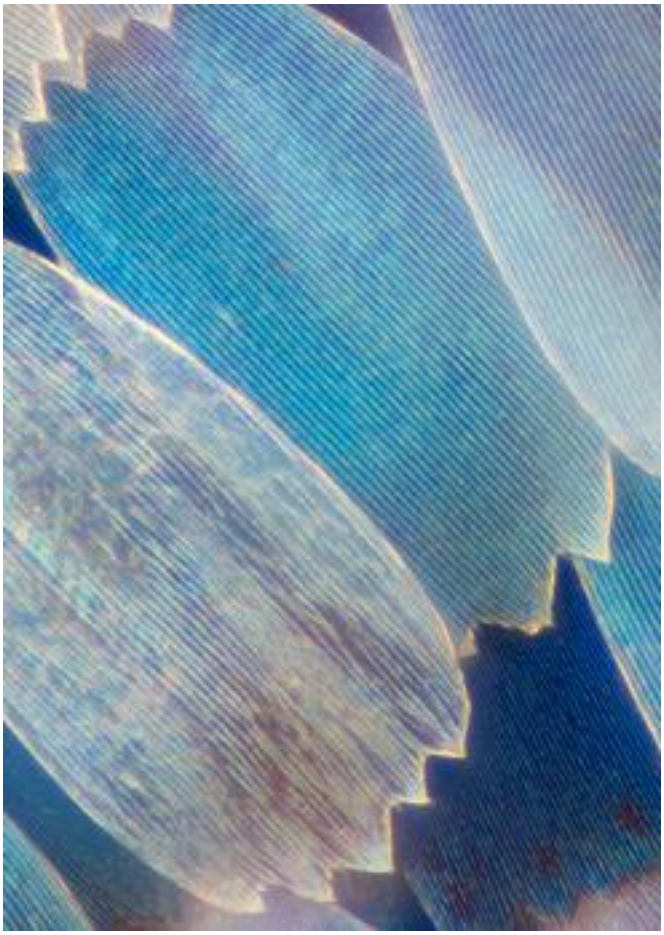

[27] Article XIV(3), the Aircraft Protocol.

[28] This is known as a recognition of rights agreement in the aviation industry.

CONTACT US

SIMON WONG

Partner
+ 852 2533 2885
simon.wong
@stephensonharwood.com

ALVIN CHEUNG

Partner
+ 852 2533 2761
alvin.cheung
@stephensonharwood.com

DANIEL ANDREWS

Partner
+ 44 20 7809 2616
daniel.andrews
@stephensonharwood.com