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Uncertainty in the Airline Industry: An Overview of Slots, Gates and Routes Pledged as Collateral in the Wake of COVID-19

In recent years, several major US airlines have entered into loan facilities secured solely by certain of its slots, gates and routes (“SGR”). This alert provides (i) a brief overview of SGR, (ii) how SGR collateral may be perfected, (iii) the regulatory overlay of SGR, and (iv) the monetization of SGR.

WHAT ARE SLOTS, GATES AND ROUTES?

A “slot” is the authorization granted by the applicable governmental authority for an aircraft to either take-off or land at a particular airport during a particular time. Similarly, “gates” are the authorization for passengers to board and deboard planes at a specific gate of an airport and “routes” are the authorization to fly a specific route throughout the airways. Collectively, SGR act as a limitation on aircraft operations in an effort to manage air and airport traffic, specifically at the world’s busiest airports.

Whether or not an airport utilizes slots depends on how busy it is as determined by the International Air Transport Association (“IATA”). Generally, airports are categorized into three levels, with Level 3 being the only airports that outright require slots (Level 2 airports are less stringent with slot allocation and Level 1 airports do not require slots at all due to minimum capacity). Globally, there are approximately 177 Level 3 airports, which include:

- In the UK, all London airports, Manchester, Bristol, and Birmingham
- In the US, JFK, LaGuardia and Washington National
- In Asia, Hong Kong, 11 domestic airports in China, Kuala Lumpur, Singapore, Tokyo, Narita and Haneda, Fukuoka, Mumbai, Delhi, and Chennai



Additionally, some airports are only slot controlled seasonally, such as those in Italy and Greece during the summer peak seasons.

SGR PLEDGED AS COLLATERAL

SGR have proven to be immensely valuable assets to airlines. Historically, the authorization to utilize highly traveled take-off and landing times, gates at busy airports and coveted routes have provided airlines with strategic long-term competitive advantages. Consequently, SGR have been instrumental in raising capital for airlines, specifically when pledged as collateral in debt financings.

In the past, SGR have been pledged as part of an overall collateral package in aviation financings, which would typically include an airline's tangible assets such as its equipment and fleet. Over the last ten years, however, as some airlines' need for liquidity has surpassed their traditional collateral base, SGR have been pledged as the sole source of collateral to secure certain aviation financings. As an example, each of American Airlines, Delta and United have recently received billions of dollars under multiple loan facilities, secured solely by their respective SGR.

HOW ARE SECURITY INTERESTS IN SGR PERFECTED?

In the context of secured financings, a "perfected" security interest provides a lender with rights and remedies against a borrower's pledged assets if the borrower breaches its obligations to the lender or an event of default exists. If a security interest is not properly perfected, a court will not recognize a lender's claim against the collateral and the lender will be left with no recourse with respect to the underlying collateral.

Typically, the perfection of a security interest is governed by Article 9 of the Uniform Commercial Code ("UCC"), unless preempted by applicable federal law. While the perfection of certain aircraft collateral is governed by the Federal Aviation Act (e.g. aircraft, engines, and spare parts), the perfection of slots, gates and routes are not.

Slots and routes are general intangible assets and perfection under the UCC may be obtained by filing a UCC-1 financing statement. Gates are general leasehold interests which are considered chattel paper and perfection under the UCC may be obtained by filing a UCC-1 financing statement or by taking actual possession of the lease. A UCC-1 financing statement must contain (i) the legal name and mailing address of the grantor, (ii) the legal name and mailing address of the lender, and (iii) a description of the collateral covered by the UCC-1. The description of the underlying collateral may be as broad as possible. While a lender may want to specifically identify a particular item of collateral, doing so without including such terms as "all replacements of and substitutions for" and "all proceeds on account thereof" could inadvertently leave the lender unperfected. In order to maintain a perfected security interest, continuation statements must be filed every 5 years and within 6 months prior to expiration—if the continuation statement is filed any earlier, it will be ineffective.

REGULATORY OVERLAY

While gates are considered traditional leasehold interests governed by real property law, slots and routes are rights granted by certain regulatory authorities, and as such, are accompanied by complexities that are non-existent when it comes to more traditional collateral. Slots and routes are only the authorization to conduct certain operations, which authorization may be revoked under certain circumstances as discussed below. The ability of a regulatory authority to revoke its authorization to use slots and routes makes SGR collateral not only difficult to value, but has caused some to question the enforceability of liens against SGR collateral. However, courts have generally recognized the validity of such liens. In the prior American Airlines bankruptcy, for example, the bankruptcy court approved debtor-in-possession and exit financing secured by SGR collateral, and in doing so, recognized the legitimacy of such liens.¹

¹ *In re AMR Corporation, et al.*, Case No 11-15463 (SHL) (S.D.N.Y. Bankr. 2011).



The Federal Aviation Administration (“FAA”) monitors slot allocation in the US, which typically tracks the IATA’s Worldwide Slot Guidelines that provides a comprehensive set of procedures for the allocation and management of slot administration globally. Typically, airlines provide airports with their proposed schedules twice a year, for the summer and winter seasons, and the FAA will assign slots based upon those requests in conjunction with historic slots that have been allocated to a particular airline and how often such slots are utilized throughout the season. One of the issues with slots is that if they are not 80% utilized by the airline, they may be subject to forfeiture (which is one of the main reasons airlines will still conduct empty flights). Recently, in light of COVID-19, the FAA temporarily suspended the minimum slot use requirement at US airports, but such waiver is currently scheduled to expire on October 24, 2020.

Routes are governed by multilateral agreements between countries, and are subject to capacity restrictions at each airport and limitations imposed by the applicable country under the respective agreement. In the US, the Department of Transportation (“DOT”) processes requests by US airlines for the authority to serve foreign markets. If more carriers seek routes than are available, the DOT must allocate the routes among US air carriers using a comparative selection process.

Additionally, the US Department of Justice (“DOJ”) can mandate divestitures of SGR when there are competition concerns including, as a result of mergers between airlines. For example, following their 2013 merger, US Airways and American were forced to divest 17 slot pairs (i.e. take-off and landing slots) at LaGuardia and 52 slot pairs at Ronald Reagan Washington National in order to gain DOJ approval. Similarly, the DOT also plays a role in the management of SGR. In 2016, it granted immunity for the proposed alliance agreements submitted by Delta Air Lines and Aeroméxico on the condition that the carriers divest slots in favor of competing airlines. In 2016, the DOT also awarded American Airlines route authority between Los Angeles and Beijing over Delta, due to American’s superior connectivity (resulting in a greater number of US travelers benefitting from one-stop connections over Los Angeles).

In 2016, United Airlines announced a \$412 million charge to earnings based on the FAA’s decision to eliminate slots at Newark Liberty International Airport. The FAA’s decision rendered the once-valuable landing and takeoff slots owned by United at Newark worthless.

The above are only a few examples illustrating the impact that regulatory authorities may have on SGR, and ultimately, their value as collateral.

MONETIZATION OF SGR

SGR may be monetized in several ways. Slots and routes may be traded between airlines, leased to other airlines, or bought or sold. However, as referenced above, such trades, leases or sales of SGR will be subject to restrictions and oversight by the applicable governmental authority.

In March 2008, Continental Airlines paid \$209 million for four pairs of landing slots from GB Airways in Heathrow Airport. In February 2016, Oman Air paid \$75 million to Air France for a coveted set of early morning slots at Heathrow Airport. In 2015, American Airlines paid \$60 million to Scandinavian Airlines for some of its slots at Heathrow Airport.

There are several third-party appraisers that are often hired to assign value to a particular piece of SGR collateral. However, such value is tied not only to a specific airport, time of day and/or flight route, but overall demand and any governmental restrictions that are either in place or anticipated. Additionally, the relatively small number of completed SGR sales transactions makes any sale difficult to value on a comparative basis, with sales of routes occurring even less frequently than sales of slots.



CONCLUSION

With the recent depression of the airline industry due to COVID-19, concerns are being raised, by both airlines and their lenders, as to the current value of SGR collateral and the ability to monetize SGR in the current economic climate. That said, SGR are an essential asset that will likely remain pivotal to the airline industry as the pandemic hopefully subsides.

In the coming weeks, King & Spalding will be offering a webinar/roundtable discussion titled “What to expect from your SGR Collateral in Bankruptcy.” Please watch for additional information and in the meantime, please reach out to us with any questions regarding SGR.

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