# Q&A with Laurence M. Smith, Esq.

*of Wolff & Samson*

*The discussion that follows is meant to provide general information and should not be acted upon without obtaining professional advice appropriately tailored to your needs and the circumstances of your situation.*

Despite $15 billion in grants and loan guarantees earmarked for the domestic airline industry under the Airline Transportation and System Stabilization Act, Midway Airlines, U.S. Airways and United Airlines were forced to file for bankruptcy and other carriers may suffer the same fate. How might the bankruptcy of a carrier affect a corporation with whom the carrier has entered into a preferred carrier agreement? ACTE Global Business Journal had an opportunity to discuss this topic with Laurence Smith, a partner with the New Jersey-based law firm of Wolff & Samson.

Smith counsels corporate travel managers in all facets of their business, including preferred carrier contracts, online booking tools, agreements for pre-trip and post-trip reporting, and travel management agreements. Managing the relationship with preferred carriers has become increasingly difficult given the chaotic state of the airline industry.

According to Smith, the spirit of cooperation and partnership that once defined the relationship between preferred carrier and corporate customer has been eclipsed by the fight for economic survival faced by most major carriers today. Airlines simply cannot afford to be as accommodating as they once were, even with their best customers. Consequently, the terms of preferred carrier agreements are much more likely to be enforced by the airlines and have therefore assumed a greater importance. In addition to negotiating the best possible terms for his clients, Smith makes sure that they are aware of, and to the extent possible, protected against, the consequences of a carrier filing for bankruptcy.

ACTE Global Business Journal: Generally speaking, how may the bankruptcy of an airline affect its relationship with a corporate customer?

Laurence Smith: Most likely, the bankruptcy will be a Chapter 11 reorganization rather than a Chapter 7 liquidation, so the airline will continue conducting business and, from an operational standpoint, the corporate customer may experience little, if any, change in the day-to-day relationship. However, filing for bankruptcy, in essence, insinuates the bankruptcy

court in the carrier–customer relationship and invokes a series of laws and rules known as the U.S. Bankruptcy Code.

GBJ: How can bankruptcy law affect a preferred carrier agreement that was entered into before an airline filed for bankruptcy?

LS: Although the Bankruptcy Code does not result in a wholesale modification of a preferred carrier agreement entered into prior to the date that a carrier files for bankruptcy, the overlay of bankruptcy law may alter the parties' contractual rights and remedies. To facilitate the reorganization of the debtor — the party that files for bankruptcy — the Code grants the debtor the option of assuming or rejecting its "executory" contracts. These are defined as contracts in which both parties still have obligations to perform; an example would be a preferred carrier agreement under which the corporate customer has a continuing obligation to purchase tickets and the carrier a continuing obligation to provide commercial air transportation. In most cases, the debtor airline need not decide whether to assume or reject a preferred carrier agreement for many months after the bankruptcy filing, and there is little the corporate customer can do to accelerate the process. If the contract is assumed by the carrier, the relationship continues; if it is rejected, the relationship comes to an end.

Also noteworthy is the Code section that invalidates any provision in an agreement that purports to alter or terminate a debtor's rights simply because the debtor has filed for bankruptcy protection. The rationale behind this rule is that the assumption by a debtor airline of preferred carrier agreements that are critical to its reorganization would be of little practical value if the corporate customers could then terminate the agreements based upon a clause in the contracts stating that the bankruptcy of the carrier constitutes a default.

GBJ: Many preferred carrier contracts contain a "termination for convenience" provision, allowing either party to terminate upon 30 days' notice. Such a provision is not, on its face, tied to the carrier filing for bankruptcy. Could a termination for convenience clause be invoked by a corporation to terminate a preferred carrier agreement in the wake of a bankruptcy filing by a carrier?

LS: In light of the goal of the Bankruptcy Code of allowing the debtor to decide whether to assume or reject executory contracts, it is unlikely that a bankruptcy court would permit a corporate customer to terminate a preferred carrier contract for convenience. In any event, in order to attempt to terminate the contract, the corporate customer would have to file a motion in bankruptcy court requesting this relief; simply sending a termination notice to the airline would not be permitted under the Code. Thus, attempting to unwind the relationship could become costly and time consuming and is not likely to yield favorable results.

GBJ: If, after filing for bankruptcy, a carrier reduces capacity on certain routes covered by market share goals under the preferred carrier agreement, will the customer be relieved of the obligation of meeting those goals?

LS: This is not a question that is susceptible of a "yes" or "no" answer. One of the assumptions underlying the decision to commit to certain market share goals under an agreement is that the carrier will maintain the same level of service — measured by the number of flights per week, the aircraft used on those flights and the elapsed time between origination and destination — that it had at the inception of the agreement. All too often, however, that critical assumption is not stated in the contract. In that case, if a carrier in bankruptcy reduces its capacity in certain markets, and the corporate customer would like relief from its market share goals, the corporation will have to convince a bankruptcy judge that such relief is warranted. It may not be apparent to a bankruptcy judge why the carrier, who previously offered 10 daily non-stops between a city pair and has cut back to seven daily flights, only five of which are non-stops, cannot properly service a corporate customer who has committed a 70 percent market share to that carrier. Thus, it is less than

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clear whether the corporate customer can obtain relief from those goals.

GBJ: In contracting with a carrier that is not in bankruptcy, is there anything a corporation can do to protect itself in the event the carrier subsequently files for bankruptcy and reduces service?

LS: Yes, one solution is for the corporate customer to insist on including in the contract a provision stating that its obligation to deliver market share is contingent upon the carrier maintaining the same level of service in the relevant markets that the carrier had at the commencement of the agreement. If the carrier fails to do so, the market share goals in the affected markets should be automatically reduced in proportion to the reduction in service by the carrier. Such a provision would be self-executing and should not require seeking the approval of the bankruptcy court.

GBJ: How can a corporation that has committed to certain market share goals protect itself if the carrier's fares are no longer competitive after it files for bankruptcy?

LS: Here, again, the provisions of the preferred carrier agreement are key. The preferred carrier agreement should state that the market share commitments are predicated upon the carrier's business fares remaining competitive with those of other airlines serving the same markets; the definition of "competitive" should be tied to the corporation's internal travel policies dictating when a lower priced flight must be chosen, even if the carrier offering it is non-preferred. As long as this requirement is set forth in the agreement, the corporation should, by the terms of the agreement, be relieved of its market share goals if the carrier's pricing becomes non-competitive. If the requirement of competitive pricing is not made clear in the agreement, the corporation may have to file a motion in bankruptcy court and convince a judge that it is entitled to relief from those market share commitments.

GBJ: If a corporate customer fails to meet its market share or revenue goals and the carrier files for bankruptcy, what recourse does the carrier have?

LS: The carrier may have a claim for damages based upon the corporate customer's failure to meet the market share or revenue goals contained in the contract. This damages claim would exist even if the carrier had not filed for bankruptcy, but in light of the circumstances that precipitated the filing, the carrier may be less inclined to overlook the customer's breach. Further, in bankruptcy court, the carrier could seek to specifically enforce the corporation's promise to deliver the market share set forth in the agreement. To avert this situation, preferred carrier agreements often contain a waiver by the carrier of its right to seek damages or any other relief if the customer falls short of the contractual goals. If well drafted, the contract should state that the carrier's sole remedy in that situation is to terminate the contract upon notice to the customer.

GBJ: Are there other consequences to a carrier filing for bankruptcy that are likely to have a direct financial impact on a corporate customer?

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LS: A corporate customer should recognize that, if its preferred carrier agreement is rejected by the airline in bankruptcy, any claim the customer may have for back-end rebates, which accrued prior to the carrier filing for bankruptcy, constitutes a general unsecured claim, with respect to which the corporate customer may receive pennies on the dollar. An example here may be illuminating. Assume that for travel during the quarter ending September 30, 2002, a corporation earned

$150,000 in back-end rebates, which the carrier is obligated to pay by December 31, 2002. The carrier files for bankruptcy on December 15, 2002, before paying the rebates and subsequently rejects the preferred carrier agreement. In bankruptcy parlance, the corporation's claim for $150,000 is an "unsecured, pre-petition" claim, i.e., it arose prior to the date the carrier filed for bankruptcy and is not secured by collateral of any type. The treatment accorded general unsecured creditors under the plan of reorganization, which may provide for the payment of as little as 10 or 20 cents for each dollar owed by the carrier, will determine the amount that the corporation receives on account of its $150,000 claim. Moreover, that amount probably will not get paid for many months after the date specified under the preferred carrier agreement.

If the carrier desires to assume the preferred carrier contract, as a condition to doing so, it will have to pay the entire back-end rebate, but payment may not be forthcoming for many months after it was due.

GBJ: We have discussed a variety of means by which a corporate customer can protect itself or enhance its rights under a preferred carrier contract. Could you summarize these?

LS: Knowing the potential impact of a preferred carrier filing for bankruptcy, the corporate customer may want to address the following points in future preferred carrier agreements:

- Make all market share commitments contingent upon the carrier maintaining the same level of service in the relevant markets as the carrier had at the time it was awarded a particular market share. The carrier's failure to maintain that level of service should, at a minimum, result in an automatic and commensurate reduction in market share goals and, under certain circumstances, the elimination of market share goals for the affected city pairs.

- To the extent relevant, make sure company travel policy, and its impact on market share goals, is addressed in the agreement. For example, if company travel policy prohibits a traveler from taking a flight if there is an alternate flight at least $150 cheaper which arrives within two hours and has an elapsed travel time of within one hour of the other flight being considered, then this proviso should be stated clearly in the agreement. Thus, if the preferred carrier does not keep its fares for a particular route within $150 of the fares of its competitors, the corporation would be excused from the market share goals for that city pair.

- If there is serious concern that an airline may file for bankruptcy, it may be advisable to opt for an agreement with a shorter term — say one year — and an option for the corporation to renew, rather than to enter into a two-year commitment with that airline.

- Upfront discounts are always preferable to back-end rebates. If back-end rebates are unavoidable, they should, to the extent possible, be calculated and paid monthly rather than quarterly.

- To limit the company's potential exposure, include in the agreement an exclusive remedy provision, stating that in the event the company fails to meet its market share goals, the airline's sole and exclusive remedy is to terminate the agreement upon written notice to the company. ■

*Wolff & Samson is a general practice law firm of approximately 90 attorneys. Headquartered in Roseland, New Jersey, the firm will be relocating its principal office to West Orange in January 2003. Since Smith joined the firm in 1987, it has more than doubled in size but, significantly, has not changed its service-oriented approach to the practice of law.*