The Economic Downfall of Japan Airlines and its Prospects for Reorganization

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Introduction

On January 19, 2010, Japan Airlines Corporation, its subsidiary Japan Airlines International Co., Ltd., and its affiliate JAL Capital Co., Ltd. (collectively, "JAL") simultaneously commenced a proceeding under the Corporate Reorganization Law (*Kaisha Kosei Ho*) of Japan in Tokyo District Court, Civil Department No. 8 ("Japan Proceeding"), and a case under chapter 15 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York ("Bankruptcy Case").[1] The Japan Proceeding, generally considered to be the fourth largest bankruptcy in Japanese history, came upon the heels of a substantial increase in the company's public and private debt and a years-long decline in JAL's business, and came at a time when JAL was being singled out as an investment target by Delta Air Lines ("Delta") and American Airlines ("American"). With new political leadership in Japan and a changing climate towards the protection of formerly state-owned businesses, JAL could be facing a particularly rough landing in its attempt to successfully reorganize.

JAL's Origins, Problems, and Ultimate Downfall

JAL was founded in 1951 and became the national airline of Japan in 1953. The Japanese government, recognizing the need for a reliable air carrier to help the country emerge from the aftermath of World War II, started the company with an initial investment of ¥100 million. During the 1950s, the company first operated flights between Japan and the United States using leased aircraft and, in the 1960s, acquired an all-jet fleet and expanded international service. By 1965, JAL was making more than half of its revenue from trans-Pacific flights to the United States.

During the 1970s, the airline expanded its jet fleet to service its increasingly large domestic and international route network. In 1972, JAL was designated as a "flag carrier," was authorized to operate further international routes, and was also designated to operate domestic trunk routes in competition with All Nippon Airways ("ANA") and Japan Air System ("JAS").

In 1987, Japan Airlines was privatized, with ANA and JAS authorized to engage in unregulated competition with JAL on both domestic and international routes. With

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increased competition came fundamental changes in JAL's structure, which was reorganized into three divisions: international passenger service, domestic passenger service, and cargo service. The 1990s saw JAL struggling with Japan's own economic downturn and the effects of recessions in the United States and the United Kingdom. After showing continuous profits since 1986, JAL posted operating losses beginning in 1992. Increasing pension and payroll costs, as well as the growing expense associated with serving a network of unprofitable domestic routes, were factors in this decline. JAL Express, a low-cost international and domestic carrier, was founded in April 1997, with a new fleet of Boeing 737 aircraft. Cost-cutting measures, including the elimination of 1,300 jobs and the transfer of tourist operations to a new subsidiary, helped JAL turn a profit in 1999. Just the year before, JAL had posted a record loss of ¥94.2 billion (US $476.7 million).

JAL received its first of four government bailouts in 2001. JAL then merged with JAS in 2002. The merged company became the sixth largest airline in the world based on the number of passengers carried. In 2007, JAL joined the Oneworld Alliance founded by American, British Airways, Canadian Airlines, Cathay Pacific, and Qantas.

Affiliation with Oneworld, however, did not remedy JAL's operational problems or its decreasing profitability. Passenger traffic was greatly reduced due to the global economic downturn of 2008 and 2009, and increasing competition from ANA drove down JAL's market share. In June 2009, JAL accepted its fourth government bailout, in the form of ¥100 billion (US $1.1 billion) in loans from state-backed Development Bank of Japan and other banks.[2] The company lost ¥131.2 billion (US $1.4 billion) just in the span of March 2009 to September 2009.[3]

Throughout the second half of 2009, JAL continued to falter. It moved to discontinue 24 of its international flights by March 2012 (projecting a 20 percent drop in sales from overseas flights), and scheduled an increase in the number of previously planned staff cuts by 1,000 for a total of approximately 6,000. JAL's share price was greatly reduced on rumors of a pending bankruptcy filing. In September 2009, the Ministry of Land, Infrastructure, Transport and Tourism ("MLIT") formed a five-person task force directed towards pursuing a corporate turnaround at JAL, which would include cost cuts and development of partnership or merger proposals.

The partnership or merger option became more fully developed in November 2009, as Delta and American pursued JAL in a growing bidding war sponsored by each airline and its respective alliance partners, with offers of more than $1 billion in assistance. Delta offered JAL $500 million in equity, as well as a substantial increase in passengers and revenue from its SkyTeam Alliance, while American offered $1.4 billion for JAL to stay within its Oneworld Alliance. At the same time, JAL consulted the Enterprise Turnaround Initiative Corporation of Japan ("ETIC"), a state-sponsored turnaround fund, regarding a debt restructuring. ETIC asked JAL to defer accepting investments from Delta or American while it continued to negotiate. In early January 2010, the Development Bank of Japan doubled its June 2009 loan to ¥200 billion (US $2.2 billion), and JAL's stock briefly rose by nearly 36 percent upon this news as concerns about operating liquidity were eased.[4] New reports at the time indicated that ETIC favored a transaction with Delta and entry into the SkyTeam Alliance as part of that deal, but an out-of-court restructuring or affiliation was not to be. The negotiations with ETIC ultimately led both JAL and the Japanese government to conclude that a court-supervised restructuring would be necessary.

The Japan Proceeding and the Bankruptcy Case

At the commencement of the Japan Proceeding and the Bankruptcy Case, JAL was saddled with over $25 billion in debt. ETIC, as JAL's principal post-filing lender, pledged a facility of up to ¥900 billion yen (US $10 billion) in financial support, in the form of ¥600 billion in credit lines and a ¥300 billion capital infusion. ETIC has made clear its plans to eliminate nearly 16,000 jobs (a third of JAL's work force), to greatly reduce pension benefits, and to do away with 30 (roughly equivalent to one-fifth) of JAL's international routes and 15 of the carrier's least profitable domestic routes.

The law applicable to the Japan Proceeding is substantially similar in most respects to proceedings under chapter 11. ETIC's power, however, comes from the fact that unlike a debtor-in-possession model for chapter 11 cases, Japanese law requires the designation of one or more trustees who assume full responsibility for managing the company through formulation, confirmation, and full performance of a corporate reorganization plan. ETIC and the MLIT have considerable influence on the trustee and the direction of JAL's reorganization proceeding.

The current status of the case indicates that equity will be wiped out in a 100 percent capital reduction, which will go toward paying off JAL's debt. The main creditor banks have been asked to write off as much as ¥700 billion in debt, including losses after accounting for other debts such as bonds and derivative contracts. Recent developments have offered mixed indicators of JAL's likely success. On the one hand, the company has indicated that it will likely need another ¥100 billion (US $1.1 billion) in further financial assistance from the government as it now expects larger write-down losses from asset valuations and, in its latest earnings, reported a net loss of ¥46.7 billion in the October to December quarter 2009, worse than a net loss of ¥38.5 billion in the same period a year earlier.[5] Also, high fixed costs continue to be a problem. As recently as late June 2010, the trustee asked the government to lower mandatory domestic landing fees and aircraft fuel taxes, as such costs are proving to be equivalent to more than 10 percent of JAL's sales.[6] On the other hand, JAL management has represented that it expects to achieve profitability on a consolidated basis for the first time in three years in the current fiscal year (through next March), one year earlier than initially planned, based on expected increases in passenger demand and a forecast of ¥22 billion in profit in its draft operating budget recently presented to lenders.[7] JAL has also renewed its commitment to the Oneworld Alliance and has asked the Japanese government for antitrust immunity for a deepening of cooperation with American in support of a proposed joint business agreement over the North Pacific.[8]

As for the case procedure, the trustee must formulate and submit a formal plan of reorganization to the Japanese court presiding over the restructuring within one year of entry of the commencement order, subject to extension for cause. The plan is then submitted to the debtor's creditors (and stockholders if the debtor's assets exceed its liabilities) for formal approval. If the votes for plan confirmation are not obtained, the court must either terminate the reorganization proceedings or, in the alternative, confirm the plan over dissenting creditors, through procedures similar to the Bankruptcy Code's "cram down" mechanism.

The trustee has already missed one self-imposed deadline to submit a reorganization plan in June 2010 and currently intends to submit its proposal at the end of August

2010. The present uncertainty regarding JAL's prospects should be somewhat reduced by the submission of the plan, but it is still not clear whether the creditors will support the plan. Substantial diplomatic efforts towards Japanese business partners and strong statements by the government in support of JAL and its restructuring were all made after filing to give comfort to vendors that JAL's business would not be disrupted.[9] At the same time, competition has become more robust, as ANA has recently announced its plan, as the first customer of Boeing's 787 Dreamliner (with 55 of the planes on order at a cost of approximately $6 billion), to start flying the aircraft overseas in March 2011 while JAL reduces its routes.[10] Overall, the effect of the anticipated fleet, route, and personnel changes on both the market and creditors' confidence in a successful reorganization are still unknown.

Recent Political Events

On June 3, 2010, Yukio Hatoyama, the leader of the Democratic Party of Japan ("DPJ") and the country's Prime Minister, resigned in response to political pressure and allegations of financial scandal. Naoto Kan, the former Finance Minister under Hatoyama and an advocate of increased government support for JAL in the days prior to its bankruptcy (but an opponent of bailouts in December 2009), was elected as the leader of the DPJ and appointed Prime Minister on June 8, 2009.[11] Seiji Maehara, the Transport Minister under Hatoyama, has retained his post under Kan and will perform the key cabinet role in supervising the JAL reorganization.

Kan and Maehara are generally popular and seen as advocates of economic reform. JAL's newly appointed chief executive officer, Kazuo Inamori, has close ties with the DPJ, but it is not clear to what extent these ties could lead to benefits for JAL. Landing fees, fuel taxes, and aircraft property taxes in Japan continue to create pressure on JAL's revenues and devalue its domestic operations, especially relative to the imbalance that competitors in other countries enjoy with respect to such charges. While the DPJ is said to be examining these issues closely, JAL may face a difficult task in getting the current administration to make changes, since the government is also concerned with its own budgetary stability and these fees provide substantial revenue.[12] In any event, the new government will play a central role in the composition and consummation of JAL's exit plan.

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[1] *In re Japan Airlines Corp.*, No. 10-10198 (JMP) (Bankr. S.D.N.Y. Jan. 19, 2010).

[2] Yoshio Takahashi and Alison Tudor, *JAL Asks for Another Bailout; Tokyo Balks*, Wall St. J., September 25, 2009.

[3] *Japan Airlines Files for Bankruptcy*, Associated Press, Jan. 20, 2010.

[4] Ashley Seager, *Struggling Japan Airlines Thrown £1.33bn Lifeline*, The Guardian, Jan. 3, 2010.

[5] Yoshio Takahashi, *JAL May Need $1.1 Billion More in Aid*, Wall St. J., June 21, 2010.

[6] Shoichi Shirahaze and Masataka Morita, *Costs Threaten ANA Budget Carrier*, Daily Yomiuri, June 23, 2010.

[7] *JAL Expects to Move Into Black One Year Earlier Than Planned*, Wall St. J., June 5, 2010.

[8] Bradley Perrett, *JAL Applies For ATI For Deal With AMR*, Aviation Week, June 21, 2010.

[9] Hiroko Tabuchi, *JAL Bankruptcy Filing Sets Off Reorganization and State-Led Bailout*, N.Y. Times, Jan. 20, 2010.

[10] Chris Cooper and Kiyotaka Matsuda, *All Nippon Plans First 787 Overseas Flights in March*, Bloomberg Businessweek, June 4, 2010.

[11] Hiroko Tabuchi, *Investors Sell as Japan Airlines Nears a Bankruptcy Filing*, N.Y. Times, Jan. 12, 2010.

[12] *Japan Aviation Policy Under a Kan-Do Government: Bureaucracy the Stumbling Block to a New Future*, Centre for Asia Pacific Aviation, June 17, 2010.