

Eastern Air Lines Bankruptcy Case
The Financial Statements Tell the Whole Sad Story!
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Objective:

To examine the dynamic evolution of the Eastern Air Lines (EAL) chapter 11 bankruptcy case as reflected in EAL's reported financial statements. This case demonstrates some of the main features of financial reporting during a Chapter 11 reorganization process, while powerfully illustrating pitfalls associated with bankruptcy reorganization.

In the midst of severe conflict with its labor unions, EAL filed a voluntary bankruptcy petition on March 9, 1989. Between March 1989 and its ultimate demise into Chapter 7 liquidation in January 1991, EAL operated under Chapter 11 Bankruptcy protection. During this time, the company attempted to reorganize its operations under the supervision of the bankruptcy court and its appointed trustee.

Analysis Questions:

1. Peruse the 1989 and 1990 balance sheets. Note that the total assets of EAL shrank significantly between 1989 and 1990. Look also at the section entitled "Cash Flow Provided by Investing Activities" in EAL's 1989 and 1990 Statement of Cash Flows, and notice the cash from dispositions of assets. What do these facts tell you about what is going on at EAL over this period? At 12/31/1990 how much does EAL owe to "pre-petition" creditors?
2. Consider next EAL's income statements and statements of cash flows. Operating profits in 1989 and 1990 are hugely negative and EAL's operations are consuming significant amounts of cash (i.e., Net cash *used* for operating activities). How did EAL finance these large negative cash flows from operations?
3. Find on the balance sheet the item entitled Restricted Investments. What do these investments represent? Using the balance sheet and cash flow statement, track the changes in the account (deposits and withdrawals) from January 1989 to 12/31/90. How much was released to meet EAL's working capital needs?
4. How much did EAL pay in "lawyer and accountant fees" in 1989 and 1990?

EASTERN AIR LINES, INC. BALANCE SHEETS (In thousands of dollars)

	December 31,	
	1990	1989
Current Assets:		
Cash and other bank deposits	\$ 18,351	\$ 4,211
Temporary cash investments	76,195	82,537
Total cash and cash equivalents	94,546	86,748
Restricted investments	791,954	574,903
Accounts receivables, less allowance for doubtful receivables of \$10,000 and \$4,000	253,184	312,650
Spare parts and supplies, less allowance for obsolescence of \$97,395 and \$97,590	135,341	136,066
Prepayments and other	42,107	39,392
Total current assets	1,317,132	1,149,759
Accounts receivable, net	138,785	148,655
Deposits	84,925	122,750
Operating property and equipment:		
Flight Equipment	817,860	1,016,697
Other	357,362	468,792
Less: accumulated depreciation	397,932	361,556
	777,290	1,123,933
Capital leases:		
Flight equipment	607,277	645,290
Other	13,787	24,310
Less: accumulated amortization	248,708	204,794
	372,356	464,806
Flight equipment	-	86,986
Less: accumulated depreciation and amortization	-	17,189
	-	69,797
	1,149,646	1,658,536
Other assets:		
Slots	12,238	27,168
Routes	-	12,542
Other	1,027	82,465
	13,265	122,175
	<u>\$2,703,753</u>	<u>\$3,201,875</u>

EASTERN AIR LINES, INC.

LIABILITIES, NON-REDEEMABLE PREFERRED STOCK AND COMMON STOCKHOLDER'S EQUITY

	December 31,	
	1990	1989
Current liabilities:		
Current portion of debt	\$ 1,675	\$ 568
Accounts payable	270,677	176,977
Air traffic liability	118,270	142,637
Accrued payroll, pensions and related costs	236,461	48,104
Accrued taxes	8,569	32,062
Accrued other liabilities	47,268	50,690
Total current liabilities	682,920	451,038
Liabilities subject to compromise	3,807,049	3,503,350
Debt	8,436	8,077
Deferred credits and other liabilities	108,130	39,434
Commitments and contingencies		
Redeemable preferred stock:	403,567	406,383
Non-redeemable preferred stock and common stockholder's equity:		
20% Participating Noncumulative Convertible Preferred Stock--2,383,687 shares issued and outstanding (liquidation preference \$206,594)	8,545	8,545
Common Stock, par value of \$1.00 per share Authorized--150,000,000 shares		
Issued and outstanding--72,518,913	72,519	72,519
Capital in Excess of Par Value	238,637	235,837
Accumulated Deficit	(2,626,050)	(1,523,308)
	(2,306,349)	(1,206,407)
	<u>\$2,703,753</u>	<u>\$3,201,875</u>

EASTERN AIR LINES, INC. STATEMENTS OF OPERATIONS (In thousands of dollars)

	<u>Years ended December 31,</u>		
	1990	1989	1988
Passenger	\$1,970,809	\$ 1,370,698	\$ 3,509,793
Cargo and mail	59,396	49,091	131,991
Other, net	100,785	78,317	164,314
Total operating revenues	2,130,990	1,498,106	3,806,098
Operating expenses:			
Wages, salaries	736,526	729,060	1,478,915
Aircraft fuel	477,468	268,672	576,413
Rentals and landing fees	194,802	175,580	202,200
Commissions	181,417	138,751	303,442
Aircraft maintenance materials and repairs	167,304	107,495	204,069
Passenger food and supplies	103,676	69,681	124,708
Advertising and promotional	99,085	60,610	100,328
Depreciation and amortization	201,001	254,647	318,310
Other	503,065	558,331	707,150
Total operating expenses	2,664,344	2,362,827	4,015,535
Operating loss	(533,354)	(864,721)	(209,437)
Interest and debt expense	(225,454)	(322,933)	(300,711)
Interest income	33,215	53,256	59,997
Gain on disposition of property and equipment	-	16,072	126,657
Provision for pilot back pay and displacement	(11,400)	(65,514)	-
Other, net	(3,267)	23,007)	(11,857)
Total nonoperating income (expense)	(206,906)	(342,126)	(125,914)
Reorganization income (expense) items:			
Interest income	64,892	21,090	-
Gain on disposition of property and equipment	347,900	543,309	-
Pension settlement costs	(284,807)	(117,967)	-
Expenses relating to Chapter 11 proceedings	(32,090)	(36,931)	-
Severance and notice pay	(109,300)	-	-
Asset write down	(21,491)	(54,969)	-
Termination of frequent flyer program	(350,752)	-	-
Total reorganization income (expense)	(385,648)	354,532	-
Net loss	<u>(1,125,908)</u>	<u>(852,315)</u>	<u>(335,351)</u>

EASTERN AIR LINES, INC. STATEMENTS OF CASH FLOWS (Excerpts)
(In thousands of dollars)

Years ended December 31,

	1990	1989	1988
Net cash used for operating activities	(352,700)	(491,492)	(26,281)
Cash Flows Provided by Investing Activities:			
Proceeds from the disposition of assets, net	754,525	862,237	394,872
Decrease in marketable securities	-	1,500	199,193
Cash deposited into restricted investments	(730,240)	(784,903)	-
Withdrawals of cash from restricted investments	475,000	210,000	-
Withdrawn from restricted investments for debt payment	38,189	-	-
Cash received on notes receivable	8,425	43,412	16,016
Acquisition of property and equipment	(40,161)	(41,425)	(62,519)
Reimbursement of capital improvements	10,000	-	-
Issuance of notes receivable	-	-	(57,074)
(Increase) Decrease in cash deposits	9,818	28,449	(47,034)
Net cash provided by investing activities	525,556	319,270	443,454
Net cash used in financing activities	(165,058)	(121,200)	(148,623)
Net Increase (Decrease) in Cash and Cash Equivalents	7,798	(293,422)	268,550
Cash and Cash Equivalents at January 1	86,748	380,170	111,620
Cash and Cash Equivalents at December 31	\$ 94,546	\$ 86,748	\$ 380,170
Cash Payments For:			
Interest paid	\$ 77,203	\$ 154,363	\$ 266,896

1 - Chapter 11 Reorganization

On March 9, 1989, Eastern Air Lines, Inc. ("Eastern") filed a voluntary petition in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") seeking to reorganize under Chapter 11 of the Federal Bankruptcy Code (the "Code"). The filing for protection under the Code was necessary due to Eastern's inability to continue substantial operations as a result of the refusal by most of Eastern's pilots, represented by the Air Line Pilots Association ("ALPA"), to report to work since the commencement on March 4, 1989 of the strike against Eastern by Employees represented by the International Association of Machinists and Aerospace Workers (the "IAM").

From March 9, 1989 until April 18, 1990, Eastern was operated as a debtor-in-possession under the Code. On April 19, 1990, the Bankruptcy Court appointed a Trustee to replace the debtor-in-possession and to operate Eastern as a going concern and to explore a viable business plan. The Trustee has all the powers of the Management and Board of Directors to operate and manage Eastern's business, but may not engage in transactions outside of the ordinary course of business without approval, after notice and hearing, of the Bankruptcy Court. Since the appointment of a Trustee, the Board of Directors of Eastern no longer controls the business and operations of Eastern.

Throughout 1990, Eastern continued to incur substantial losses which significantly drained its cash reserves. Eastern's operations, particularly its efforts to attract business passengers, continued to be adversely affected by the uncertainties generated by the bankruptcy proceeding, including questions concerning Eastern's continued viability. In addition, hostilities in the Middle East, which began in August 1990, resulted in a significant increase in jet fuel costs as a result of the increase in crude oil prices. Eastern's revenues, particularly for December 1990 and early January 1991, were significantly less than anticipated and accordingly, its ability to rebuild and continue operations as a viable airline was materially adversely affected. Therefore, to protect its assets from further losses, Eastern ceased operations on January 18, 1991 and commenced an orderly liquidation of its assets under Chapter 11 of the Code.

The following table summarizes estimated liabilities subject to Chapter 11 reorganization proceedings as of December 31 (in thousands):

	1990	1989
Debt	\$1,505,697	\$1,592,991
Capital lease obligations	560,159	673,765
Accounts payable	617,694	392,775
Air traffic liability	49,068	69,020
Accrued payroll and other	144,194	167,330
Allowed PBGC pension claim	565,000	-
Accrued pension	18,993	382,456
Accrued taxes	22,176	13,799
Accrued interest	308,134	194,950
Accrued other liabilities	15,934	16,264
	\$3,807,049	\$3,503,350

In addition, other substantial claims have been submitted and may require significant litigation to resolve. Under the Code, Eastern is required to pay substantial legal and professional expenses associated with Chapter 11 proceedings. Since the commencement of the Chapter 11 proceedings, Eastern has expensed \$69.0 million, of which \$32.1 million was expensed during 1990. As of December 31, 1990, \$21.1 million of these expenses have not been paid pursuant to a court order requiring hold back of a portion of legal and professional fees.

Effective January 1990, Eastern ceased accruing interest on its pre-petition unsecured debt. Eastern continues to accrue interest on secured debt.

5 - Leases

Eastern leases certain aircraft and other assets under long-term leasing arrangements which are recorded as capital leases. Although generally no payments can be made with respect to outstanding debt issues until the Bankruptcy Court has approved a plan of reorganization, Section 1110 of the Code provides special treatment for aircraft lenders and lessors with certain purchase money security interests in the aircraft, permitting them to obtain possession of such aircraft if payments are not made when due. As part of the liquidation process, all leases are currently under review for rejection or assignment of contractual interests to third parties. As of March 26, 1991, 56 aircraft leases have been assigned or rejected, resulting in 18 aircraft being returned to the lessors. Obligations (subsequent to date rejection), if any, that may be incurred due to the rejection of leases would be considered unsecured claims.

8 - Restricted Investments

At December 31, 1990, \$792.0 million of restricted investments were held in segregated accounts for the benefit of secured and unsecured creditors. These funds include cash generated from asset sales, rental income from aircraft leased out to third parties and interest income earned on such restricted investments. Application of these funds for use by Eastern for working capital purposes, to pay down debt related to asset dispositions, and to satisfy unsecured creditor claims is subject to approval of the Bankruptcy Court. During 1989 and 1990, Eastern obtained the release of \$685.0 million from its restricted accounts for working capital purposes.

12 - Transactions with Continental Holdings and Subsidiaries

Through a joint venture agreement which was finalized in September 1988, Eastern and Continental operated a combined frequent traveler program known as One Pass. The joint venture agreement contained a termination clause in the event of cessation of service by one of the parties, whereby the party which ceased operations would be liable to other party for the remaining mileage credits it would have to satisfy by itself. Based upon the formulas in the termination clause, Eastern recorded a \$370 million liability to Continental in December 1990, of which \$266.0 million was considered pre-petition and \$104.0 million was considered a post-petition liability.