PART 3

DEAL TYPES, STRUCTURES AND ENHANCEMENTS

Introduction: basic transaction types

Aircraft Finance transactions come in many shapes and sizes but, fundamentally, they are either a lease financing or a mortgage financing (or some combination thereof). These two fundamental prototypes can be summarized as follows.

Lease Financing

The airline/operator of an Aircraft Asset (lessee) does not own the asset but borrows it from a third party who does own it (lessor) for a period of time (lease term) during which the lessee will have the right to possession and use of such asset in exchange for rent, and at the end of the lease term the airline/operator must return that asset to the lessor. While leases may be Operating Leases or Finance Leases (which are disguised Mortgage Financings), for the purposes of this book we are treating a ‘Lease Financing’ as a financing with the characteristics of an Operating Lease, where the lessor is treated as the true owner of the Aircraft Asset; that is, see ‘Finance/Capital Lease’, for an extensive discussion of the Finance Lease versus Operating Lease criteria determinants and see Exhibit 3.1 for a schematic depiction of a Lease Financing.¹

Mortgage Financing

The owner of an Aircraft Asset (whether a lessor or airline/operator) borrows money from lenders to finance or refinance the purchase price (or value) of that asset and the lenders receive a Security Interest in that asset as collateral to secure repayment of the related loan. A Mortgage Financing includes a Finance Lease where the lessor is treated, not as an owner, but rather as a mortgagee. See Exhibit 3.2 for a schematic depiction of a Mortgage Financing.

The variations on these two prototypes keep Aircraft Financiers rather busy. Financings may involve multiple jurisdictions to take advantage of different tax regimes; they may involve public or privately placed securities to achieve the best pricing; they may be placed in the capital markets or the commercial bank/loan market; they may involve a single Aircraft Asset, or many of them; and they may be subject to airline or lessor risk or have the support of an Export Credit Agency (ECA).

Ultimately, the structure choice of Lease Financing or Mortgage Financing is determined by the operator in its ‘lease versus own’ analysis. The following criteria will have a hand in the operator’s decision.
Exhibit 3.1 Lease Financing
Source: Author’s own

Exhibit 3.2 Mortgage Financing
Source: Author’s own
• Operational flexibility.
• Cost:
  ◦ lease rates versus debt rates; and
  ◦ ability to take advantage of tax benefits.
• Residual risk:
  ◦ long-term view of asset value appreciation;
  ◦ risk appetite;
  ◦ view on emergence of new aircraft models and technology;
  ◦ view on current and future aircraft needs (‘lift’) and gaps (taking into consideration its own order book);\(^2\)
  ◦ future maintenance costs;
  ◦ perceived future availability of asset model from other sources; and
  ◦ Original Equipment Manufacturers (OEM) order book for future deliveries generally.
• Corporate policy:
  ◦ keep fleet ‘young’;\(^3\)
  ◦ interest in de-leveraging (in a Lease Financing, the lessor would be the one to bear the burden of debt financing); and
  ◦ accounting policy to minimize on-balance sheet debt.\(^4\)
• Technological advancements:
  ◦ cheaper maintenance for newer models;
  ◦ better fuel burn for newer models; and
  ◦ ability to retrofit these advancements on older models (for example, Winglets).
• Access to capital:
  ◦ debt markets;
  ◦ equity markets; and
  ◦ lessor markets.
• Tax:
  ◦ ability to take advantage of tax benefits available to an owner (for example, depreciation).

In this Part of the Handbook, the various structures used to finance Aircraft will be reviewed as well as different features that may be appended onto these structures.

**Placement**

Prior to delving into the various transaction structures, a word should be said about the *placement* of Aircraft Finance transactions in the financial markets. There are two considerations here: (i) the identity of the purchasers of the financing; and (ii) the nature of the placement itself.

**The Purchaser**

While the previous discussion largely revolved around the needs of the airline/operator, the other side to these matters is making sure the needs of the purchaser
of the Aircraft Finance security are similarly satisfied. These purchasers can be broken down into two groupings:

1. the third party equity, being the lessor/owner in a transaction; and
2. the debt.

**EQUITY**

In lease financings, there will be an equity component. The purchaser of the metal, the person who would become the lessor/owner of the Aircraft Asset, is driven by its interest in the operating business of leasing and obtaining: (i) residual returns; (ii) current cash flow (rent); and/or (iii) tax benefits. Its economic return requirements based on these three criteria must be satisfied, taking into account the following (non-comprehensive) set of risks associated with any Aircraft Finance transaction (‘Risk Factors’).

- Lessee performance (and other credit support providers) (credit risk).
- Aircraft asset value stability (technological developments, obsolescence, life cycle, secondary markets, and so on) (residual value).
- Jurisdictional issues (ability to enforce/repossess – country risk) (legal).
- Airline industry performance (local and international; terrorism, SARS, and so on).
- Economy performance (local and international).
- Airline regulatory developments (airworthiness directives (ADs), noise rules and so on).
- Fuel costs.
- Change-of-law/accounting rules.

Of course, the longer the lease term, the greater the chance that any of these Risk Factors might surface into a problem, thus the tenor of a transaction will have a tremendous bearing on risk assessment (and, accordingly, return requirements).

Investors in Aircraft Asset equity include:

- traditional operating leasing companies (AerCap, GECAS, ACG, and so on);
- specialized operating leasing companies (Vx, Apollo, Compass Capital, and so on);
- tax-play investors (for example, MetLife);
- hedge and private equity funds (Strategic Value Partners, Fortress, Wayzata, and so on);
- finance companies (for example, Siemens Credit);
- banks (for example, SMBC); and
- pension plans.

The longer term trends show Aircraft leasing to be on the rise. Approximately 40 percent of new Aircraft deliveries are funded by Operating Lease Finance. The investor pool is constantly expanding as investors from all of the sectors described...
above are looking for the ‘next big opportunity’, with Aircraft ownership and leasing an increasingly visible opportunity. The historically strong performance of commercial aircraft investments should continue to attract sufficient equity (and any necessary leverage).\(^5\)

**DEBT**

In Back-leveraged Lease financings and in mortgage financings there is a requirement for debt. Providers of debt have more simple criteria than equity for assessing their return which is primarily covered by: (i) up-front fees; and (ii) interest earnings. The economic return requirements of debt providers will necessarily factor in the Risk Factors spelt out above and, similarly, the tenor of a transaction will have a bearing on the risk assessments and return requirements. Investors in Aircraft Asset debt components include:

- commercial banks;
- non-bank lenders: insurance companies, finance companies, pension plans and funds (for example, Fidelity);
- public debt/capital markets;
- ECAs (directly or through guaranteed-debt); and
- OEMs.

The interest of these equity and debt participants in Aircraft Finance rise and fall with market developments and cycles. Boeing Capital, in their annual ‘Current Aircraft Finance Market Outlook, 2013–2017’ provides a useful snapshot of the current trend lines for the various Aircraft Finance funding sources; see www.boeingcapital.com/cafmo/.

**Distribution; securities laws**

While placement of the equity component is typically a straightforward matter of private contract law, the distribution of the debt component will require an examination of the securities laws. In the U.S., the securities laws (primarily the Securities Act of 1933, as amended (the ‘Securities Act’)) covers the offer and sale of any, *inter alia*, debt security, and, absent an exemption, requires the preparation and filing with the SEC of a registration statement in respect thereof (which is a rather costly undertaking that requires both public disclosure and ongoing compliance obligations) for any offer and sale of such security. Here is a list of the primary debt placement options and their relationship to the Securities Act.

- Bank financing – bank loans are not a security covered by the Securities Act, so may be placed without a registration statement.
- Rule 144A Financing – Rule 144A is a rule of the SEC that allows an exemption to registration for resales of debt securities to institutional investors previously acquired in a private placement. Such institutional investors must be Qualified Institutional Buyers (defined below). Holders and prospective purchasers of Rule 144A-placed securities must have the right to obtain from the issuer, upon request, certain bank information about
the issuer and the securities. For this reason, in a Rule 144A transaction, there is often drafted an offering memo describing the transaction.

- Private placement – under Section 4(a)(2) of the Securities Act, the obligation to register the offer and sale of securities does not apply to transactions by an issuer not involving a public offering. The SEC adopted Regulation D under the Securities Act to provide guidance as to what would constitute a private placement. Regulation D has varying criteria for exemption depending on the size of the offering. Rule 506 of Regulation D under the Securities Act is the particular private placement exemption that most Aircraft-secured debt securities would utilize because there is no limit on the dollar amount that may be raised under Rule 506. To have a valid private placement under Rule 506: (i) investors must be Accredited Investors (defined below); and (ii) neither the issuer nor any person acting on behalf of the fund may offer or sell interests in the fund by any form of general solicitation or general advertising.

- Government-guaranteed securities – Section 3(a)(2) of the Securities Act exempts securities guaranteed by the U.S. Insofar as U.S. Ex-Im-guaranteed transactions (see ‘ECA Financings’) have the full faith and credit of the U.S. standing as guarantor, the related securities sold to investors are not subject to the registration requirements of the Securities Act.

- Registered offering – while, as noted above, there are significant expenses and ongoing compliance obligations for registered offerings, investors provide to issuers pricing benefits if a security is registered, since the registration significantly enhances the liquidity of the security (as offerings and sales of debt securities in secondary market trades are similarly subject to securities laws restrictions). Issuers of debt securities who are already ‘reporting companies’ under the Securities and Exchange Act of 1934, as amended (for example, companies that are publicly traded and which, accordingly, regularly make filings with the SEC) have already in place the mechanisms for their initial disclosure and ongoing compliance requirements, so many of these issuers will take the extra steps to have their debt securities registered. For this reason, many of the Enhanced Equipment Trust Certificates (EETCs) issued by U.S. publicly-traded airlines are registered.

The placement of Aircraft Asset-backed securities in the financial markets is not without aspects of financial engineering. Investment bankers and others tasked with this placement slice and dice the securities to minimize yields by tranching the debt so as to appeal to different investors’ risk, yield and tenor appetite. It would not be unusual to see, for example, an EETC security structured as follows:

- Senior A Tranches:
  - A-1 – amortizing over 12 years;
  - A-2 – bullet maturity in year 7; and

- Junior B Tranche.
Each Tranche, then, is targeted to the needs of particular investors, thus expanding the market and optimizing yields for the issuer.

Balance of supply and demand

In the light of the foregoing review, we see that the need for Aircraft finance is, practically speaking, driven by the ‘lift’ needs of the airline/operators. Their need for Aircraft Assets drives the need to find the means for financing these expensive assets. The need for financing – the demand side of the equation – must, then, be satisfied by a supply of financing sources. Whether the supply and demand are in balance – whether there is enough product to supply the needs of Aircraft Financiers, and whether there is enough available financing to meet the needs of the airlines (and lessors) – is not always assured. On the one hand, there are times when Aircraft Financiers are bemoaning the fact that there are not enough deals out there; airlines and lessors may be paying (gasp!) cash\(^7\) or turning to the capital markets for funding. On the other hand, there may be an overall lack of liquidity in the markets due to market developments, much as there was in 2008, 2009 and 2010 following the Lehman Brothers crash and resulting financial tailspin. In the aftermath of that market crash, a number of major international banks disbanded their aircraft finance teams and left the sector while other banks went on a lending ‘hiatus’ or had vastly reduced lending budgets. This phenomenon was the result of a number of factors:

- banks were looking to preserve capital, so as to minimize the addition of further liabilities at a time when their balance sheets are already rather stressed;
- banks were being cajoled, or even forced, by their new taskmasters and owners (that is, national and state governments) to redirect their available liquidity to local businesses and industries; and
- banks were having difficulty accessing capital with which to make loans in the light of restrictive credit exposure limitations imposed by their funding counterparties.\(^8\)

The withdrawal of bank liquidity in the aircraft finance sector in the aftermath of the bank liquidity crisis led to much discussion as to whether there would be a ‘Funding Gap’; that is, will there be enough available funding sources to finance new deliveries (as well as to refinance those aircraft the financings of which mature)?\(^9\) The bottom line to the ‘funding gap’ debate is usually the question as to what degree the ECAs and the manufacturers\(^10\) will step up to fill the gap so as to avoid, for new deliveries, the prospect of whitetails in the desert. In fact, in the aftermath of the 2009 funding crisis, the ECAs and the remaining market participants stepped up and no Funding Gap materialized. ECAs fill funding gaps in one of two ways. First, they can support with bank guarantees an increasing number of aircraft exports so as to tap the pool of ECA banks (which seem to have faced a less severe liquidity cutback than banks that are asset-based lenders). Second, some of the ECAs can issue loans on a direct basis if ECA banks are not willing to step up to the plate at competitive pricing (or at all). Importantly, the ECA financings can only support
exports. So, due to that fact and agreements that exist among the ECAs, ECA financing is not available for purchasers/users of commercial aircraft located in the U.S., France, Germany, Spain or the UK (see Part 7, ‘Aircraft Sector Understanding’). This lack of availability of ECA financing partially explains why airlines in these jurisdictions are more apt to turn to the capital markets.

Prospects
In the light of the foregoing, then, what are the industry prospects for these various debt funding sources?

ECA Financings
As discussed in ‘Export Credit Agency (ECA) Financing’, the ECA-guaranteed loan product remains an important source of Aircraft Financing, covering some 23 percent of new Aircraft Financings. The increasing usage of the capital markets to fund these (primarily U.S. Ex-Im) financings for both airlines and lessors. However, with the Aircraft Sector Understanding (ASU) rules requiring ECA financings to more closely approximate private market pricing, there will likely be a tail-off of usage for this financing source.

Bank Financings
With a number of years now having passed since the bank liquidity crisis of 2008–2009, the commercial bank market has become increasingly robust in appetite. While a number of European banks (especially German landesbanks) have permanently exited the market, the remaining European (primarily French and German) banks and the U.S. banks are being joined by new (or returning) market entrants from commercial banks in Japan, Australia, the Middle East and (in the case of financing Chinese airlines) China. Commercial banks currently fund approximately 28 percent of new Aircraft deliveries.11

Capital Markets
The prognosis for continued availability of Aircraft Financing in the capital markets is similarly positive. The EETC market continues to be strong, and that market’s liquidity and improving pricing remains an important feature. In addition to airlines (who are accessing the capital markets with EETCs), lessors should continue to evolve their use of the capital markets through Collateralized Lease Obligations (CLO) type structures. The expansion of lessor penetration into the capital markets will need to coincide with an evolution of the credit rating agencies’ understanding of the aircraft leasing business and the development of rational and consistent rating criteria for aircraft lessors. Rating agencies also have a role in introducing non-U.S. airlines to the efficiencies of capital markets financing and shaping the market for international EETCs relying on the Cape Town Convention.12 While the U.S. capital markets are expected to continue to be the primary market for the origination and syndication of aircraft public debt, regional capital markets may start to play a growing role. The capital markets fund approximately 14 percent of new Aircraft deliveries.13
Non-bank Financing
Non-bank debt investors in Aircraft Finance are most prevalent in the purchasing of capital markets products. However, they are increasingly looking at this sector on a private basis for improved yields and palatable risk levels. This investor pool is constantly expanding, with Aircraft Finance investing an increasingly visible opportunity. The historically strong performance of commercial aircraft investments should continue to attract new investors to this sector, especially in the secondary markets (post-delivery) and with used Aircraft (which will provide stronger yields).

Original Equipment Manufacturers
OEM financing support has not played a significant role in recent years, although many purchasers do require OEMs to provide ‘back-stop’ financing for new order deliveries. This means that the OEM will agree to finance its Aircraft on delivery on specified conditions if the purchaser is not able to source financing on its own or is not able to finance the Aircraft at desired commercial terms.

Secondary market trading
The conversation on placement of Aircraft Asset-backed securities would not be complete without saying a word about secondary market trading. Trading these securities is subject to the securities laws rules, so, absent a registered security, one of the exemptions touched on above would need to be utilized. The trading of these securities has historically been rather light following initial placement, since the investors are usually making their initial acquisitions to fill a need in their portfolios. However, if there are (usually bad) market developments, there is often a rush to the exits, since many investors have internal policies on the holding of distressed securities. The obvious example of this is when a U.S. airline issuer enters bankruptcy. At the early stages of a bankruptcy, when there is tremendous uncertainty about the ultimate exit or exit strategy for the airline, these debt securities may sell at a deep discount. Hedge funds and other investors with a high risk tolerance (and a (hopefully) savvy market view) often snap up these securities at these times, looking to maximize value once the airline’s exit strategy settles down. As well, these investors may buy the securities: (i) to negotiate with the debtor Section 1110(b) agreements (see Part 8, ‘Section 1110’) so as to restructure a transaction; (ii) to cash in on the Deficiency Claim aspects on these securities as the market stabilizes; and (iii) to acquire Aircraft Assets on the cheap.

The buyer of these distressed securities may, accordingly, end up with three items of value:

- a restructured lease with the debtor (with associated rent cash flow);
- deficiency claims; and
- the residual value of an Aircraft Asset at its lease termination.

Each of these items is subject to monetization in different ways: the Leases can be backleveraged or sold; the Deficiency Claims can be traded; and the Aircraft Assets can be sold on a current or forward basis. Mind you, the ability to be in a
position to so monetize these assets may require Foreclosure (discussed in detail under Part 8, ‘Foreclosure’) and the taking of other enforcement action.

**U.S. dollar supremacy**

Aircraft Finance transactions are almost universally done in U.S. dollars. The primary reason for this is that Aircraft Assets are priced and traded exclusively in U.S. dollars. With transactions priced in this fashion: (i) airlines which operate in non-U.S. dollar environments (and whose revenue is earned in other than U.S. dollars) need to take into consideration currency risks on U.S. dollar-denominated liabilities such as leases and mortgage financings; and (ii) financiers who would normally fund themselves in non-U.S. dollars must likely either hedge their exposure to U.S. dollar-denominated assets or obtain funding from U.S. dollar sources.

**Repossession risks**

Finally, a word about repossession risks. Aircraft Finance is necessarily a discussion about asset-based financing where the fact that there is a valuable asset standing behind the obligation of a debtor is critical. The ability to repossess the financed Aircraft Asset, then, is of utmost importance in a distress situation. Section 1110 of the U.S. Bankruptcy, and comparable provisions under Cape Town, accordingly, are highly important features for Aircraft Financiers’ assessment of repossession risk. The availability of these legal rights (or lack thereof) in any particular jurisdiction will, therefore, greatly color the view of Aircraft Financiers on doing business in that jurisdiction and acquiring any associated securities. The robustness of the U.S. EETC market is largely owing to the availability to the financiers of Section 1110 rights in respect of the financed Aircraft. See Part 8 for a discussion of repossession and other risks associated with defaults.

**AFIC**

Aircraft Finance Insurance Consortium (AFIC) is a credit insurance product developed by Marsh Aviation Aerospace Practice, an affiliate of Marsh & McLennan Companies, for financiers providing financing to operating lessors and airlines acquiring Boeing-manufactured aircraft. AFIC is intended to replicate, in large part, the credit support provided by U.S. Eximbank in its traditional support arrangements for Boeing-manufactured aircraft. This product was launched, for among other reasons, to provide an alternative to U.S. Eximbank financing support due to the freezing of U.S. Eximbank’s export support programs because of political disputes over matters of U.S. Eximbank’s role in the economy and corporate welfare concerns.

The AFIC product is a non-payment insurance policy; that is, it will pay the insured financier if the obligor under the related aircraft financing fails to make payments when due. The AFIC insurance policy is underwritten by international insurance companies that are affiliates of Allianz, Axis and Sompo International. These underwriting arrangements are on a several basis. Thus, an insured taking this policy is assuming credit risk of each of the underwriting insurance companies
– the individual underwriters do not backstop the underwriting obligations of the other underwriters. Insofar as the credit of the insurers is inferior to that of the U.S. government, combined with the risk inherent in the ‘several liability’, the insureds may have a greater interest in the aircraft collateral than they do in a U.S. Eximbank transaction.

At the time of this writing, the AFIC product is fairly new to the market, so it is difficult to ascertain how successful it will be at this stage. We would anticipate that Airbus will seek to replicate this product as an alternative to European ECA-supported financing transactions for Airbus aircraft.

**Asset-backed Securities (ABS)**

Asset-backed Securities (ABS) are issued in the private and capital markets secured by assets and lease (or debt) cash flows. The predominant forms of ABS in the realm of Aircraft Financing are transactions structured as CLOs and Collateralized Debt Obligations (CDOs). EETCs are not typically characterized as ABS since they are highly reliant on the single issuer credit (in addition to the Aircraft Asset collateral security).

**Aircraft, Crew, Maintenance and Insurance (ACMI)**

Aircraft, Crew, Maintenance and Insurance (ACMI) is a form of Wet Lease. The operator/lessor provides ACMI for the lessee. This arrangement is most prevalent in the cargo market.

**Back-leveraged Lease**

This is an Operating Lease which, together with its related Aircraft Asset, is collaterally assigned-mortgaged by a lessor in favor of an Aircraft Financier as security for a loan. The Debt Service requirements under such loan are serviced by the rentals under such Operating Lease, see Exhibit 3.3. Insofar as such rentals may not be sufficient to repay such loan, the related Aircraft Asset may need to be sold to pay off any resulting Balloon (and most Back-leveraged Lease facilities are Non-recourse). A Finance Lease is not well suited for a back-leveraging insofar as the ‘lesser’ (borrower) has no equity interest in the asset; accordingly, among other things, there can be no Balloon exposure (unless there is a matching balloon-type payment under the Finance Lease), and there is no ‘equity cushion’.

From an airline’s perspective, back-leveraging of an Aircraft should not be cause for too much concern as, other than a redirection of rental payments and amendments to the insurance certificates, the relationship between the operating lessor and the airline remains unaltered. However, that could change if the lessor defaults, if the airline defaults, or if the lessor does not refinance the debt balloon. In each case, the lender may be taking management of the lease and Aircraft away from the operating lessor. As a result, the airline may lose the operating lessor as a business partner with whom it has a larger relationship and for which waivers, workouts or management of Aircraft returns might yield a different result than with
a new lessor (the lender) which has a different agenda. Of course, the ultimate identity of a lessor is never fixed as lessors always retain the right to trade their Aircraft positions. In addition, tapping bank financiers or the capital markets for the back-leveraging of Aircraft may absorb credit capacity that the same airlines wish to use for other bilateral or capital markets transactions. Finally, airlines should be mindful that certain ‘bankruptcy remote’ protections might conflict with the airline’s interest to have the operating lessor guarantee the obligations of the lessor.

PRACTICE NOTE

Financiers taking Balloon risk in Back-leveraged Lease deals must be prepared to take over the asset and the lessor should be advising the financier in a timely manner if it is walking away from the asset so that the financier can prepare for potential repossession and remarketing at Lease maturity.

Bankruptcy Remote

This is a transaction using a Special Purpose Vehicle (SPV) that is structured in a manner to protect the financing from the bankruptcy of the originator, sponsor or servicer of the financed assets (see ‘Securitization’) or the entity that owns the entity that owns the financed assets. Transactions are characterized as Bankruptcy Remote rather than bankruptcy proof since there is no way to ensure 100 percent bankruptcy-proof protections (especially in the light of the fact that bankruptcy courts are courts of equity).
Collateralized Debt Obligation (CDO)

Collateralized Debt Obligations (CDOs) are a type of structured asset-backed security, substantially similar to a CLO described below, with the primary difference being that the CDO securitizes debt obligations (that is, principal and interest debt service) and the CLO securitizes lease obligations (that is, rent).

An Aircraft Finance-related CDO, then, is the Securitization of multiple Aircraft-secured loans/bonds into a single facility. The principal and interest on the debt underlying the security is paid back to the investors regularly from the cash flow of the assigned equipment notes. Exhibit 3.4 displays a traditional CDO structure.

In a CDO, the originator assembles the debt securities that it wishes to securitize. Once a suitably large portfolio of assets is assembled or ‘pooled’, they are transferred to an SPV (the issuer), a tax-exempt company or trust formed for the specific purpose

Exhibit 3.4 CDO Structure

Source: Author's own
of funding the assets. Once the assets are transferred to the issuer, there is normally no recourse to the originator. The issuer is designed to be Bankruptcy Remote.

Issuance
To be able to buy the debt securities from the originator, the issuer issues tradable securities to fund the purchase. Investors purchase the securities, either through a private offering (targeting institutional investors) or on the open market. Alternatively, this structure can be funded by bank lenders in the loan market. The performance of the securities is then directly linked to the performance of the assets. Credit rating agencies are often required to rate the securities which are issued as a matter of corporate policy (or regulatory necessity) for an investor, as well as to provide an external perspective on the liabilities being created and help the investor make a more informed decision.

The securities can be issued with either a Fixed Rate or a Floating Rate coupon, which will largely be driven by: (i) investor appetite for one or the other; and (ii) the nature of the cash flows (interest debt service) thrown off by the related loans.

Credit enhancement and tranching
Unlike conventional corporate bonds which are unsecured, securities generated in a CDO are ‘credit enhanced’, meaning their credit quality is increased above that of the unsecured debt of the obligor(s) of the underlying bundled debt obligations or the underlying asset pool. This enhancement is achieved by the availability of the Aircraft collateral, the related Loan to Value ratios (LTVs) and the other features described below. Such enhancements increase the likelihood that the investors will receive cash flows to which they are entitled or, at a minimum, recoupment of their principal investment on final maturity, and thus causes the securities to have a higher credit rating than such underlying obligor(s). Some Aircraft Finance CDOs use external credit enhancement provided by third parties, such as a Liquidity Facility.

Many Aircraft CDOs benefit from asset/obligor/geographic diversification, which are reflected in Concentration Limits (see Part 13, ‘Concentration Limits’) which seek to protect this diversity.

Individual securities issued by the CDO SPV are often split into Tranches, or categorized into varying degrees of subordination. Each Tranche has a different level of credit protection or risk exposure than another: there is generally a senior (‘A’) class of securities and one or more junior subordinated (‘B’, ‘C’ and so on) classes that function as protective layers for the ‘A’ class. The senior classes have first claim on the cash (including the proceeds from the liquidation of Aircraft Asset collateral) that the SPV receives, and the more junior classes only start receiving repayment after the more senior classes have been repaid. This cascade is effected through the Waterfall. In the event that the underlying loan pool generates insufficient debt service to make payments on the securities, the loss is absorbed first by the Subordinated Tranches, and the upper-level Tranches remain unaffected until the losses exceed the entire amount of the Subordinated Tranches.20

The most junior class (often called the equity class) is the most exposed to payment risk. In some cases, this is a special type of instrument which is retained
by the originator as a potential profit flow. In some cases, the equity class receives no coupon (either fixed or floating), but only the residual cash flow (if any) after all the other Tranches have been paid. In addition to Subordination, credit may be enhanced through a reserve account, in which funds remaining after expenses such as principal and interest payments, charge-offs and other fees have been paid-off are accumulated, and can be used when debt service on the CDO exceeds the SPV’s income.

A CDO may employ a Servicer to collect payments, to monitor the assets that are the subject of such Securitization and to provide remarketing and re-deployment services if the Aircraft are subject to return (due to scheduled or early (default) termination situations). A Servicer may be less likely in a CDO as compared with a CLO since the underlying debt securities typically used are full pay-out instruments, thereby minimizing redeployment risks.

PRACTICE NOTE
Securitizations may employ Turbo, Debt Services Coverage Ratio (DSCR) and LTV tests.

In contrast to a CLO where the investors have an opportunity to obtain value from the Aircraft Assets serving as collateral up to the entire value of those assets, the CDO investor is capped at the value of the underlying debt serving as collateral vis-à-vis the issuer thereof; with the airline or operator of whose debt is included in the CDO entitled to keep all of the equity in the Aircraft collateral.

Another difference with the CLO is that while the CLO would most likely have a diversity of underlying credits/lessees, CDOs may either have such diversity or may involve just a single credit (and, therefore, look more similar to EETC). In fact, CDOs are often masqueraded as EETCs to tap investor acceptability of that product, especially if Section 1110 or Cape Town remedies are available in connection with the underlying debt obligations.

Collateralized Lease Obligation (CLO)

A Collateralized Lease Obligation (CLO) is a type of structured asset-backed security, substantially similar to a CDO described above, with the primary difference being that the CDO securitizes debt obligations (that is, principal and interest debt service) and the CLO securitizes lease obligations (that is, rent).

An Aircraft Finance-related CLO, then, is the Securitization of multiple Aircraft leases packaged into a single facility. The principal and interest on the debt underlying the security is paid back to the investors regularly from the cash flow of the assigned lease rentals. Exhibit 3.5 displays a traditional CLO structure.

In a CLO, the originator, typically a leasing company, assembles the Aircraft Assets that it wishes to securitize. Once a suitably large portfolio of assets is assembled or ‘pooled’, they are transferred to an SPV (the issuer), a tax-exempt company or trust
formed for the specific purpose of funding the assets. Once the assets are transferred to the issuer, there is normally no recourse to the originator. The issuer is designed to be Bankruptcy Remote. Accounting standards govern when such a transfer is a sale, a financing, a partial sale, or a part-sale and part-financing. In a sale, the originator is allowed to remove the transferred assets from its balance sheet; in a financing, the assets are considered to remain the property of the originator. Because of these structural issues, the originator typically needs the help of an investment bank (the *arranger*) in setting up the structure of the transaction and placing the related securities.

**Issuance**

To be able to buy the Aircraft Assets from the originator, the issuer issues tradable securities to fund the purchase. Investors purchase the securities, either through a private offering (targeting institutional investors) or on the open market. Alternatively, this structure can be funded by bank lenders in the loan market as part of a loan (not securitization) facility.

The performance of the securities is then directly linked to the performance of the assets. Credit rating agencies are often required to rate the securities which are issued as a matter of corporate policy (or regulatory necessity) for an investor, as well as to provide an external perspective on the liabilities being created and help the investor make a more informed decision.

The securities can be issued with either a Fixed Rate or a Floating Rate coupon, which will largely be driven by: (i) investor appetite for one or the other; and (ii) the nature of the cash flows (interest debt service) thrown off by the related loans.

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**Exhibit 3.5** CLO structure

*Source: Author’s own*
Credit enhancement and tranching

Unlike conventional corporate bonds which are unsecured, securities generated in a CLO are ‘credit enhanced’, meaning their credit quality is increased above that of the unsecured debt of the obligor(s) of the underlying bundled lease obligations or the underlying asset pool. This enhancement is achieved by the availability of the Aircraft collateral, the related LTVs and the other features described below. Such enhancements increase the likelihood that the investors will receive cash flows to which they are entitled or, at a minimum, recoupment of their principal investment on final maturity, and thus causes the securities to have a higher credit rating than such underlying obligor(s). Some Aircraft Finance CLOs use external credit enhancement provided by third parties, such as a Liquidity Facility.

Many Aircraft CLOs benefit from asset/obligor/geographic diversification, which are reflected in Concentration Limits (see Part 13, ‘Concentration Limits’), which seek to protect this diversity.

Individual securities issued by the CLO SPV are often split into Tranches, or categorized into varying degrees of subordination. Each Tranche has a different level of credit protection or risk exposure than another: there is generally a senior (‘A’) class of securities and one or more junior subordinated (‘B’, ‘C’ and so on) classes that function as protective layers for the ‘A’ class. The senior classes have first claim on the cash lease rentals (including the proceeds from the liquidation of Aircraft Asset collateral) that the SPV receives, and the more junior classes only start receiving repayment after the more senior classes have been repaid. This cascade is effected through the Waterfall. In the event that the underlying lease pool generates insufficient debt service to make payments on the securities, the loss is absorbed first by the Subordinated Tranches, and the upper-level Tranches remain unaffected until the losses exceed the entire amount of the Subordinated Tranches.

The most junior class (often called the equity class) is the most exposed to payment risk. In some cases, this is a special type of instrument which is retained by the originator as a potential profit flow. In some cases the equity class receives no coupon (either fixed or floating), but only the residual cash flow (if any) and the residual value of the Aircraft Assets after all the other Tranches have been paid.

In addition to Subordination, credit may be enhanced through a reserve account, in which funds remaining after expenses such as principal and interest payments, charge-offs and other fees have been paid-off are accumulated, and can be used when debt service on the CLO exceeds the SPV’s lease rental income.

In a CLO, a Servicer is often engaged to collect payments, to monitor the assets that are the subject of such Securitization and to provide remarketing and redeployment services if the Aircraft are subject to a lease return (due to scheduled or early (default) termination situations). The servicer is often the originator, because the servicer needs very similar expertise to the originator (and the originator may be interested in the servicing fee income it charges for its undertaking of this role). The provision of these services is effected through a Servicing Agreement.
Credit Default Swap (CDS)

A Credit Default Swap (CDS) is a credit derivative transaction that is a financial swap agreement pursuant to which a seller of the CDS will compensate the buyer in the event of a loan default or other credit event. The buyer of the CDS makes a series of payments (the CDS ‘fee’ or ‘spread’) to the seller and, in exchange, receives a payoff if the loan defaults. A CDS is linked to a ‘reference entity’ or ‘reference obligor’, usually (in our context) an airline or operating lessor. The reference entity is not a party to the contract. The buyer makes regular premium payments to the seller, the premium amounts constituting the ‘spread’ charged by the seller to insure against a credit event. If the reference entity defaults, the protection seller pays the buyer the par value of the bond in exchange for physical delivery of the bond, although settlement may also be by cash.

A default is often referred to as a ‘credit event’ and includes such events as failure to pay, restructuring and bankruptcy, or even a drop in the reference entity’s credit rating.

Credit default swaps are often used to manage the risk of default that arises from holding debt. A bank, for example, may hedge its risk that a borrower may default on a loan by entering into a CDS contract as the buyer of protection. If the loan goes into default, the proceeds from the CDS contract cancel out the losses on the underlying debt.

A bank can also use a CDS to free up regulatory capital. By offloading a particular credit risk, a bank is not required to hold as much capital in reserve against the risk of default. This frees resources the bank can use to make other loans to the same key customer or to other borrowers.

There are other ways to eliminate or reduce the risk of default. A lender could sell (that is, assign) the loan outright or bring in other banks as participants. However, these options may not meet a particular lender’s needs.

PRACTICE NOTE

In a CLO, investors have an opportunity to obtain value from the Aircraft Assets serving as collateral up to the entire value of those assets, in contrast to a CDO where the CDO investor is capped at the value of the underlying debt serving as collateral vis-à-vis the issuer thereof. The residual value of the Aircraft Assets subject to the CLO may be a substantial value component for the CLO ‘equity’ investor.

While CLOs would most likely have a diversity of underlying credits/lessees, they could be structured with a single lessee obligor. Either way, if a CLO’s lease obligors are subject to Section 1110 or Cape Town remedies, then they may be packaged and marketed as EETC-type products, thereby taking advantage of the deep market for EETC securities.

CLOs may employ Turbo, DSCR and LTV tests.
Club Deal

This is a financing where the debt participants are not led by a single arranger or agent but are on relatively equal footing when negotiating a financing with a borrower. Club Deals are, by their nature, somewhat more difficult to close since there are many ‘captains’ to co-ordinate.

Cross-border Tax Lease

This is a Finance Lease where the lessee and the lessor are domiciled in different jurisdictions and where, due to different accounting and/or tax treatment in the respective jurisdictions, both parties are able to obtain tax/accounting benefits of ownership in their respective jurisdictions. Such deal structures typically are successful where the lessor’s jurisdiction treats the form of the transaction as the guiding principle and the lessee’s jurisdiction treats the substance of the transaction as definitive. Cross-border Tax Leases have largely disappeared because many jurisdictions have shifted away from a ‘form’ to a ‘substance’ analysis.

Depository

This is a financial institution (typically a bank with a high credit rating) that holds the proceeds of loans in a financing transaction when such loans are pre-funded, such as in a pre-funded EETC. Loans are pre-funded so that an issuer can lock in current interest rates and take advantage of market liquidity in anticipation of scheduled future deliveries for specified Aircraft. The prefunded amounts are deposited with the Depository, are evidenced by escrow receipts and are made available to the EETC issuer only upon the delivery and financing of the earmarked Aircraft from the OEM. Such funds on deposit are not intended to be assets of the issuer.

Dry Lease

A Dry Lease is an Operating Lease that provides lease financing only for the equipment itself, and does not extend to personnel, maintenance, fuel and provisioning necessary to operate the asset. In contrast, there are the Wet Lease and ACMI arrangements.

Export Credit Agency (ECA) Financing

This is a financing supported by an Export Credit Agency (ECA). ECAs provide financing, or governmental-based guarantees to lenders, to support the export of aircraft, engines and other manufactured goods from the home country. ECAs supply billions of dollars of support annually for Aircraft and Engine exports alone. The primary ECAs involved in Aircraft Asset support are:

- Brazil – Banco Nacional de Desenvolvimento Economico e Social (BNDES) (supporting Embraer aircraft);
Canada – Export Development Canada (EDC) (supporting Bombardier aircraft);
France – Bpifrance Assurance Export (formerly known as COFACE) (supporting Airbus and ATR aircraft, among others);
Germany – Euler Hermes Aktiengesellschaft (Euler Hermes) (supporting Airbus aircraft, among others);
UK – Her Britannic Majesty’s Secretary of State acting through the Export Credits Guarantee Department (ECGD), operating as UK Export Finance (supporting Airbus aircraft and Rolls Royce engines, among others); and
U.S. – U.S. Ex-Im (supporting Boeing aircraft and CFM, IAE, GE and Pratt & Whitney engines, among others). 21

ECA Financings by the ECAs described above are currently regulated by the ASU arrangements. However, it is worth noting other substantial ECAs, as follows, are not subject to the ASU rules. The roles being played by these ECAs are expanding and are increasingly factoring into export financings in the Aircraft Asset space.

Nexi (Japan).
China Ex-Im.
Servizi Assicurativi del Commercio Estero (SACE S.p.a.) (Italy).

ECA Financings come primarily in two structures.

1 Guarantees issued by the ECA to lenders, whose loans allow an owner or operator to acquire the exported asset.
2 The ECA itself provides the financing to allow an owner or operator to acquire the exported asset. 22

Most ECA Financings using the guarantee structure are constructed on the basis of the arrangements noted in Exhibit 3.6.

ECA guaranteed financing structures can support both privately placed loans funded (primarily) by banks or securities placed with investors in a public-type offering. In a typical public-style issuance the guaranteed loans would either be: (i) prefunded; or (ii) funded on a preliminary private basis. In the case of a prefunding, all of the funds necessary to fund the Aircraft would be drawn down at an initial closing, placed with a Depository and would be represented by escrow receipts until applied to the Aircraft’s purchase price on delivery. In the case of a private funding, a bank funds each Aircraft as and when the Aircraft Assets are delivered, and once there is a sufficient sized pool of loans to support a placement in the public markets, the loans are converted to these public instruments and so placed. Capital market access for ECA guaranteed financings has been primarily available to financings supported by U.S. Ex-Im; U.S. Ex-Im was instrumental in the facilitation of transaction structures allowing for the issuance of securities in the capital markets that were comprised of U.S. Ex-Im guaranteed loans. This U.S. Ex-Im guaranteed bond structure is expected to evolve further, expanding the market breadth and improving its efficiency. 23

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ECA guaranteed financing (absent some global shock akin to 9/11 or the Lehman collapse) is likely to reduce over time in the light of the ASU’s requirements to impose market-level fees and rates on these financings, thereby making these types of financings less advantageous to Aircraft Asset purchasers.

**ECA Co-commercial Financing**

ECA Co-commercial Financing is the provision of commercial (non-guaranteed) funding by financiers secured by Aircraft on a transaction when such Aircraft also secure debt in an ECA guaranteed financing. In the light of the ECA’s rather strict LTV advance rates and rapid paydown requirements, opportunities are created for extending commercial/non-guaranteed debt secured by the otherwise ECA-guaranteed debt. Based on these economics, certain financiers are willing to lend to airlines or lessors side-by-side with lenders that are receiving ECA support. Such loans may be effected at the time of the initial borrowing and/or may accrete over time as the ECA supported loans are repaid. The latter are called Stretched Overall Amortization Repayment (SOAR) loans, or ‘mismatch loans’; however, the latest ASU has largely eliminated this particular financing structure. All such commercial lenders’ loans are subordinate to the ECA’s guaranteed loans in respect of the financed Aircraft and such commercial lenders have no power to direct the exercise of remedies unless and until the ECA-supported loans are paid in full.
If an airline or lessor elects to use a commercial loan to finance the difference between the purchase price of an Aircraft and the related guaranteed loan, the commercial lenders will receive proceeds from the exercise of remedies on an Aircraft-by-Aircraft basis, only after the related guaranteed loan and all other amounts due and owing to the ECA and the guaranteed lenders with respect to such Aircraft have been paid in full. However, the commercial lenders receive proceeds prior to the application of amounts toward other ECA-supported financings for that airline or lessor.

As long as either: (i) the related ECA guarantee in favor of the guaranteed lenders is in effect; or (ii) there are any amounts owing to the ECA under the related transaction; the ECA will have the sole right to direct the taking of any action under the transaction documents, including, without limitation, exercising any remedies after the occurrence of an event of default. If neither (i) nor (ii) applies, the commercial lenders would be the instructing party.

Even though these commercial lenders have limited rights with respect to the collateral, the commercial lenders often have the right to pursue claims directly against the airline or lessor for any amounts owed to them that are not covered by an ECA guarantee, provided, so long as the relevant ECA guarantee is in effect or the ECA has any exposure or is owed any amounts arising out of the transaction documents, that:

- no recovery may be had directly from, and no such suit shall assert any rights or claims against, the collateral or borrower;
- such action does not interfere with, or otherwise adversely affect, any restructuring, enforcement or other collection efforts by, or on behalf of, the ECA (other than by requiring payment of moneys then due to such person but only to the extent enforcement is on assets not constituting part of the collateral or part of the collateral securing any other obligation running to or for the benefit of or otherwise relating to any transaction involving the ECA);
- such commercial lender may not initiate any bankruptcy, suspension of payment or other insolvency proceedings against the borrower or the lessor/airline in connection with such recovery; and
- the ECA has not sent a notice that such action materially interferes with the enforcement or remedial actions which are being taken or could be taken by or the direction of the ECA, or otherwise materially adversely affects the ECA.

Any amount recovered by any lender is required to be applied through the standard waterfall.

The above detailed description of the relative rights between an ECA and a commercial lender is based on a typical U.S. Ex-Im transaction. The other ECAs may adopt similar or more stringent or relaxed intercreditor terms.
ECA Co-financing

ECA Co-financing arrangements are arrangements made by different ECAs to supply credit support for Aircraft with components manufactured in multiple jurisdictions. The manufacture of large commercial jets is a global business. By way of example, for today’s Boeing Aircraft, more and more of the components are manufactured outside the U.S. before they are shipped to, and installed on, an airframe in Boeing’s States-side plants. This can and does significantly affect the strict eligibility requirements for U.S. Ex-Im financing. If a particular Aircraft has, for example, only 50 percent U.S. content, then U.S. Ex-Im’s support would be limited to this amount. If the balance of the content would be eligible for support from another ECA, then it may be possible to arrange separate support from such other agency. To address this particular situation and streamline the financing process, U.S. Ex-Im has entered into a number of so-called ‘co-financing’ arrangements with other ECAs. This creates real value for the airline or lessor acquiring the aircraft by allowing ‘one-stop shopping’ for its export credit financing. Under a co-financing arrangement, there is normally a lead ECA which co-ordinates all negotiations, documentation, disbursements, administration and exercise of remedies. With respect to the airline/lessor borrower, its sole interaction is with the lead ECA who is typically given broad authority under the co-financing arrangement to service a transaction. As part of the co-financing arrangement, the other ECAs involved agree to insure the lead ECA for such other ECA’s proportionate share of a transaction.

U.S. Ex-Im has active co-financing agreements for large commercial Aircraft with the UK’s HM Export Credit Guarantee Department (ECGD), Japan’s Nippon Export and Investment Insurance (NEXI) and Korea’s Export-Import Bank, insofar as many Boeing aircraft components are manufactured in these countries. Similarly, the European export credit agencies (ECGD, COFACE in France and Euler Hermes in Germany) use co-financing arrangements frequently in supporting Airbus financings. In fact, in many European ECA-supported financings of Airbus Aircraft, a single of these ECAs may act as a ‘fronting’ ECA in a transaction, with internal arrangements as among all the participating ECAs behind the curtain to address risk-sharing protocols.

EETC Rating

An EETC Rating is a rating that assesses the likelihood that a borrower makes ‘full and timely payment of interest and ultimate payment of principal’. This analysis treats interest and principal differently. As for interest, the requirement is for interest to be paid currently. This means that there cannot be any interruption of the interest payment even if the borrower is in default or bankruptcy. The primary means to ensure current payment of interest is to employ a Liquidity Facility (see ‘Liquidity Facility’) that will ensure payment of interest (only) if the borrower fails to pay interest. As for principal, ultimate payment of principal means that the principal needs to be paid in full by the relevant Final Legal Maturity Date (see ‘Final Legal Maturity Date’) which is a date, typically 18 months (in U.S. airline transactions), after the
underlying debt is scheduled to mature. This extra period is the period that the rating agencies perceive is the maximum length of time it should take to repossess and liquidate a financed aircraft asset and apply the proceeds to outstanding balances of principal. This rating methodology is utilized by the rating agencies rating EETCs and certain other aircraft-secured debt securities.

Enhanced Equipment Trust Certificate (EETC)

An Enhanced Equipment Trust Certificate (EETC) is a publicly (but sometimes privately) issued, rated security that:

- relies on the credit of a single corporate issuer;
- is secured by Aircraft Assets as collateral;
- utilizes a Liquidity Facility to provide up to 18 (or, in some cases, 24) months of missed interest payments;
- utilizes structural enhancements to provide improved LTV ratios for the more senior levels, or Tranches, of debt securities; these structural enhancements include:
  - tranching
  - cross-default
  - cross-collateralization
  - cross-subordination
- relies on the certainty of remedies afforded by Section 1110 of the U.S. Bankruptcy Code or, in the case of non-U.S. airlines, comparable rights under Cape Town (or other local law);
- is rated based on an EETC Rating; and
- maintains a constant level of over-collateralization.

Exhibit 3.7 is a schematic that boils down the primary characteristics of an EETC. Exhibit 3.7 highlights the following primary features of an EETC:

- as a credit matter, there is a single full-recourse airline issuer on whose credit the financing rests; and
- as a collateral security matter, the Aircraft Assets serve as collateral and, as a matter of supreme importance to the structure, have the benefit of Section 1110 of the U.S. Bankruptcy Code (or the equivalent under Cape Town or local law), which provides certainty as to the ability to repossess the collateral (or be given assurances of continued performance).

Over $90 billion of EETC securities have been issued since the product was developed in 1994. While predominantly a financing vehicle used by U.S. airlines, non-U.S. airlines as diverse as Air Canada, DORIC/Emirates, LATAM, British Airways, Virgin Australia, Turkish Airlines (THY) and Norwegian Air Shuttle have utilized this product as well. The attraction of EETCs from the airline issuer’s perspective are manyfold:
Size: Given the capacity of the capital markets into which EETCs are issued, airlines may finance in a single financing upwards of $1.5 billion of aircraft debt in one fell swoop, which can cover dozens of aircraft. This saves airline treasury staff the trouble of needing to hit-up large numbers of financial institutions to finance a year’s-worth of deliveries.

Fixed rate: EETCs are typically issued at a fixed interest rate which is often desired by airlines.

Ease of execution: While by no means simple to document (and rather expensive to do so given disclosure requirements typically subsumed in a detailed offering memorandum issued to investors), EETCs are subject to largely standardized documentation across the board (that is, from airline to airline) and, as to any single airline issuer, its transaction documentation will be entirely uniform across its EETC-financed fleet. This standardization applies as well to intercreditor terms, which can involve laborious negotiations in private transactions.

Financing diversification: The access to the capital markets may be a very attractive option for airlines concerned with relying exclusively, say, on the bank market (with that market’s difficulties such as risk of Market Disruption, Increased Costs and other costs).

Pricing: The structural enhancements provided by an EETC allow the senior-most Tranches to be rated investment grade, with the attendant pricing advantages associated with such ratings.

Exhibit 3.8 provides a structural overview of a typical EETC transaction (with this indicative transaction including a financing done on a prefunded basis (utilizing a Depository); prefunded transactions are not universal to every financing).
The EETC is fundamentally a secured corporate credit, not a securitization. The investor takes default risk of a single airline (and not a diversified borrower/lessee base). There are two primary financing structures for EETCs that create the underlying obligation of the airline to make its scheduled payments. The first is a Mortgage Financing. In this type of financing, the airline will issue promissory notes (commonly known as equipment notes) in Tranches, with the ‘A’ note Tranche being ranked ahead of the ‘B’ note Tranche, the ‘B’ note Tranche being ranked ahead of the ‘C’ note Tranche and so on. The equipment notes are issued on a per-aircraft basis, and are secured by that aircraft in the airline’s fleet.

The second type of underlying financing is a U.S. Leveraged Lease Financing. In this type of financing, an equity investor, acting through an owner trustee, will

Exhibit 3.8 EETC Overview
Source: Author’s own
purchase an Aircraft, borrowing up to 80 percent of the Aircraft Fair Market Value (FMV), with the balance provided by the equity investor. The borrowed funds will be obtained by the issuance by the owner trustee of equipment notes in Tranches as described above. The owner trustee will then lease the aircraft to the airline issuer. As collateral for the equipment notes, the owner trustee will grant the equipment note holders a mortgage on the aircraft and assign the lease to the holders. The equipment notes are issued by the owner trustee on a non-recourse basis and will be entirely serviced by the lease cash flows.

An EETC financing may involve 30 or more Aircraft. The equipment notes issued with respect to each aircraft will be aggregated and held by a separate pass through trust for each class of notes pursuant to a Pass Through Certificate (PTC) structure. Thus, all of the A equipment notes for all of the Aircraft in a particular EETC are held by a class A pass through trust, all of the B equipment notes for all of the aircraft are held by a class B pass through trust, and so on. Each pass through trust, then, issues PTCs to investors. Each investor can then purchase PTCs at either the class A, B or C level. EETCs have historically been almost exclusively the domain of U.S. airline issuers, but with the advent of Cape Town (which satisfies the need for assured repossession), non-U.S. airlines have been making significant inroads with this product; see Practice Note below.

Since 2005, EETC transactions have benefited from the Cross-default and Cross-collateralization across all of the Aircraft in the financed pool. These two features allow issuers to combine diverse pools of Aircraft Asset collateral such as superior younger collateral pooled with older, less liquid aircraft types, since the weaker assets will be supported by the stronger ones. Putting it differently, the airline issuer will not be able to compel the return of Aircraft Assets under Section 1110(c) of the Bankruptcy Code if it wants to keep the stronger Aircraft Assets under Section 1110(a) of the Bankruptcy Code (see Part 8, ‘Section 1110’).

While the Mortgage Financing or Lease Financing facing an EETC issuance may be fairly standard, the transaction gets somewhat complicated among the investors, since they are often Tranched. The Tranched investors of different classes will have varying inter-creditor rights. An EETC will typically feature:

- Controlling Party rights transitions;
- Waterfalls;
- Minimum sales prices; and
- Buyout rights.

In addition, multi-Tranched EETCs, also feature, through the Waterfalls, Asset and Credit Subordination. An interesting feature of this subordination is that there are situations where the holders of the more junior Tranches of PTCs may be in a position vis-à-vis the airline-issuer worse than the holder of that airline’s unsecured debt. Whereas the holder of a bankrupt airline’s unsecured debt may receive pennies on the dollar (or equity in the reorganized airline), the holders of the more junior Tranches of PTCs have absolutely no direct claim at all. All Deficiency Claims flow through the Waterfall, even those attributable to the most junior classes of equipment notes. For example, if the controlling party were to sell all of the equipment notes...
in an EETC for, say, 60 percent of the outstanding principal balance of the equipment notes, the proceeds of such sale would, as per the Waterfall, be applied to the more senior Tranches leaving the holders of class C certificates with no further claim since the equipment notes, which represent the ‘direct’ claim against the airline (and would have the benefit of the Deficiency Claim), have been sold. Another interesting feature of EETC intercreditor terms which is rather unique to EETCs is that the Waterfall provides that the holders of the junior classes of the PTCs receive ‘adjusted’ interest on their PTCs ahead of distributions to the holders of the senior classes of PTCs. This feature is intended to incentivize the holders of the senior PTCs to maximize recoveries post-default. Exhibit 9.3 summarizes the primary intercreditor terms in a traditional (2017) EETC.

All EETCs have the benefit of a Liquidity Facility, which assures EETC investors with continued payments of interest (only) for up to 18 months (or more in the case of certain non-U.S. jurisdictions) if the issuer ceased making debt service payments. This continued payment of interest for such period – being the period the rating agencies perceive as the maximum period required to repossess, market and liquidate the Aircraft Assets subject to an EETC – enables the rating agencies (together with the other structural features of the EETC) to provide enhanced ratings for the EETC, see ‘EETC Rating’ and ‘Liquidity Facility’.

The enhanced ratings provided by the rating agencies tasked with rating a particular EETC issuance, of course, provide the EETC with improved marketability and liquidity, allow the issuer to obtain advantageous pricing and allow institutional investors to participate in such a type of transaction.

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**PRACTICE NOTE**

While EETCs have traditionally been a financing vehicle enjoyed by U.S. airlines by reason of the availability of Section 1110 of the U.S. Bankruptcy Code in the U.S., with the advent of Cape Town’s Alternative A, which is the Section 1110 equivalent for Contracting States, one would expect the EETC product to (theoretically) work for airlines in Contracting States that have adopted Alternative A. In fact, both Air Canada and Emirates have entered the EETC market on the basis of their jurisdiction’s adoption of Cape Town (and Alternative A). As well, Doric Nimrod Air Finance Alpha Limited, an aircraft leasing company, has issued EETCs on at least two occasions (with Emirates and British Airways as lessees). One should expect increasing attention paid to this market by non-U.S. carriers as ECA financings become more expensive as ASU requirements are reflected in loan pricing. See ‘International EETCs’.

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1 British Airways has also utilized the EETC markets, notwithstanding that the UK is not a Contracting State, on the basis that rating agencies became comfortable with the UK’s general creditor-friendly insolvency regime and structural enhancements offered by the EETC structure.
EETC documentation is somewhat voluminous, with two broad categories addressed. The first category is the aircraft financing documents. These would include:

- Note Purchase Agreement
- Participation Agreement
- Trust Indenture and Security Agreement (one per Aircraft)
- Equipment Notes

The second category covers the documents associated with the PTCs or trust-level documents. These would include:

- Underwriting Agreement
- Pass Through Trust Agreements
- Trust Supplements
- Pass Through Certificates (PTCs)
- Revolving Credit Agreements (Liquidity Facilities)
- Intercreditor Agreement
- Deposit Agreement(s) (for pre-funded facilities)
- Escrow Agreement(s) (for pre-funded facilities)

**Equipment Trust Certificates (ETCs)**

Equipment Trust Certificates (ETCs) are promissory notes issued by an airline or U.S. Leveraged Lease equity Owner Trust that evidence the loans made by lenders that are secured by Aircraft Assets and, in the case of a U.S. leveraged lease, the related lease. This term was primarily used as the name given to the debt securities issued as part of a public offering of the promissory notes to investors.

**Finance/Capital Lease**

This is a lease transaction that is treated as a Mortgage Financing for any particular purpose. The criteria for ascertaining whether a particular lease transaction is a Finance Lease will, in the first instance, depend on whether the determination is for tax, Uniform Commercial Code (UCC) or, in the case of U.S.-registered Aircraft, FAA filing purposes. As for accounting purposes, in light of newly adopted accounting rules under both GAAP and IFRS standards (ASC 842 and IFRS 16, respectively), the distinction between operating leases and finance leases has lost much significance for disclosure purposes insofar as the lessee, under any lease – howsoever characterized – is required to recognize (under GAAP): (a) assets and liabilities for all leases with a term of more than 12 months (unless the underlying asset is of low value); and (b) depreciation of leased assets separately from interest on lease liabilities in the income statement; provided that lessors will need to continue to classify their leases as either an operating lease or a finance lease, and to account for those two types of leases differently (see IAS 17).
Each of the tax, UCC and FAA disciplines has its own set of determination criteria.

**Tax**


The U.S. Internal Revenue Service (IRS) developed the Guidelines specifically for ‘leveraged lease’ transactions, which involve three parties: a lessor/owner, a lessee/user and a lender to the lessor. However, the Guidelines are also used to aid in structuring single investor leases, which involve two parties – a lessor and lessee. The Guidelines are not controlling as a matter of law, but provide a set of criteria by which the IRS decides the character of a transaction for purposes of providing advance income tax rulings. The application of the Guidelines to single investor leases, while useful, has largely served as a voluntary construct on which to conservatively structure a lease involving a lessor and lessee. The theory is that if the structure works for the more complex leveraged leases, the structure should work for single investor transactions.

A lessor under a U.S. Leveraged Lease should qualify as the tax owner of property if the following Guidelines criteria are satisfied.

- The lessor must maintain a minimum unconditional ‘at risk’ equity investment in the property being leased (at least 20 percent of the cost of the property) during the entire lease term. Within this general concept, a lessor must show that it expects the property at the end of the lease term to have a fair market value equal to at least 20 percent of its original cost. The lessor must also demonstrate that it expects that the equipment will have a useful life at the end of the lease of not less than 20 percent of its original useful life (or at least one year). These requirements are sometimes called the ‘20/20 tests’.
- The lessee may not have a contractual right to buy the property from the lessor at less than fair market value when the right is exercised.
- Lessee lease renewal options must be at fair rental value at the time of renewal.
- With exceptions, the lessee may not invest in the leased property.
- The lessee may not lend any money to the lessor to buy the property or guarantee the loan portion of a leveraged lease that the lessor uses to buy the leased property.
- The lessor must show that it expects to receive a profit apart from the tax benefits.

Importantly, the Guidelines are just that, guidelines. Leveraged (and single investor) leases may deviate from the Guidelines and still qualify as true tax leases for federal income tax purposes.
Under the Uniform Commercial Code (UCC) in the U.S., § 1–201(37) of the UCC provides guidance: whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and: (i) the original term of the lease is equal to or greater than the remaining economic life of the goods; (ii) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; (iii) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or (iv) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

See ‘Appendix C-2A’ for the complete text of UCC § 1–201(37) which includes further elaboration on the above.

Importantly, the common ‘commercial’ understanding of the term ‘Finance Lease’ – that is, a lease intended for security, which is substantively equivalent to a mortgage financing – does not comport with the definition of that term under Article 2A of the UCC. Under Section 2.A-103(1)(g), a ‘Finance Lease’ is a lease with respect to which:

- the lessor does not select, manufacture, or supply the goods;
- the lessor acquires the goods or the right to possession and use of the goods in connection with the lease; and
- one of the following occurs:
  - (A) the lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
  - (B) the lessee’s approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods is a condition to effectiveness of the lease contract;
  - (C) the lessee, before signing the lease contract, receives an accurate and complete statement designating the promises and warranties, and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party, such as the manufacturer of the goods, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods; or
  - (D) if the lease is not a consumer lease, the lessor, before the lessee signs the lease contract, informs the lessee in writing (a) of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire the goods or the right to possession and use of the goods from that person, (b) that
the lessee is entitled under this Article to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods, and (c) that the lessee may communicate with the person supplying the goods to the lessor and receive an accurate and complete statement of those promises and warranties, including any disclaimers and limitations of them or of remedies.

Insofar as this particular definition does not comport to our usage of Finance Lease for the purposes of this Handbook, it should be ignored for our purposes.

Bankruptcy

Under U.S. bankruptcy situations, the matter of true versus finance leases would most likely be determined by reference to the UCC tests.

FAA

The U.S. FAA pays attention to identify properly the entity in whose name an Aircraft should be registered. In 1990, pursuant to the so-called ‘Leiter Letter’, the FAA’s Chief Counsel issued a legal opinion setting out the relevant criteria for FAA purposes. According to that opinion, the FAA will recognize the lessee as the owner for Aircraft registration purposes under a lease with an option to purchase in three specific scenarios.

1. The purchase option price is 10 percent or less of the value of the Aircraft determined at the time the lease is executed.
2. The purchase option price is above the 10 percent bright line, but contains a requirement that if the option is not exercised, the lessee nevertheless is obligated to pay a residual value or termination sum equal to or exceeding the purchase option price.
3. The purchase option price is higher than 10 percent and there is no mandatory full payout if the option is not exercised, but the option price is less than the lessee’s reasonably predictable cost of performing under the lease if the option is not exercised.

In addition to one of the above, both of the following factors must also be present:

• the lessee must have the obligations of maintenance, insurance, taxes, operations and risk of loss with respect to the Aircraft; and
• the lease must not permit the lessee the unilateral right to terminate the lease without an economic penalty.

As the Leiter Letter does not have the binding nature of a statute or regulation, it is prudent to consult with the FAA and obtain an opinion from the Aeronautical
PRACTICE NOTE

While the lessor in a Finance Lease holds ‘title’ to the asset, holding such title is akin to having a mortgage interest in the asset with the lessee being treated as the true owner of the asset insofar as the benefits and burdens of ownership ultimately rest with the lessee. Transactions are structured as Finance Leases, rather than mortgages, for many reasons, including to obtain benefits of a Cross-border Tax Lease or for the financier to achieve ‘lessor’ status under local law in overseas jurisdictions (which almost universally entitles the financier to a more beneficial status in the exercise of remedies than it would have had it been classified as a mortgage).

The mischaracterization of a lease as a true lease can have major ramifications.

In the context of tax matters, a mischaracterization for a lessor would result in recoupment by the IRS of tax benefits previously taken plus fines and penalties.

In the context of commercial matters, failure to obtain true lease characterization would eliminate any residual recovery and potentially leave the lessor with a substantial economic downside loss. In addition, if a lease is construed to be a loan, for usury purposes, the lessee may argue that the lessor violated applicable usury law and should suffer the penalties of overcharging the lessee for the imputed ‘interest’ paid by the lessee on the financing.

In the context of a lessee bankruptcy proceeding, a lessee may challenge a lessor’s true-lease characterization and rights under a purported lease. Consequences of losing a true lease challenge include the following.

- **Loss of Section 365(d)(10) payments (if Section 1110 not applicable).** A lessor has meaningful rights to payment on leases under Section 365(d)(10) of the federal Bankruptcy Code. Section 365(d)(10) requires debtors-in-possession to ‘timely perform all of the obligations of the debtor . . . first arising from or after 60 days after the order for relief in a . . . Chapter 11 . . . under an unexpired lease of personal property . . . until such lease is assumed or rejected’.

- **No required cure of defaults under Section 365(b).** Under Section 365(b) of the Bankruptcy Code, a debtor-lessee must cure all monetary and non-monetary defaults before the debtor-lessee can assume the lease. A lessor does not enjoy this right if the court characterizes the transaction as financing instead of a true lease.

- **Potential loss of lien and/or priority.** If for any reason a lessor fails to make a timely and correct filing of financing statements under the UCC or other priority-creating statute to perfect a security (versus ownership) interest, the lessor may not achieve expected priority with
respect to the leased property. In that instance, another secured party may take priority and leave the lessor with little or no recovery in a bankruptcy. Even if a valid, secured claim exists due to a proper grant of a security interest, the security interest may still be subject to:

- the ‘cram down’ provisions under Section 1129 of the Bankruptcy Code (producing lower payments to the lessor than contractual rent);
- a reduction of the value of the collateral (leased property) under Section 506 of the Bankruptcy Code; or
- the ‘strong-arm’ powers of the trustee in bankruptcy to avoid a lien of the lessor against the leased property Section 544(a) of the Bankruptcy Code.

• Loss of favorable lessor remedies. When a lessor properly structures a ‘lease’ as a true lease, the lessor obtains remedies as an owner, instead of remedies as a secured party under Article 9 of the UCC. For example, Part 6 of Article 9 of the UCC requires a secured party (even if called a ‘lessor’) to give reasonable notice of a disposition of foreclosure of collateral, and to sell the collateral in a commercially reasonable manner, paying the excess proceeds to the debtor (even if called the ‘lessee’). The true lessor is not bound by these rules. Lessors can cancel a lease, recover the equipment, collect discounted rents and even require the payment of liquidated damages (a genuine pre-estimate of damages, including lost residual value, that cannot be easily or accurately calculated). The remedies available under a true lease provide several advantages to a lessor over those of a secured party with respect to the same property.¹

¹ Mayer, DG, ‘True leases under attack: lessors face persistent challenges to true lease transactions’, Journal of Equipment Lease Financing 23(3), Fall 2005/Part B.

A Finance Lease financing is, as noted, the economic equivalent of a Mortgage Financing, insofar as the ‘lessor’ has no upside (or downside) risk in the financed Aircraft. The utilization of Finance Lease structures is ubiquitous in the financing of Aircraft world-wide in the situation where a mortgage financing would otherwise suffice; that is, the financiers are providing debt financing with no residual interest in the Aircraft. This financing structure is so highly favored for, among others, the following reasons:

• The laws, and the courts, of the local jurisdiction of the airline may provide greater rights in an airline default situation to lessors over mortgagees (notwithstanding the substantive equivalent of the two structures).
• Procurement of a mortgage in the local jurisdiction may be prohibitively expensive (by reason of, for example, stamp taxes on recorded mortgages).
In fact, nearly all ECA financings utilize the Finance Lease structure. Exhibit 3.9 is a schematic illustration of a standard Finance Lease structure utilized to finance Aircraft.

**Final Legal Maturity Date**

In an EETC or other aircraft-secured facility that is rated using the EETC Rating, the Final Legal Maturity Date is the date that is 18 months (or, in certain cases, 24 or 36 months) after the date that is the economic maturity date of the underlying security. This 18-month period (or other period, as explained below) is the period determined by the rating agency providing the EETC Rating on a given security to be the longest length of time it should take to repossess and liquidate aircraft collateral starting on the last possible day the security can be in default.

While 18 months is the norm in deals for U.S. airlines that utilize the EETC Rating methodology, rating agencies may assess longer periods in other jurisdictions based on their assessment of the time it might take to repossess and liquidate aircraft collateral.
DEAL TYPES, STRUCTURES & ENHANCEMENTS

French Lease
This is a Cross-border Tax Lease where the lessor is domiciled in France. These types of leases are increasingly difficult to arrange in the light of EU investigations into whether these amount to an illegal subsidy. French commercial banks have historically been the investors in these transactions, with their subsidiaries acting as lessors.

Interchange
This is an arrangement whereby an Aircraft changes operators and Registration when its jurisdiction of operation changes. Interchange arrangements are a matter of increasing interest with the conglomeration of airline operators across jurisdictions, especially in Central and South America. There is the tension between Cabotage rules, on the one hand and the desire by operators to maximize Aircraft utilization, on the other.

PRACTICE NOTE
The change of Registration of an Aircraft as it bounces from jurisdiction to jurisdiction has critical effects on Aircraft Financiers for all the reasons noted in Part 7, ‘Re-registration’. Documentation to deal with this can be rather arduous and complex.

International EETCs
This is the issuance of an EETC by a non-U.S. airline/issuer. As discussed in the Practice Note in ‘EETCs’, EETCs are no longer the sole domain of U.S. airline issuers. EETCs issued by non-U.S. airlines are, absent any particular local or issuer requirements, structured in the identical fashion as those issued by U.S. airlines. The Rating Agencies’ willingness to rate non-U.S. airline issuers will turn almost exclusively on the built-in requirement of the EETC to have legal and practical certainty to the return of the Aircraft Asset collateral in a default situation. Section 1110 is the lynchpin to this in the U.S. The adoption of Cape Town in non-U.S. jurisdictions may provide the necessary support for non-U.S. carriers. You will note that the preceding sentence uses the word ‘may’. Whether a jurisdiction which has adopted Cape Town will satisfy the Rating Agencies will depend on the following criteria.

• Has the jurisdiction adopted the ‘right’ Cape Town Declarations?
• How do the Rating Agencies evaluate the rule of law in that jurisdiction?

A guide to what the ‘right’ declarations are is in Appendix II to the ASU. That appendix identifies the Cape Town declarations necessary for a country to receive a discount from the minimum premium rate in respect of export financing support.
from the applicable ECAs. Key declarations like Alternative A, choice of law, IDERA, self-help and timely remedies are must-haves under the ASU rules and are usually must-haves for Rating Agencies as part of their analysis. The Organization of Economic Co-operation and Development (OECD) assesses whether countries that have adopted Cape Town have adopted the proper ‘qualifying declarations’ under Appendix II to the ASU. The OECD website, www.oecd.org/tad/exportcredits/ctc.htm, provides a status list of countries qualified for the ASU discount. That list details those countries eligible for the ASU discount, those countries currently under review or subject to future review, those countries which did not adopt the qualifying declarations and those countries that have adopted the qualifying declarations but on which there are implementation issues.

The adoption of Cape Town with all of the right declarations may not be enough, however. An analysis will be made by the Rating Agencies as to the degree that the attendant repossession laws will be enforced under local law and by law enforcement authorities. This analysis follows the Country Risk analysis discussed in Part 7, ‘Country Risk’.

Finally, it should be noted that Cape Town, and the adoption of all of the right, qualifying, declarations is not dispositive for the Rating Agencies. As they have done in a British Airways (England) and a Virgin Australia (Australia) EETC issuance, the applicable Rating Agencies have concluded that the legal system in the relevant jurisdiction, even absent Cape Town or Section 1110 like laws, is creditor-friendly enough to allow a positive rating assessment because creditors in that jurisdiction are assured of repossessing their Aircraft Assets in a timely manner.

**PRACTICE NOTE**

If Rating Agencies conclude that a particular jurisdiction, even with the proper legal framework, would not allow a timely (for example, 60 to 90 days) recovery of an asset, rather than excluding that jurisdiction altogether, they may add on more time to the requisite Liquidity Facility to cover the longer recovery period. Thus, 24 month Liquidity Facilities have been required in the DORIC 2013 1 EETC which was a United Arab Emirates based transaction (with Emirates Airlines as the underlying credit).

**Islamic Finance**

Islamic Finance in the context of Aircraft Finance is the financing of Aircraft Assets in compliance with Sharia’a requirements. Sharia’a is the religious law forming part of the Islamic tradition. This law is derived from the holy book of the Muslims – the Koran – and the Hadith (the body of statements or actions ascribed to Mohammed, the Prophet) and Sunnah (the verbally transmitted record of the teachings of Mohammed, the Prophet). The particular item in the Sharia’a impacting matters of aircraft finance is the prohibition against the charging or receipt of interest. Accordingly, for a transaction to be Sharia’a compliant, it cannot employ the
payment of interest as a return factor for investors. The matter of whether a particular transaction is compliant with Sharia’a precepts is often passed upon by a panel of experts in Islamic law.

While there are multiple forms of Sharia’a compliant forms of financing for commercial aircraft, three types stand out as worthy of mention:

Ijarah – Ijarah is, in concept, akin to the leasing of an aircraft.
Murabaha – Murabaha is a financing method where a financial institution will take title to an asset and then sell that asset to its customer – which may be over time. The repayment to the investor may include a component for a reasonable profit. Such profit element serves as compensation to the investor for having taken title to the asset – and the associated risk of ownership.

Sukuk – See ‘Sukuk’ herein.

Japanese Leveraged Lease (JLL)
A Japanese Leveraged Lease (JLL) is a Cross-border Tax Lease where the lessor is MOST COMMONLY domiciled in Japan. This structure was a frequently used financing mechanism in the 1980s and 1990s, but became largely untenable when the Japanese tax authorities shifted to a more substance-based approach in their analysis of Aircraft ‘ownership’. JLLs are no longer a financing option.

Japanese Operating Lease (JOL)
A Japanese Operating Lease (JOL) is an operating lease fully or partly funded by a Japanese investor or equity sourced from Japan.

Japanese Operating Lease Call Option (JOLCO)
A Japanese Operating Lease with Call Option (JOLCO) is a long term operating lease with a call option in the form of an early buyout option for the benefit of the lessee. Such call option provides to the lessee the right to purchase the subject Aircraft at a fixed purchase price at a fixed date prior to the expiry date of the related lease.

The JOLCO is a tax/financing structure that can provide airlines with 10 to 12 years of low-cost aircraft funding. An investor with Japanese tax liability puts up a minority portion of equity funding (the balance is debt) in exchange for the tax benefits associated with the ownership and debt financing of the Aircraft. The tax investor must take some actual asset risk to receive this tax benefit.

When the Japanese tax authorities required that an investor take some portion of asset risk for most transactions, the JOLCO was developed. A key requirement for any JOLCO is the ‘90 percent test’. This means the overall lease rentals payable during the life of the transaction cannot exceed 90 percent of the lessor’s acquisition cost of the financed aircraft, together with debt costs and other costs such as fees. The lessee’s exercise of the fixed price call option must not be economically
compulsory. To demonstrate that the lessee’s purchase option is not compulsory, that purchase option price is supported by third party appraisals. The call option purchase price in a JOLCO would be an amount sufficient to repay the JOLCO debt and provide a return to the equity investor.

The debt component of the JOLCO is typically bank debt. The JOLCO debt is repaid from the rents under a JOLCO lease. The JOLCO debt may amortize to zero prior to the maturity of the related JOLCO lease. If it has a balloon payment due at the final maturity of the JOLCO lease, the balloon would be repaid from the sale of the financed Aircraft.

From an investors’ perspective, there is the risk that the lessee under a JOLCO will not exercise its call option for the leased Aircraft (leaving the Japanese equity and, if applicable, financiers with a balloon on their financing, with the concomitant asset risk). This risk can be minimized by maximizing the lessor’s investment recovery to the extent that the transaction is not classified as a finance lease for the Japanese tax purposes combined with more stringent redelivery conditions (e.g., payment of maintenance accruals by the lessee when the aircraft is returned at the lease expiry). In practice, the risk of a non-exercise of the call option has not materialized.

Debt of a JOLCO lease is in principle booked by the lessor domiciled in Japan to avoid Japanese withholding taxes. The Japanese equity investor can earn fixed income during the lease term and make capital gains by disposal of the Aircraft at the lease expiry. These investors can only take depreciation of the Aircraft to the extent of their invested equity amount if the transaction is partly funded by non-recourse debt. The typical equity investor in a JOLCO is a small and medium-size Japanese company that is privately held.

There are some disadvantages associated with the JOLCO. It is a long-term commitment – typically the transactions are of about 10 years’ duration. JOLCO structures can be relatively inflexible – once they are up and running it can be difficult to revisit the terms of a JOLCO if anything changes. An airline is not dealing with an operating lessor in the traditional sense; it is really dealing with Japanese investors. Over the life of a transaction, an airline may need to go to those investors and seek their consent from time to time to do various things. That process needs to be handled quite carefully in order to make sure the investors fully understand the issues and the airline gets an answer within the time frame it needs.

**Kommanditgesellschaft (KG)**

Kommanditgesellschaft (KG) is an Aircraft Asset financing by individuals participating as limited partners (directly or by employing a trustee) in single purpose companies which are organized in the legal form of a German limited partnership (that is, a Kommanditgesellschaft). The KG has one general partner and one or several limited partners. In the majority of cases, the general partner of a German KG is a limited company (that is, Gesellschaft mit beschränkter Haftung (GmbH)). The limited partners may be participating in the KG directly or via a trustee. The KG may have an advisory board representing the investors’ interests by monitoring the management of the general partner. The purchase of the Aircraft
Asset acquired by the KG is partly financed by the equity provided by the investors and partly leveraged by bank loans. The KG receives income from leasing the Aircraft Asset to a lessee. The KG is liquidated after the financed Aircraft Assets have been sold.

**Lease Financing**

See introductory provisions to Part 3.

**Lease/Head Lease Structure**

This is the lease financing of an Aircraft whereby the owner of the Aircraft (head lessor) leases an Aircraft Asset to an intermediate lessee/lessor and that intermediate lessee/lessor subleases such Aircraft Asset to the operator/lessee.

**PRACTICE NOTE**

These structures are used typically to allow the operator/lessee to make payments to the intermediate lessee/lessor without having to pay withholding taxes on the net payments, taking advantage of favorable tax treaties between the jurisdiction of the operator/lessee and the intermediate lessee.

**Lease-in Lease-out (LILO)**

A Lease-in Lease-out (LILO) structure is akin to a Lease/Head Lease Structure.

**Liquidity Facility**

A Liquidity Facility is a facility appended to a larger financing that provides for payment of debt service (typically interest only) by a bank or other creditworthy entity if the underlying obligor defaults in the making of such payment. A Liquidity Facility is usually a revolving credit facility, but could be structured as a Standby Letter of Credit (SBLOC). Liquidity Facilities are utilized in EETCs to provide (typically) 18 months of interest coverage. The provider of the Liquidity Facility would typically have a super-priority position in the Aircraft Assets securing the larger financing. As such, principal and other amounts owing to the beneficiaries of the Liquidity Facility are subordinated to recovery by the Liquidity Facility provider of amounts it has paid. Effectively, then, the beneficiaries are trading timely payment of interest for future offsets to recoveries in the amount of such interest plus a financing cost payable to the Liquidity Facility Provider. A Liquidity Facility, therefore, is of value only if the investor (or the Rating Agency) places a value on current, timely receipt of principal, since the investor will ultimately have to repay the Liquidity Facility provider from collateral liquidation proceeds ahead of repayment of principal.
The coverage period of 18 months is used in EETCs as this is the perceived (by rating agencies) maximum period it should take to liquidate the Aircraft Assets subject to an EETC. However, this period may be lengthened if the EETC issuer is located in a jurisdiction in which the repossession time frame for financed Aircraft Assets may exceed that in the U.S. Liquidity Facilities may be drawn if the liquidity provider has its Credit Ratings downgraded to a specified threshold level or it does not renew the facility by its renewal date.

**Mortgage Financing**

See introductory provisions to Part 3.

**Non-recourse**

This is an arrangement in a Back-leveraged Lease where the financier agrees that recourse for its debt is expressly limited to the related Lease, the mortgage on the leased Aircraft and other pledged collateral. In other words, the lessor is not otherwise personally liable for the debt (except, perhaps, the Rats and Mice), and none of its other assets are at risk.

**PRACTICE NOTE**

Some Back-leveraged Lease financings do provide for recourse to the operating lessor, but those are atypical. Allowing for some level of recourse may provide an operating lessor with better pricing and other terms, as well as access to a broader lender pool. Also, in the case of an especially strong operating lessor as to which there is full recourse, that lessor may be able to retain more (exclusive) control over any Back-leveraged Lease that serves as security for the transaction.

**Operating Lease**

Relating to any particular discipline (for example, tax, accounting, commercial law or bankruptcy), this is a Lease Financing which does not meet the criteria of a Finance Lease under the rules of such discipline. See a detailed discussion of these criteria in ‘Finance/Capital Lease’. This would capture the structure where the owner of the equipment (the operating lessor), rather than the lessee, retains most of the benefits and risks of asset ownership. Operating Leases do not usually provide the lessee with an option to terminate the lease prior to its scheduled termination date.

**Orphan Trust Structure**

This is a financing structure where the ultimate owner of the asset is a charity. Orphan Trust Structures are employed to provide Bankruptcy Remote protection and as a
method for certain banks to avoid aggregating lessor/borrower exposure for internal or regulatory lending-limit purposes. Exhibit 3.10 is a schematic showing the parties’ relationships in an Orphan Trust Structure.

**PRACTICE NOTE**

While the idea behind Orphan Trusts is to place ultimate ownership of Aircraft Assets with a charity for the reasons outlined above, truth-be-told, the charity never (intentionally) benefits from such ownership (other than by earning an accommodation fee). By means of residual interest certificates in a CLO (which entitle the holders of such certificates to residual value interest in the Aircraft Assets) or a bargain purchase option granted to an operating lessor of the financed Aircraft Assets at transaction conclusion, all upside and residual value is engineered away from the charity.

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**Exhibit 3.10 Orphan Trust Structure**

*Source: Author’s own*
**Owner Trust**

This is a grantor trust established by a lessor (as beneficiary) to own an Aircraft. In the U.S., Aircraft may be registered in the name of an owner trust. This is usually accomplished by having the trust company/department of a bank establish a trust to hold legal title to the Aircraft on behalf of one or more beneficiaries. An Owner Trust has historically been the ownership vehicle of choice in U.S. Leverage Leases, and for many other U.S. transactions. The benefits of using an Owner Trust are comparable to other SPVs, with the added benefit that they will enable non-U.S. lessors to own U.S.-registered Aircraft. In addition, under U.S. bankruptcy laws, grantor trusts are not a type of legal entity that is susceptible to a bankruptcy filing. The trustee of such a trust (often the trust department of a U.S. bank) must be either a U.S. citizen or a resident alien. If any beneficiary is not a U.S. citizen, the trust may still register the Aircraft in the U.S. provided the trustee also files an affidavit stating that the trustee is not aware of any reason, situation, or relationship the result of which would be that those persons who are not U.S. citizens together would have more than 25 percent of the aggregate ‘power’ to influence or limit the exercise of the trustee’s authority.

If the beneficiaries of a trust consist of non-U.S. citizens that do have such power, the trust instrument itself must provide that those persons together may have no more than 25 percent of the aggregate power to direct or remove a trustee. This is ordinarily accomplished by adding limitation language to the trust agreement to the effect that the beneficiary will have no rights or powers to direct, influence or control the trustee’s absolute and complete discretion concerning the ownership and operation of the Aircraft. To protect the non-U.S. citizen’s interests, this limitation language is normally subject to the requirement that the trustee exercise due regard for the interests of the beneficiary and agree not to sell, mortgage or otherwise encumber the Aircraft without the prior consent of the beneficiary.

**PRACTICE NOTE**

On 18 June 2013, the FAA published in the Federal Register ‘Notice of Policy Clarification for the Registration of Aircraft to Citizen Trustees in Situations Involving Non-U.S. Citizen Trustors and Beneficiaries’ as an official rule of the FAA. This Notice made clear that all owners of U.S.-registered Aircraft, whether or not Owner Trusts and regardless of onshore or offshore beneficiaries, have obligations ‘to communicate [to the FAA] critical safety information’. To meet these obligations, an owner must maintain current information about the identity and whereabouts of the actual operators of an Aircraft and location and nature of the operation on an ongoing basis, thereby allowing that owner to provide the operator with safety critical information in a timely manner, and to obtain information responsive to FAA inquiries, including investigations of alleged violations of FAA regulations.

The FAA expects that an owner trustee of Aircraft on the U.S. registry, in carrying out the above-described obligations, normally should be able to
respond to a request by the FAA for the following information about the Aircraft and its operation within two business days.

- The identity of the person normally operating, or managing the operations of, the Aircraft.
- Where that person currently resides or has its principal place of business.
- The location of maintenance and other Aircraft records.
- Where the Aircraft is normally based and operated.

The FAA further expects that an owner trustee of Aircraft on the U.S. registry normally should be able to respond within five business days to a request by the FAA for more detailed information about the Aircraft and its operations, including:

- information about the operator, crew, and Aircraft operations on specific dates;
- Maintenance and other Aircraft records; and
- the current airworthiness status of the Aircraft.

In the event of an emergency, the FAA may request a trustee to provide information more quickly than the timelines noted above.

The FAA will in most cases, go directly to the air carrier or similar operator through FAA personnel (for example, principal operations or maintenance inspectors) to obtain information about the Aircraft and its operation. The FAA will, however, always reserve the right to seek information from the registered owner of an Aircraft on the U.S. registry.

### Participation

This is a mechanism for a bank (or other debt financier) to off-load the obligations and benefits of holding a loan (or credit commitment) by having a third-party lender agree to take on the risks and rewards of such loan (or a portion thereof). As compared with an assignment, where the lender holding the loan assigns its interest to a new lender and is out of the picture once the assignment becomes effective, the bank selling the Participation remains in the transaction as the lender of record with the borrower. The purchaser of the Participation, the participant, in these transactions, therefore, has no privity with the borrower, and is entirely reliant on the selling bank to perform on the contract evidencing such Participation. Accordingly, the participant is not only taking borrower risk, but also the risk of performance by the bank from which it acquires the Participation. Also, it is the subject of negotiation as to what instructions the facing bank must comply with coming from the participant, and other intercreditor issues as between the two parties may come into play. There are two types of Participations: funded and unfunded. In a funded
Participation, the participant pays the facing bank the full amount of the loan (or portion thereof) in which it has purchased the participation, and such participant receives distributions of principal and interest, at the contracted or agreed rate, made by the borrower. In an unfunded Participation, the participant pays the facing bank the amount of the loan (or portion thereof) in which it has purchased the Participation if and when a default occurs, and in the ordinary course such participant receives a participation fee out of interest payments received by the facing bank. Many Participations are sold such that the borrower is not aware of it (as the selling bank may not want the borrower to know); these are called ‘blind participations’.

While most loan agreements permit the granting of a Participation interest in the related loans, restrictions are often placed on the ability of the participant to have consent rights on other than the basic economics of the transaction.

**PRACTICE NOTE**

The term ‘participation’ is what I consider a loaded term. It may be used in this context as a simple, straightforward term, but actually it needs a lot of fleshing out to get to intended allocation of rights and obligations.

**Pre-delivery Payment (PDP)**

A Pre-delivery Payment (PDP) is a facility for the financing of the incremental (progress) payments required to be made by Aircraft purchasers to OEMs prior to the delivery of Aircraft. Aircraft production, for obvious reasons, has long lead times. Procuring parts and construction of a particular Aircraft can take 6 to 18 months. During this construction period, the OEM is making large expenditures for labor and materials. To offset these ongoing pre-delivery costs, the OEM typically requires in the related Purchase Agreement for its customer to make periodic progress payments. These progress payments may be for as much as 20 to 30 percent of the Aircraft’s purchase price. Insofar as these progress payments represent a large outlay of cash by the airline or lessor Aircraft purchaser, financing is often sought to maintain liquidity. An impediment to a financing is that there is no hard asset (yet) that can be used as collateral. This is where the PDP comes into play. A PDP is a full recourse financing by the purchaser secured by a collateral assignment of the rights of the purchaser in the Purchase Agreement as relates to the delivery positions of the Aircraft whose progress payments are being financed. The PDP financier, therefore, can step in to the delivery of an Aircraft if the borrower defaults. The crux of this benefit is the purchase price at which the financier can take delivery. Insofar as Aircraft purchasers often receive significant discounts off OEM list prices, this right of the financier to obtain delivery of an Aircraft at below market prices and thereafter ‘flip’ the Aircraft at a higher price would enable the financier to recover its loan. In addition, the financier does not typically fund 100 percent of the progress
payments, so there is so-called equity of the borrower in the Aircraft which improves the LTV of the Aircraft’s delivery position.

Importantly, the OEM’s co-operation in the PDP is critical since the Aircraft Purchase Agreements are not assignable without consent. The OEM, however, while normally co-operative, typically does not provide to the financier the full discounted purchase price under the Purchase Agreement, but rather a higher number. It is this higher OEM offered purchase price (taking into account the borrower’s ‘equity’) that the financier must assess relative to market values when analyzing this financing. As well, the financier will need to be mindful of, and build in restrictions concerning:

- Aircraft price escalation;
- engine pricing and credits, if applicable;
- change orders to the Aircraft Purchase Agreement;
- Buyer Furnished Equipment (BFE) costs of the Aircraft; and
- OEM-required buy-back options (and the price the OEM will pay).

A further consideration for these types of financings is the Claw Back Risk inherent in this structure. See Part 8, ‘Claw Back’.43

PRACTICE NOTE

PDPs are more credit-oriented than an Aircraft Financing in the light of the lack of a hard asset serving as collateral.

As noted above, the OEM plays a major role in PDP financings. Here is a summary of items the PDP financier and the OEM would normally agree to.

- PDP financiers may buy PDP-financed Aircraft for an agreed purchase price from the OEM and thereafter exercise the borrower’s right to purchase PDP-financed Aircraft under the Purchase Agreement.
- PDP financiers may step into the borrower’s shoes (to the exclusion of the borrower) under the Purchase Agreement within a specified time frame following a borrower default and not to sell the PDP-financed Aircraft if a related ‘Event of Default’ is continuing under the Facility.
- OEM may buy out PDP financiers for the debt balance of the PDP facility (subject to agreed caps on breakage, expenses and interest) within a specified time frame following a borrower default.
- PDP financiers can assign rights under Purchase Agreement, subject to customary conditions; the assignee will be entitled to certain warranties, customer support and so on.
- OEM will apply PDPs against PDP-financed Aircraft purchase price.
- OEM will not refund PDPs to borrower (only to PDP financiers).
• OEM will not release the borrower from its obligations under the Purchase Agreement or accept cancellation of the Purchase Agreement unless OEM repays PDPs to PDP financiers.
• Subject to customary exceptions, OEM will not amend the Purchase Agreement without PDP financier consent.
• Upon request, the OEM will notify the PDP financiers of any outstanding breaches by the borrower which would entitle the OEM to terminate the Purchase Agreement and, if the OEM intends to exercise any right of termination it may have, the OEM will agree not to exercise any such right without giving the PDP financiers the opportunity to elect to cure the breach that gave rise to the right of termination or complete the purchase of the relevant PDP-financed Aircraft within an agreed period. In addition, the OEM will promptly notify the PDP financiers of any cancellation by the borrower of the Purchase Agreement or any part thereof.

Certain PDP financiers may require that there be in place at the time the PDP facility is entered into definitive and binding arrangements for the PDP-financed Aircraft to be financed on delivery to the borrower. In such a case, the financier can rest assured that the borrower will have access to funds for repayment of the related PDP loan on that Aircraft’s delivery.

Finally, PDP financiers wishing to create a relationship with an airline located in a jurisdiction with relatively high repossession risk may turn to PDP financing because the collateral (that is, the Purchase Agreement) is per se located in the OEM’s jurisdiction.

**Pfandbrief**

This is an internationally recognized type of covered bond as used in Germany by German banks to leverage their aircraft loan portfolios. Pfandbrief-covered bonds are highly secure securities that have wide appeal and a high level of liquidity. They are regulated by statutory law (Pfandbrief Act and supporting directives). The Pfandbrief product was only recently approved in Germany to be available for aircraft loans (having long been available for shipping, government-backed and real estate portfolios); the aircraft-secured loans in a Pfandbrief program are known as the covered pool. This Pfandbrief program can be used by qualifying financial institutions to finance aircraft loans on their books. Pfandbrief bonds offer high levels of security as a result of a combination of safety mechanisms. Under a Pfandbrief program, a fiduciary agent (Treuhänder) and at least one deputy are appointed by the Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, commonly referred to as ‘the BaFin’). The most important duty of the fiduciary agent is to monitor the prescribed cover of the Pfandbrief on a day-by-day basis. The Pfandbrief program contains detailed provisions on requirements for a ‘day one’ LTV of 60 percent with an accelerated amortization profile required, a going forward ‘normal’
LTV reduction requirement through the amortization of the loan and additional obligations to provide additional collateral in case of a severe LTV disturbance. In addition, the Pfandbrief Act imposes detailed specifications for qualifying collateral and a risk management system in order to further improve protection for Pfandbrief creditors. Furthermore, the transparency provisions of the Pfandbrief Act are intended to permit investors to assess the composition of the Pfandbrief cover pool on a quarterly basis. Finally, anything relevant for the Pfandbrief program of a Pfandbrief bank is supervised and monitored by the BaFin, which makes random checks on the cover of the Pfandbrief. The separation of cover pool assets from the general estate of a Pfandbrief bank (as issuer) in the event of a Pfandbrief bank’s insolvency is achieved by the registration of cover assets in a cover register which is – under statutory law – sufficient to secure the segregation. This is a fundamental difference to other covered bond programs where the cover assets are transferred to SPVs. As a result of such segregation, the claims of the Pfandbrief creditors are not affected by the commencement of insolvency proceedings against the assets of the Pfandbrief bank. Pfandbrief debt may be issued in the U.S. capital markets as a 144A transaction.

Pooling

Pooling is the contribution by two or more aircraft operators of Spare Parts and/or Engines into a common pool for utilization by the parties to such pooling arrangement. Pooling is a way to reduce, through economies of scale, the carrying costs of Spare Parts and Spare Engines. Participants in a pooling arrangement are entitled to withdraw items from the agreed stock (pool) held by any participant.

PRACTICE NOTE

Financiers are rather reticent to allow Pooling of their Aircraft Asset collateral since tracking and traceability are greatly impaired once the asset leaves the possession of the operator that is the beneficiary of the financing. Pooling arrangements might have impacts on ownership and security-interest rights in collateral.

Pass Through Certificates (PTCs)

Pass Through Certificates (PTCs) are securities issued to investors by, usually, a trust established by an issuer, that represent a fractional undivided interest in that trust. The main assets of these types of trusts as utilized in Aircraft Finance transactions are promissory notes (also known as ‘equipment notes’) of an airline issued pursuant to Mortgage Financings (or, in the old days of U.S. Leveraged Leases, equipment notes of Owner Trusts issued pursuant to Lease Financings). By utilizing these trusts, equipment notes of a comparable economic nature from
multiple Aircraft can be pooled into a single security. EETCs use the PTC structure. Holders of a PTC have only such rights and benefits as flow through to it from the equipment notes held in the related trust.

**Securitization**

This is the financial practice of pooling various types of contractual payment obligations to investors which, in the context of Aircraft Finance, would typically be Lease rental receivables or debt obligations in a CLO or CDO, respectively, as discussed above.

**Spare Parts Financing**

This is the financing of an airline’s Spare Parts inventory (see Part 2, ‘Spare Parts’).

**Special Purpose Vehicle (SPV)**

A Special Purpose Vehicle (SPV)\(^4\) is a legal entity (corporation, partnership, owner trust, limited liability company) established for the sole purpose of participating in a particular financing, typically as the owner/lessor/borrower of a particular asset or group of assets. In a typical structured finance transaction of Aircraft Assets that involves a Bankruptcy Remote entity, the legal entity is created whose purpose is limited to acquiring Aircraft Assets (and related Leases) to be financed and undertaking ancillary obligations. The SPV acquires the Aircraft Assets and enters into a financing arrangement, pledging the equipment and the leases as collateral. Some of the customary features of an SPV are: (i) organizational documents and transactional document covenants that limit the entity’s business to a single, specific and narrow purpose (generally, acquiring, leasing, financing, refinancing and eventually liquidating the Aircraft Assets); (ii) organizational documents and financing documents that contain ‘separateness’ covenants that require the subsidiary to be managed and operated in a manner that is distinct from the assets and business of the related lessor or transaction originator (among other entities); (iii) Non-recourse (recourse is limited only to the financed assets); and (iv) the appointment of one or more independent managers or independent directors of the SPV who meet certain requirements that provide some comfort to financing parties that the independent director is not overly sympathetic to the interests of the related lessor or transaction originator. The independent director’s favorable vote or consent is typically necessary for the SPV to approve a voluntary bankruptcy filing, to consent to an involuntary bankruptcy or to engage in a corporate restructuring.

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**PRACTICE NOTE**

There are a variety of reasons SPVs are so frequently employed to own Aircraft Assets on behalf of an operating lessor.
Importantly, independent directors appointed by creditors – notwithstanding that their appointment is to protect creditors – must be subject to normal director fiduciary duties. Thus, if it is in the best interest of the SPV to file for bankruptcy, a director is required to authorize the same. This legal requirement should not impair the intended purpose to protect an SPV from bankruptcy as a matter of consolidation with a parent entity, but does present risk when the underlying financing is at risk due to, for example, an impaired lessee in a Back-leveraged Lease situation.

Statutory Trust

A Statutory Trust is a trust formed by statute (for example, Delaware Statutory Trusts (DSTs) formed pursuant to the Delaware Statutory Trust Act, 12 Del. C. § 3801 et. seq. (the ‘DST Act’)). Due to the inherent vagaries of common law and fact-specific case law, certain states felt that they could clarify the benefits offered by trusts and provide more certainty as to the availability of such benefits (and in certain circumstances actually enhance the benefits) by codifying the benefits under state law, creating Statutory Trusts. The laws governing Statutory Trusts vary slightly by state jurisdiction. Any such variations will typically concern the wording on the topics of: (i) the description of the subject-matter of trusts; (ii) the nature of the writing required; (iii) the party who must sign or subscribe; (iv) the use of an agent or attorney; and (v) whether there must be a signature or subscription. For example, Delaware defines a Statutory Trust as an unincorporated association which:

1. is created by a governing instrument;
2. [is a trust] under which property is or will be held, managed, administered, controlled, invested . . . and/or operated, or business . . . activities . . . are carried on or will be carried on, by a trustee or trustees . . . for the benefit of such person or persons as are or may become beneficial owners or as otherwise provided in the governing instrument; and
3. files a certificate of trust pursuant to § 3810 of [the DST Act].

An additional requirement is that of trustee residency. Therefore, the trustee must be a citizen residing in the state under which the Statutory Trust will be formed. If
the trustee is a natural person, such individual must reside in such state; or if the trustee is a business entity, such entity must have its principal place of business in such state. Once formed, a Statutory Trust will have perpetual existence, except to the extent otherwise provided in the governing instrument (commonly referred to as a Trust Agreement). With respect to common law Grantor Trusts, on the other hand, the rule against perpetuities continues to apply, and common law Grantor Trusts must have a limited life.

Structurally, the beneficiary holds the beneficial interest in the trust and thereby indirectly owns all the assets therein. In Aircraft transactions, the trustee owns the aircraft on behalf of and for the benefit of the owner of the trust and must follow the direction of the owner. A key feature of Statutory Trusts is that they protect the assets held in trust so that no creditor of a beneficial owner of the trust has any right to obtain possession of, or exercise legal or equitable remedies with respect to, the assets of the trust. Unless otherwise provided in the governing instrument, the beneficial owners of a Statutory Trust have the same limitation of liability as would a stockholder of a corporation.

A validly formed Statutory Trust offers many other attractive features. It has broad power to provide indemnification to a trustee, a beneficiary and any other person, except as restricted by the governing instrument. Furthermore, the risk of bankruptcy may be minimized by vesting the decision of whether to voluntarily commence bankruptcy proceedings in an appropriate decision maker, such as an independent trustee or other manager.

**Sukuk**

*Sukuk* is an Islamic law-compliant financing. A *Sukuk* (which works in a broadly similar way to a conventional securitization) is evidenced by a certificate that provides an investor with ownership or part-ownership in the underlying asset, usufruct, or service. The *Sukuk* represents beneficial ownership of the underlying assets and therefore entitles its holders to receive a pro rata share of profits generated by the asset (not a fixed return tied to their face value). A *Sukuk* can also be issued in tradable form and listed on investment exchanges. A *Sukuk* transaction is intended to comply with Sharia’a prohibitions on the charging of interest and, therefore, represents an equity, not a debt, interest. Other forms of Islamic finance structures include *ijara, mudaraba* or *murabaha* financings.

**Synthetic Lease**

This is an off-balance sheet (or ‘synthetic’) lease financing structure treated as a lease for accounting purposes but as a loan for tax and commercial finance purposes. This structure is used by corporations who may be seeking off-balance sheet reporting of their asset-based financing, and who can nevertheless efficiently use the tax benefits of owning the financed asset.

To achieve off-balance sheet treatment, a ‘lease’ financing must satisfy the standards set out in Statement of Financial Accounting Standards No. 13 (SFAS 13). SFAS 13, as modified by various amendments, interpretations and technical
bulletins issued by the Financial Accounting Standards Board (FASB), applies fairly objective tests between operating leases (the desired result) and capital leases. The goal of the lessee in a synthetic lease is operating lease treatment for financial accounting purposes, such that neither the asset nor the liability from the transaction is reflected on its balance sheet. To reach this goal, the lease must:

- not automatically transfer ownership of the leased property to the lessee by the end of the lease term;
- not contain a bargain purchase option (that is, a purchase price not less than the reasonable estimate of fair market value at the end of the lease term);
- have a term of less than 75 percent of the estimated economic life of the property; and
- be priced such that the present value (typically discounted at the debt rate) of the rentals and other minimum lease payments is less than 90 percent of the fair market value of the leased property.

These SFAS standards are subject to ongoing review and will likely change in the near term. In order to effect an off-balance sheet lease financing, the borrower/lessee sells the assets to be subject to the financing to a lender/lessor for the amount of the intended financing (typically for an amount of 80 to 100 percent of its then current fair market value; the applicable percentage to be based on credit and asset considerations). The lender/lessor immediately leases the financed assets back to the borrower/lessee. The amortization (that is, the amount of ‘rent’ earmarked for the principal component of debt service), back-end balloon (that is, the unamortized amount of the loan) and tenor of the lease must satisfy the guidelines set out above. On maturity of the synthetic lease, the lessee will have the option either to purchase the leased assets for the amount of the unamortized portion of the loan (the Balloon) or to pay an amount (the ‘deficiency guarantee amount’) to the lessor (and receive nothing in return). The at-risk portion for the lessor/lender, the difference between the Balloon and the deficiency guarantee amount (the At-Risk Amount), is a risk the lender/lessor is willing to take because it would make economic sense for the lessee/borrower to walk-away from its asset by paying the deficiency guarantee amount only if the value of the financed assets are less than the At-Risk Amount. In fact, at the outset of an off balance sheet synthetic lease financing, the projected value of the financed assets is typically many multiples in excess of the At-Risk Amount.

An off balance sheet lease financing is, in substance, a mortgage financing. For tax and commercial (UCC) law purposes, the lessee is viewed as the true owner of the asset. This is because, except for title, indicia of ownership reside with the lessee:

- the lessor/lender’s return on the transaction is equivalent to a loan financing; there is no upside available;
- the lessee/borrower retains the burdens (maintenance, insurance, risk of loss and so on), as well as the benefits (use, upside, and so on), of ownership; and
the lessee/borrower may not unilaterally terminate the lease without recouping for lessor/lender its entire investment.

The conveyance of title to the financed asset and leaseback structure is, under commercial law terms, a ‘lease intended for security’ with the holding of title to the asset simply a security device akin to a mortgage.

By way of illustration, consider the following example. Company X desires to finance on an off-balance sheet basis a sizeable asset on its books, such as a corporate jet. An appraisal shows that the asset is worth U.S.$110 million has a remaining economic life of 9 and one third years and has a projected value of U.S.$75 million in 7 years (75 percent of 9 and one third years). A lessor/lender may be willing to advance U.S.$100 million on the asset (based on its assessment of both the asset and Company X). Based on the 90 percent test, Company X can agree to a Deficiency Guarantee Amount of U.S.$66 million and a Purchase Option Payment of U.S.$82 million (assuming a U.S.$700,000 a month rent payment, interest at 7 percent per annum and interest and principal allocated on a mortgage-style basis). The At-Risk Amount is U.S.$16 million (U.S.$82 million minus U.S.$66 million), which is well below the projected value at the end of the lease term.

PRACTICE NOTE
In 2002, the Financial Accounting Standards Board (FASB) promulgated a number of ‘interpretations’ that largely rendered the Synthetic Lease untenable.

U.S. Leveraged Lease
This is a long-term leveraged Operating Lease where the lessee brings together both the equity investor owning the lessor and the lender (in contrast with a Back-leveraged Lease where the lessor sources the lender) to finance an Aircraft. The lessor owns the equipment and will generally provide a portion of the purchase price (20 percent) while borrowing the remainder, usually on a non-recourse basis, from the lender. The lessor’s economic return in these transactions includes the tax benefits accruing to an owner of Aircraft (depreciation and so on), and such benefits are factored in the rentals payable by the lessee thereby reducing the lessee’s rental obligations. As compared with traditional Operating Leases, U.S. Leveraged Leases allow for an early termination for obsolescence (which includes the lack of a need by the lessee for the Aircraft). U.S. Leveraged Leases were the preferred financing structure for the major U.S. airlines (and a number of non-U.S. airlines) in the 1980s and 1990s, and, accordingly, billions of dollars of Aircraft were financed by this structure. In the aftermath of 9/11 and with so many of the U.S. airline majors filing for bankruptcy in the 2000s, the traditional lease-equity sources of capital (Philip Morris, Disney, Ford Motor Credit, NYNEX, AT&T and so on – large corporations with income to shelter) dried up when they suffered heavy losses (and...
tax recapture) when their deals soured. Today, only the strongest credits can obtain lease equity and, accordingly, the U.S. Leveraged Lease is rarely employed.

Exhibit 3.11 shows the parties’ relationships in a U.S. Leveraged Lease.

### PRACTICE NOTE

Since U.S. Leveraged Leases are tripartite transactions (and not beholden to market standards for documentation terms, much in the way ECA transactions are), these are among the few types of transactions where the parties actually sit down in a conference room to negotiate documentation.

### Warehouse

A Warehouse is a financing facility typically supplied by banks for an operating lessor: (i) to enable the lessor to accumulate a sufficient number of owned (and leased) Aircraft Assets to effect an eventual Securitization of the accumulated pool; or (ii) as a financing vehicle for Aircraft to ‘warehouse’ them until they are traded, parted-out and/or an alternative long-term financing solution is found. Warehouses may also be employed as a short-term facility to accommodate fast acquisitions by a lessor who would then turn to long-term financing at a later date.

Warehouse facilities may be structured with an identified pool of Aircraft Assets to be financed, or may be more open-ended with no identified pool. In the latter case, the bank will identify the eligible equipment, eligible jurisdiction and eligible lessees that may be part of the facility, and impose Concentration Limits, Mandatory
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Document Terms and Mandatory Economic Terms as well. In either case, significant due diligence is performed on the financed leases, lessees and jurisdictions.

Wet Lease

A Wet Lease is an Operating Lease where the lessor provides the crew and, depending on the deal, fuel and maintenance services, to the lessee, in addition to the Aircraft itself. An ACMI is a form of Wet Lease.

Notes

1 The vast majority of leasing transactions employ an SPV structure, but that is not required. The lessor operating company can certainly be the direct owner of the leased Aircraft Asset.
2 Known as ‘interim lift’.
3 Some airlines, for example, have arbitrary policies of, for example, 50 percent leased and 50 percent owned, and use the shorted term operating leases to rejuvenate their fleets.
4 But see discussion on ‘Operating Lease’, where accounting rule changes may result in Operating Lease financing to be ‘on’ balance sheet.
6 See Nicholas Katzenbach’s opinion as Attorney General, 30 September 1966.
7 The ‘four letter word’ in Aircraft Finance.
9 The answer to this question has major ramifications in the aircraft finance sector. If there is a gap, then the major aircraft manufacturers, if they are unwilling to supply the requisite financing, may be left placing ‘whitetails’ in the desert insofar as their customers will not be able to purchase the aircraft as they roll off the assembly line. In addition, if refinancings cannot be done because of the lack of financing, airlines or operating lessors who own balloon payments on loan maturities may face bankruptcy or, at a minimum, may be forced to turn over aircraft collateral in satisfaction of debt (if a non-recourse financing). A plethora of whitetails and repossessed aircraft would serve to place pressure on aircraft values over and above the pressures placed on those values as a result of the economic downturn.
10 In a bid to obtain financing from the aircraft (and engine) manufacturers, airlines may condition new aircraft orders on new (and immediate) financing. As the treasurer of one U.S. major told an OEM (repeatedly) as it was negotiating a financing package for a new order: ‘We don’t buy airplanes; we buy financing and it comes with airplanes.’
11 The BCC Outlook.
12 Non-U.S. airlines accessing the EETC market will likely rely on private (versus public registered) offering securities exemptions such as Rule 144A so as to avoid the necessity to become a reporting entity subject to the Securities and Exchange Act of 1934.
13 Non-U.S. airlines accessing the EETC market will likely rely on private (versus public registered) offering securities exemptions such as Rule 144A so as to avoid the necessity to become a reporting entity subject to the Securities and Exchange Act of 1934.
14 Thankfully, no one is calling them (yet) ‘pre-owned’.
15 See endnote 9, for some further color on this topic.
16 At the beginning of the American Airlines bankruptcy (filed November 2011), the related Deficiency Claims were selling at 22 cents on the dollar. In June 2013, they were selling at 93 cents on the dollar.
17 Of course, if the debtor agrees to perform under Section 1110(a), the investor simply has a performing security. And, if the debtor returns the Aircraft Asset under Section 1110(c), there would be no lease attached to the security.
Similarly, they need to take into account currency issues that relate to their oil needs since oil is similarly traded only in U.S. dollars.

When the financial markets melted down in 2008–2009, many French banks, for example, lost U.S. dollar funding from U.S. money market funds. They had to scramble to find alternative U.S. dollar funding sources (or had to pull back on U.S. dollar lending).

As an intercreditor matter, the holders of the Subordinated Tranches would not typically have the right to accelerate the debt, but would have a Buy-Out Right. See Part 9, generally.

While U.S. Ex-Im actually offers both of these financing structures, many of the other ECAs only offer one or the other.


There was a period of time when many EETCs also utilized a ‘wrap’ structure; the most senior Tranche was, in essence, ‘guaranteed’ by a monoline insurance company, such as MBIA or Ambac. However, with the demise of the monoline insurance industry in the aftermath of the 2008 financial meltdown, this feature is not currently available.

As noted in U.S. Leveraged Leasing, this product is largely unavailable due to the widespread losses suffered by the equity investors who funded this market. We take the trouble to make note of it here because of the large number of older EETCs still outstanding that have embedded U.S. Leveraged Leasing structures.

A pass through trust is a grantor trust established under state law that is a ‘disregarded entity’ for federal income tax purposes. It operated just like it sounds: all money received by it is passed through the holders of the PTCs.


Cross-default/collateralization was lacking historically largely due to the fact that in EETCs having embedded U.S. Leveraged Leases, the equity investors would not permit cross-default/collateralization.

‘Adjusted’ interest is interest on junior class PTCs in respect of unimpaired pool balances.

Treatment of Leases with an Option to Purchase for Aircraft Registration, 5 Fed. Reg. 40,502 (3 October 1990). The legal opinion was addressed to Peter Leiter, General Counsel of Bank of America.

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There are other definitions of ‘Interchange Agreement’ that are used that are more likely to be used in the context of business aircraft.

Some banks with no Japanese booking office that nevertheless want to participate in this product may engage a fronting bank with a Japanese booking office and purchase a silent participation in the JOL loan. There are tax risks in taking this approach.

Most often referred to as ‘doctors and dentists’.

The KG market in the shipping and real estate sector is far larger than the aircraft sector.

14 CFR. §47.7(c). In the U.S., Aircraft are registered in the name of the owner, rather than the name of the operator.

The FAA has interpreted 14 CFR. §47.7(c)(2)(iii) as requiring registration of the applicable aircraft in the name of the trustee and not in the name of the trust itself.

This term can certainly have other meaning, and may be used to indicate that a party is simply taking a part of a facility (but for that, you do not need a definition).

The selling bank may retain a skim.

This trigger is subject to negotiation.

While this range covers a large portion of aircraft orders, there are variations above and below the range depending on the nature of the purchaser, its order book and so on.


Mortgage-style amortization is not fast enough, and ‘bullet’ maturities are not permitted.

Sometimes referred to as a special purpose corporation (SPC).