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A GUIDE FOR THE PERPLEXED: EXOGENOUS ELEMENTS TO CONSIDER WHEN INVESTING IN EETCS

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One of the most prevalent structures employed to finance jet aircraft acquired by United States (and to a much more limited degree, non-U.S.) airlines are Enhanced Equipment Trust Certificates (EETCs).[1] EETCs are complex securities in respect of which over $41 billion have been issued, with more such securities anticipated to be issued in coming years. Although complex, these securities largely follow the same structure, and basic analysis for investing in EETCs is fairly uniform, taking into account:

- Identity of the issuer/guarantor/wrap provider
- Nature and value of the collateral
- LTV coverage
- Yield
- Average Life/Tenor
- Subordination

While these six elements[2] are essential for any analysis to buy or sell any issue and tranche of an EETC, there are quite a number of factors beyond these six that an investor should consider.

In this bulletin I will set forth the factors other than these "basic six" that are worthwhile to consider over the course of the lifetime of an EETC, and increasingly so as the issuer approaches a distress situation.

I. *Mortgage or Leveraged Lease*

Aircraft financed by EETC financings have been subject to one of two underlying financing structures: mortgage financings or leveraged lease financings. At the time of this writing, while there is a grave scarcity of lease equity thereby making it rather unlikely that, at least in the near-term, further EETCs will be structured with underlying leveraged leases, a large number of existing issues have underlying aircraft financings structured as leveraged leases.[3] By way of background, an equity investor in a leveraged lease (the type of which are the subject of aircraft financings in EETCs) has typically been a passive investor who receives a portion of its "return" on the basis of its being the tax owner of the leveraged lease asset (as compared to an aircraft operating lease investor which manages aircraft as part of its business).

A. *Equity Investor Consent Rights.* The presence of an equity investor adds a number of dynamic issues as the issuer of an EETC enters distress and approaches (or enters) bankruptcy:

1. Pre-bankruptcy Work-out – In a typical leveraged lease, while the equity investor has assigned its rights under the leveraged lease to the lenders, the equity investor retains the right to consent to any changes in the economics of the lease. Thus, any pre-bankruptcy work-out requires the consent of the equity investor.

2. §1110(b) Stipulation – While the matter is not free from doubt and may depend on the terms of the lease documents, the equity investor's consent may be required for any agreement by the controlling party both to extend the "1110 Period" and to change the lease economics during such period.

3. Post-Plan Confirmation – If the end game of the controlling party is to keep the aircraft with the EETC issuer, due to the typical equity squeeze protection provision,[4] the equity investor's consent may be required to any reconstituted lease arrangement as the issuer emerges from bankruptcy.

B. *Buy-Out Potential.* The equity investor in a leveraged lease has an economic investment to protect. Not only has the equity investor invested at least 20% of the aircraft's initial fair market value, the equity investor, by taking tax benefits (depreciation, etc.) accumulates potential tax liability (recapture) in the event the investor loses its investment prior to the end of the lease term. The recaptured tax benefits that would have to be repaid to the IRS may be rather substantial. By virtue of the collateral assignment by the owner trustee/lessor to the indenture trustee acting on behalf of the Lenders of the right to exercise remedies the related lease, the equity investor has lost control of the lease and runs the risk of being foreclosed out. The equity investor has two options by which to wrest control of its aircraft:

1. Contractual Buy-out Right – Under the typical leveraged lease trust indenture, the owner participant has a right to buy-out the equipment notes issued by the owner trustee at par plus accrued interest following the issuer's bankruptcy (as well as in certain other circumstances).

2. Negotiated Buy-out -While the class A controlling party may always entertain buy-out offers for a particular aircraft and its related equipment notes, an equity investor may be a likely and aggressive bidder.

C. *Equity Investor Differentiation.* The interests of equity investors are transferable, and individual equity investors may act differently in different situations. On the one hand, the truly passive tax-based equity investor may be more willing to "go along" with a restructuring so as to preserve its tax position, whereas an equity investor that has more of an operating lease tendency (e.g., GECC) may be more interested in taking a more proactive role (and exercise and/or actively enforce its contractual rights).[5] Accordingly, an analysis of the identity (and motivations) of the equity investor in leveraged lease financed aircraft should be undertaken.

II. *Controlling Party Decision-Making Dynamics*

The ability of the controlling party on a particular EETC issue to realize effectively on the aircraft serving as collateral for such issue depends on a variety of factors, many of go beyond normal rational economic analysis.

A. *Atomization of Investors.* The more widely-held the senior tranche is, the more difficult it may be to reach a consensus ("herding cats") or even identify who the other holders are. On the other hand, if the controlling party is composed of a limited number of holders with large holdings, decision-making can be more decisively and timely undertaken. The ability to take action in a timely manner is, of course, important. Laggards may miss sale opportunities or be too late-in-the-game for issuer sponsored reverse auctions.

B. *Yield- or Asset-Based Investors.* Even with a manageable group at the controlling party level, it is important to identify who the investors are. Asset-based investors are more likely to take a proactive approach and take remedial action such as taking the aircraft back while yield-based investors will more likely shy away from exercising remedies and will more likely try to strike a deal with the airline issuer to keep the aircraft in place with them. Yield-based investors have historically been unwilling to dip into their own pockets to make the expenditures necessary to repossess and remarket aircraft and will likely take the easy (*i.e.*, leasing back to the airline) approach which may not yield as good a result as foreclosing on the aircraft and selling or re-leasing them.

C. *Cross-Holdings.*

1. **Vertical** – The senior tranches of EETCs are usually, even in the worst of situations, over secured. Thus, the controlling party should be able to dispose of the aircraft or equipment notes and come out whole. Of course, realizing on the collateral at distress prices may wipe-out the holders of the junior tranches, but as long as the controlling party complies with the constraints of the intercreditor agreement on dispositions (such as the 75%-of-FMV floor during the first nine months following bankruptcy), the controlling party is free to act to protect its senior interest. However, investors in the controlling party group may also have holdings in the more junior tranches. These junior holdings will cause

them to avoid the taking of action that would result in the realization of losses on such junior holdings.

2. **Horizontal** – Investors in a controlling party group under one EETC issue may have holdings in other issues or other relationships with the airline issuer. These other holdings may compel these investors to react on a "big picture" basis; that is, they may seek to strike a deal with the airline covering all of its interests and may therefore go "soft" on the airline in connection with the particular EETC issue.

3. **Super Horizontal** – Investors in a controlling party group under an EETC issue with a particular airline may have holdings with other airline issuers. It is conceivable that such investors may play hardball with a particular airline issuer to such a degree that the airline would be forced to liquidate, but that liquidation would boost the prospects of the other airlines in which it has invested.

D. *Fear of Litigation.* The willingness of the controlling party to take action that may undermine the position of the subordinated tranches, such as selling aircraft and/or equipment notes at prices that will wipe-out all or part of a subordinated tranche, may be partially dictated by the degree to which the controlling party is concerned with the possibility of litigation action against it by the subordinated tranches. Such fear may be unfounded, yet so deeply felt that it will paralyze the controlling party from taking action.

E. *Collective Bargaining.* While there are efficiencies for pooling similarly situated groups of investors to negotiate with the airline issuer, the abdication of power to the larger group may create situations where there are lost opportunities to realize on the aircraft collateral in a particular EETC issue. In such situations, the "greater good" trumps the interests of the controlling party with respect to a single issue. To be sure, collective bargaining does have benefits beyond mere efficiencies; the bigger club that may be wielded against the airline (more aircraft that may be pulled) certainly gives the group more clout. However, sometimes a big club is harder to wield, and an airline may be willing to call the group's bluff.

F. *Par or Discount Buyers.* Another important detail concerning the make-up of the controlling party is whether the controlling investors bought at par (at initial issue, for example) or at discount in the secondary market and, if the latter, at how deep a discount. Obviously, investors with different cost bases in their EETC investment will behave quite differently. In a similar vein, hedge fund investors will behave differently than institutional investors.

III. *Other Factors*

A. *Advisors.* The role of advisors in work-out and bankruptcy situations often plays an important part in the ability of EETC investors to realize the maximum value of their collateral. Both legal counsel and aircraft financing advisors are critical players in negotiations, and skill level does matter. These advisors also may be prone to glossing over conflict-of-interest issues when collective bargaining is in place. That is, the interests of the controlling party of a particular issue may differ from interests of controlling parties of other issues. If the professionals represent the entire group, they may not give the proper advice to separate controlling groups.

B. *Identity of Subordinated Tranche Investors.* As with certain equity investors in leveraged leases, the identity of the holders of the junior tranches of an EETC issue may dictate different results. While a yield-based junior tranche investor may simply walk away from his investment in a melt-down situation, an asset-based investor who does not want to be wiped out by a precipitous exercise of remedies by the controlling party may be more prone to exercise its buy-out right of the next most senior tranche to protect its investment. Because aircraft and engine manufacturers are often forced to buy the junior tranches of EETC issues secured by the equipment they manufacture, one should consider what position a manufacturer would take in a distress situation.

IV. *Summary*

The analysis for investing in EETCs should, accordingly, delve into the details of both the underlying financing structure and the identity of the participants in the various components of the financing structure. Once participants have been identified, decision-making motivations of such participants should be analyzed. With this information in hand, together with the "Basic Six" elements, investment decisions in EETCs can be made on a more opportune basis.

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[1] This paper assumes a working knowledge of the EETC product and the way in which EETCs are structured. For a review of the product and structure, see R. Scheinberg, *Enhanced Equipment Trust Certificates in the Downturn: An Assessment for Banks*, The Banking Law Journal, February 2004.

[2] While some investors will also consider the rating of EETC securities assigned by the rating agencies, any rating should be derivative from these six factors.

[3] The recent JetBlue 2004-1 EETC was issued on a pre-funded basis without a leveraged lease financing option. In pre-funded deals where the issuer has an option to finance on either a mortgage or leveraged lease basis, the investor, of course, will not know which option has been selected until the aircraft is delivered.

[4] Equity squeeze protection prohibits the lenders from foreclosing on their lien on the financed aircraft so long as the lenders have not dispossessed the airline of the aircraft.

[5] For example, GECC, as equity investor, exercised its contractual buy-out right of the equipment notes for its aircraft in the Midway 1998-1 EETC (GECC was equity in four of the eight CRJ-200s under such EETC) and the Midway 2001-1 EETC (GECC was equity in all seven of the delivered Boeing 737-700 aircraft subject to such EETC), thereby greatly benefiting the EETC investors to the extent of such buy-out. Verizon Capital, the equity in the remaining four aircraft in the Midway 1998-1, took a different tack in respect of its aircraft.

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