# *Business Aircraft Financing*

## (It's Like Any Other Equipment Financing, Except More Complicated)

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In the past, business aircraft financings had a certain mystique. The equipment was the plaything of the superwealthy and large public companies. Counsel were often the same few firms or attorneys, some of whom were great on the regulatory or tax issues, but often uncomfortable with commercial finance transactions. Only a handful of financing parties originated business aircraft financings and were the syndication source for the entire middle-market segment of the industry. Lessors' and lenders' counsel were also limited to a few familiar faces and firm names.

To those few participants, it was a great game, with significant deal sizes and assets that held their value for collateral and residual purposes as well as deal documents and customer attitudes that were consistent with other traditional equipment financings.

Then, however, it all changed. Due to a confluence of circumstances, including September 11 and market globalization, use of business aircraft was no longer considered to be an exotic extravagance. Instead, having the flexibility afforded by private air transportation has become an important tool for businesses that have suppliers, operations, or customers located in places that are most efficiently reached by air travel or via airports that have limited or no commercial airline service.

The exclusivity of the market changed for the financing parties as well. Many middle-market financing providers, after buying but not originating these deals, realized that the transactions were not extraordinarily different from other equipment financings. Finance providers began using experienced asset managers, attorneys, and other resources, so the related anxieties became more manageable. In addition, by developing specialized credit, documentation, and asset management procedures as well as the related staffing, finance providers reduced their reliance on specialized counsel, consultants, and deal originators. This practice reduced the cost – but increased the time and other efficiencies – of participating in these transactions.

Other market forces had an impact on the flood of financing participants in business air-finance transactions. Due partly to acquisitions within the industry, the consolidated equipment finance group engaged in shared marketing efforts with relationship and private bankers within the larger combined companies. This in turn led to more and easier opportunities to do these deals with the existing customer base. The decline in capital-market opportunities, mostly because of changes in accounting and tax considerations, pushed the participants in that arena to look down-market. Capital market financing parties, already familiar with structured or cross-border transactions, saw nothing exotic about these middle-market deals and gladly pursued these opportunities.

With this significant increase in competitors for the same deals, the customers and their counsel became more sophisticated and emboldened. Instead of receiving a few offers for a prospective financing, the customers found themselves in the enviable position of choosing from a greater number of proposals, each of which offered cheaper and more flexible financing terms. It became standard for customers to ask for and expect the right to structure the transaction so as to address various tax issues of concern to them, as well as permitting affiliated and third-party use and availability.

Moreover, the law and practice with respect to aircraft financing has recently undergone a major

Business aviation provides a growing and active market to potential financing parties. However, this arena also has unique regulatory, tax, operational, maintenance, and perfection issues, which are outlined in this article. A special section beginning on page 14 summarizes the Cape Town Convention, a treaty with major implications for business aircraft financing.

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change due to the implementation of the Cape Town Convention (CTC).[1] This treaty establishes a system for creation, priority, registration, and enforcement of "international interests" (assignment, subordination) in aircraft engines, airframes, and helicopters, those interests having been created pursuant to security agreements, lease agreements, and conditional sale agreements.[2]

An international registry was established for the registration of these and other interests in certain "aircraft objects," including prospective international interests (e.g., interests that will vest at funding); assignments and prospective assignments of international interests (e.g., collateral and syndication assignments); subordinations of various interests; and sales and prospective sales of aircraft objects.[3]

The Cape Town Convention entered into force on March 1, 2006, and, generally, applies to the interests of vested or prospective buyers, conditional sellers, secured lenders, and other lienholders and lessors of airframes, engines, and helicopters (including business aircraft) that meet the size and other requirements of the Aircraft Protocol.[4] The CTC is applicable to these vested or prospective interests only if the "debtor" (i.e., the lessee or the party granting a security interest) is "situated" (organized) in – or, with respect to an airframe or helicopter (but not the related engines), that airframe or helicopter is registered in – a "contracting state" (i.e., a country that has ratified the CTC).[5]

Financing parties will also need to be mindful of the compliance requirements of the Cape Town Convention to leveraging and syndication of air-finance transactions. New conditions to permitted third-party use and possession should also be considered, with a view to applying the CTC to this standard flexibility provision that is included in lease and loan documents involving business aircraft. Transactions structured as progress payment ("green") aircraft financings could also be affected by the provisions of the Cape Town Convention. How closings will be affected is still evolving at this time. A very brief and general summary of the impact of the CTC on aircraft financing appears as a sidebar to this article (see page 14).

So, now more than ever, it is important for financing providers to understand the legal and documentation issues that are peculiar to business aircraft financings. This article highlights the impact of some of these regulatory and other asset-specific issues when structuring, documenting, and closing a business aircraft financing. This article, however, is not intended to provide an in-depth analysis of all of the substantive issues involved in business aircraft financing.

## ORIGINATION: ISSUES UNIQUE TO AIRCRAFT FINANCING

### FAA/Cape Town Ownership, Registration and Operation

#### Generally

The owner of an aircraft must register its ownership with an aeronautical authority in the country of its choosing, consistent with the laws of that jurisdiction.[6] Although most financing parties situated in the United States would prefer that the aircraft be registered and hangared in the United States, they are willing to permit foreign registration and hangaring subject to a number of conditions. Compliance with the registration requirements of the nation of registry and, where applicable, the Cape Town Convention, is essential to protect the financing party's title to or first-priority lien against the aircraft (including, in most cases, any engines and propellers).[7] Operation of the aircraft without complying with the applicable registration requirements (other than the Cape Town Convention) is also likely to result in a violation of both the law and the required insurance coverages.

Registration outside the United States raises a number of issues that are likely to have an impact on the pricing, credit analysis, and collateral and residual forecasting. For example, foreign registration could affect the income tax treatment, increase liability, involve certain governmental and tax risks, require more expensive insurance coverages, and significantly increase the costs of being a party to a business aircraft financing.[8] In addition to these aircraft-specific issues, financing parties must consider and address all of the usual cross-border financing issues.

At least for credit officers, the most significant issue will be the expense, time delay, and enforceability uncertainties inherent in trying to repossess and remarket an aircraft that is registered outside the United States. The credit officer might take some comfort with respect to these risks if the aircraft is registered in a nation, or involves a lessee, borrower, or other party granting a security interest in the related aircraft that is situated in a country that is a party to the CTC.[9] This article however, will focus on the financing of U.S.-registered business aircraft.

**United States Registration**

United States law requires that any aircraft that is eligible for registration must in fact be registered.[10] The federal aviation regulations (FARs)[11] state that only U.S. citizens and resident aliens may register an aircraft with the Federal Aviation Administration (FAA).[12] The Transportation Code sets forth the requirements of U.S. citizenship.[13] A "citizen of the United States" may be either an individual who is a citizen of the United States or a partnership in which all of the partners are U.S. citizens. Other business entities must be domestic organizations managed and controlled by U.S. citizens. (In other words, the president and at least two-thirds of the directors and other managing officers must be U.S. citizens, and at least 75 percent of the voting interests must be owned or controlled by U.S. citizens).[14]

Financing parties must determine whether, under the proposed structure, the party that is likely to be deemed the registered owner of the aircraft under applicable law is a citizen of the United States. Although it will be obvious as to whether an individual or partnership customer is a U.S. citizen for FAA purposes, the analysis is more complicated for other business entities. Unless organized as a partnership, a business entity must pass the three-part test referenced above[15] to qualify as a U.S. citizen. Depending on the contemplated financing structure, the registered owner could be the financing party, the customer, an affiliate of either party, or a trustee for either party.

If the transaction is a loan, the determination is uncomplicated. The borrower is likely to be the owner and must register the aircraft in its name or through a U.S. citizen trustee. In some cases, the aircraft might be owned and registered in the name of an affiliate of the borrower, and the affiliate will secure the loan to the borrower by granting to the lender a security interest in the aircraft.

In an aircraft financing structured as a true lease, the lessor should be the registered owner on the FAA records. In nontrue leases, the lessee should be the registered owner. Accordingly, in a synthetic lease, the lessee is likely to be deemed to be the registered owner as the FAA considers such an arrangement to be a conditional sale.[16] Taking into consideration synthetic leases and other lease transactions documented as a "lease" but having economic provisions that might be inconsistent with true lease treatment by the FAA registry, the financing party might require the review and opinion of the FAA's Aeronautical Center Counsel as to this issue prior to closing.

If the customer or its affiliate is going to be the registered owner (either as borrower or as lessee under a nontrue lease), and it is not a citizen of the United States as previously defined, the financing party will likely require that the customer establish a voting trust or an owner trust.[17] In the case of a voting trust, the customer is identified as the registered owner of the aircraft. In the case of an owner trust, a grantor trust is formed in which the customer is the grantor and beneficiary and the trustee (a U.S. citizen) is the registered owner of the aircraft.

The trust or the trustee (depending on, among other things, whether the trust is a statutory or common law trust) will be a party to one or more of the financing documents for the purpose of granting to the financing party a security interest in the aircraft. The trust is likely to be established with one of the large U.S.-chartered financial institutions that are experienced with trusts used

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for this purpose. In lieu of the trust structure, some customers may offer to satisfy the citizenship requirements by complying with the use restrictions and reporting provisions of the U.S. Transportation Code.[18]

**Operating Restrictions**

The federal aviation regulations control the operation and airworthiness of U.S.-registered civil aircraft. Business aircraft operations generally fall under Part 91 or Part 135 of the FARs. Part 91 contains generally applicable rules for all aircraft operations (i.e., "general aviation" or "noncommercial" operations). It applies when the owner is operating its aircraft either for its own purposes or for certain affiliated and unaffiliated third-party use that is permitted under Part 91.501. In many cases, the customer will be operating the aircraft solely for its own purposes or to provide air transportation for its affiliates and senior officers or principals. If operating solely for those purposes, the customer will be subjected to the less burdensome maintenance and operational requirements of Part 91.

Part 135 of the FARs is applicable to the operation of an aircraft for the purpose of carrying third-party passengers or cargo, on an unscheduled basis, for compensation or hire. Under Part 135, the operator must obtain an air carrier certificate from the FAA and follow a more stringent regulatory regime. Part 135 operators may, however, offer the aircraft to third parties for charter.

Due to the significant expense associated with owning, operating, and maintaining an aircraft, many customers desire the flexibility to generate revenue from the aircraft when it is not being used for the customer's or its affiliates' business purposes but do not want to go through the air carrier certification process or be responsible for the maintenance and operational requirements of Part 135. For this reason, many customers contemplate entering into a management agreement with a Part 135 certificate holder. This agreement could include a lease to the certificate holder that would be operable during Part 135 operations. The "manager" takes care of all maintenance and operational requirements and is able to charter the aircraft to third parties under Part 135 when the aircraft is not otherwise being used by the customer for Part 91 operations. Under this arrangement, the customer receives a portion of the charter revenue, which can offset its operating costs.

## The Proposed Obligor and the Real Credit

**Significance of This Issue in Aircraft Financings**

**SPEs, affiliates and trusts.** Some customers, particularly "high net worth" individuals, structure aircraft transactions so that either an existing transportation subsidiary or a special purpose entity (SPE) takes title to or operates the aircraft. Individual owners of business aircraft often create or use an SPE to hold title or a leasehold interest in the aircraft for reasons such as the hope of avoiding personal liability if the aircraft is in an accident.[19] Use of an SPE might also be useful to the financing party if – by entering into the financing directly with the SPE, and not the individual who is the real "credit" in the deal – the application of consumer finance laws may be avoided.[20]

In any event, if the aircraft is going to be purchased or held primarily for personal, family, or similar purposes, the financing party must determine whether any consumer laws might be applicable to the contemplated financing transaction, even if unintended.

Affiliates of the customer might be the registered owner or operator of the aircraft based on advice from its counsel or other tax advisor of the related tax implications of the anticipated use of the aircraft.[21] The customer might ask to structure the financing so that an affiliate that is not an SPE[22] is a party to the financing documents for reasons not relating to regulations or taxes peculiar to aircraft (e.g., due to contractual restrictions imposed on the customer, or accounting considerations). As noted above, if the customer or its affiliate is going to be the registered owner (either as borrower or as lessee under a nontrue lease), and it is not a "citizen of the United States," the financing party will likely require that the customer establish a trust such that a U.S. citizen trustee serves as the owner and to grant the financing party a security interest in the aircraft.

**Structural implications.** An SPE or trust is not likely to be the real credit strength, because these entities often own very few assets other than their interests in the aircraft. Interposing such a party in the transaction structure could also complicate enforcement by the financing party of remedies against the real credit in the transaction. The credit approval will most likely be conditioned upon the transaction structure's consistency in having enforceable remedies against the most creditworthy obligor in the transaction.

The most common structure employed to accomplish this goal is a lease or loan to the SPE or affiliated entity, with a guaranty from the customer (the real credit in the deal). The financing party will want to establish that sufficient consideration exists for that guaranty.

As in other similar equipment financings, the guarantor will acknowledge (1) that it induced the financing party to enter into the financing by providing its guaranty, and (2) that this inducement constitutes sufficient consideration for the giving of the guaranty. Also, as in other guaranteed financings, the financing party will want to establish the sufficiency of the consideration by establishing that the guarantor will derive a meaningful benefit from the aircraft financing afforded the lessee or borrower.[23]

As is likely with respect to any guaranteed financings, the sufficiency of the consideration can be measured by the direct or indirect benefits to the guarantor as a result of the relationship between the borrower or lessee and the guarantor (e.g., whether it is an upstream, sideways or downstream guaranty).[24] The sufficiency of the consideration is easier to establish if the aircraft is being operated by or for the guarantor in furtherance of its business purposes.

Accordingly, some financing parties require a representation or acknowledgment by a guarantor that it will use the aircraft, or that it will be used for the guarantor's benefit. This acknowledgment can be provided either in the guaranty or in a separate certificate by the guarantor. The guarantor's acknowledgment must be consistent with the permitted use provisions of the financing documents, whether the guarantor's anticipated use is pursuant to FAR Part 91.501 or a permitted lease, sublease, charter, time-share, or other arrangement.

If the guaranty from the real credit is not available, the structure may include two or more levels to the transaction. The first level is the lease or loan to the customer's SPE or other affiliate, including the payment and performance obligations that are consistent with the financing party's standard and deal-specific requirements for this transaction. The second level of financing is more often a lease than a loan to the customer. The customer's payment and performance obligations under these second-level lease or loan documents mirror the payment and performance obligations of those imposed on the affiliated obligor in its direct lease or loan agreement with the financing party. The affiliated obligor then collaterally assigns the lease, sublease, or other secondary financing documents to the financing party, and the assigned hell-or-high-water payment obligations will be paid directly to the financing party. Bankruptcy and some other risks are associated with this structure, but they are outside of the scope of this article.

In some loan or nontrue lease financings, the customer may not be the registered owner of the aircraft but might be the lessee or borrower under the primary financing documents. In that event, the registered owner of the aircraft must grant the financing party a security interest in the aircraft to secure the customer's obligations under the primary financing documents. This grant could be made in conjunction with, and to secure, a formal guaranty by the registered owner in favor of the financing party, or merely a "hypothecation."[25]

Any hypothecation (grant) pursuant to a security agreement, and not a guaranty, should address all of the typical suretyship issues that are the subject of standard waivers in most guaranty forms. The financing party will also require opinions and corporate authority deliverables that support the enforceability of the secondary obligor's grant and related obligations under the

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hypothecation/security agreement. The secondary obligor must also be a citizen of the United States under the Transportation Code if the financing party is going to require FAA registration of the aircraft. As with any collateralized transaction, the security interest must be perfected and afforded first priority by making all appropriate filings and registrations at the FAA and Cape Town Convention registries.[26]

If the customer or other owner/obligor employs a trust for the reasons mentioned above, the trust or the trustee, depending on the trust laws applicable to the transaction, will be the registered owner of the aircraft. The trust or trustee is likely to be the primary obligor under the lease or loan. But if not, it will be required to provide a guaranty or other agreement directly with or collaterally assigned to the financing party, secured by the aircraft. If the trust or trustee is the primary obligor, the customer will be required to guarantee the trust party's obligations under the primary financing documents. Assuming that the customer is the beneficial owner of the trust, the customer might be required to pledge its beneficial interest in the trust to secure the guaranty and the primary financing documents.

Again, the trust party will be required to follow closing procedures consistent with commercial law, FAA regulations and the Cape Town Convention, in order to protect, perfect, and give first priority to the financing party's interest in the aircraft and related property and proceeds.

## The Aircraft

The aircraft to be financed will be identified by make, model, and manufacturer's serial number in the proposal letter or term sheet, and in the purchase documents, financing documents, and filings. If it was manufactured or registered in the United States, the aircraft also will be identified by and the U.S. (FAA) registration mark (an "N number"). Assuming that the aircraft is manufactured in the United States and will be delivered to a U.S. citizen, it is issued an N number (usually chosen by the customer) during its assembly and prior to delivery to the buyer. The N number may be changed from time to time in accordance with the FAR procedures.[27]

The N number for the aircraft, along with serial numbers for the engines and aircraft, will be essential in any title and lien searches at the FAA, the International Registry, or the aeronautical authority in any other nation where the aircraft was previously registered. However, serial numbers do not change, so they are reliable for the purpose of identifying the aircraft and engines in documents and filings, and the serial numbers will be the primary means of identifying the collateral under the Cape Town Convention.[28]

The financing party also should search the applicable UCC recording offices to determine whether any liens purport to attach to the aircraft or engines. However, the filing will be pertinent only to detached parts, records, proceeds, and other related collateral against which a UCC filing will perfect a security interest, because the CTC and the Transportation Code preempt perfection and priority status as to security and certain other interests relating to the airframes and engines.

Residual values, tax implications, closing costs, and other pricing concerns are likely to be affected by the type and intended use of the aircraft being financed. For example, an aircraft that is going to be chartered on a regular basis is likely to have a higher average annual hourly usage, involve unrelated third parties, increase the cost of the required insurance coverages, and increase liability and repossession risks. The credit approval will take into account each of these practicalities. In some cases, approval will be conditional, limiting the customer's flexibility or requiring some compensation from the customer if the use of the aircraft exceeds a stipulated threshold.

## Used Aircraft Financing

For used aircraft, the financing party might want to inspect and require an appraisal of the aircraft to support the value at closing, and as estimated with respect to any date on which the customer may exercise a termination, purchase, or renewal option. With respect to used aircraft, the financing party will want to determine the existence of any damage history reported to the FAA, given that any reported damage is likely to affect the collateral or residual value of the aircraft. Used aircraft financing will necessarily involve dealings with third parties, such as the seller of the aircraft and any existing financing party having an interest in the aircraft.

Whether refinancing an aircraft or buying a used aircraft, the customer must cause the appropriate seller and any existing lienholder to deliver all of the documentation, and cause registrations and discharges to be made, in order to transfer title to or grant a first-priority security interest in the aircraft, free of all liens. These sale and lien release documents, registrations, and discharges must be effective under applicable commercial law, the FARs, the Cape Town Convention, and all other pertinent laws.

If the aircraft is under foreign registry and not then owned by the customer, the customer should cause the seller to take the necessary steps to de-register the aircraft from the foreign registry in order to export it to the United States and register it with the FAA.[29] If the aircraft is registered with the aeronautical authority of another country, the costs associated with the financing can be much greater than if the aircraft is then currently registered with the FAA. For example, these additional costs could include hiring local counsel to conduct title and lien searches at the corporate and aeronautical registries in that jurisdiction, obtaining title insurance (if requested), preparing any de-registration and any releases or terminations, complying with any export or import laws, and re-registering the aircraft with the FAA. Some financing parties may require that the seller and customer take steps so that the prospective sale is registered with the International Registry.[30]

## Pre-Completion Financings

### Generally

Some financing parties will agree to provide financing prior to the completion of the aircraft. Examples of this predelivery financing include the purchase and lease of a "green" aircraft (certificated as airworthy, but still in need of additional equipment or other work) or an aircraft that is under construction. When funding prior to full completion and physical delivery, the financing party takes a calculated risk. One obvious risk is the solvency and performance of the manufacturer or other third party that will be completing the new aircraft or refurbishing a used aircraft pursuant to its agreement with the customer. If the financing party agrees to provide interim or progress payment financing, its collateral is intangible (typically, the collateral assignment of the purchase agreement) and its value much less certain than when funding at delivery of the completed aircraft. Any such additional risk may be reflected in the pricing for the transaction.

With a tax lease of green aircraft, a sophisticated tax analysis is necessary to reach a conclusion as to when the financing party may begin to take depreciation on the aircraft. In any multifunding financing, the costs of documenting and closing the transaction are likely to be significantly greater than they would be in a traditional lease or loan financing.

### Interim Financings

As with other traditional equipment financing transactions, financing parties may be willing to provide progress payment or other interim financing. The willingness to fund this pre-delivery financing is likely to be dependent on the creditworthiness of the customer and other obligors as well as the credit standing and reputation of the manufacturer. The risks in providing interim financing with respect to a business aircraft are different only because of the unique nature of the asset: including the limited number of manufacturers, and capable completion facilities, the length of the construction period, the significant amounts required as progress payments, and the limited market for the collateral.

A financing party has a much more predictable exit strategy in the typical transaction if the funding occurs at delivery. After the customer accepts the aircraft, the financing party funds, and all of the appropriate searches, filings, registrations, and other title and lien protections are accomplished at closing, the financing party has the comfort of knowing that it can exercise traditional repossession and disposition rights. The financing documents, if properly drafted,

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will provide remedies that are consistent with applicable commercial and other law.[31] To recover its investment, the financing party can reasonably expect to look to these contract remedies, the pertinent statutory and case law, and the Cape Town Convention, then follow the exit strategy contemplated in the credit analysis.

In a progress payment or other interim financing, the customer or its affiliate (whichever is the buyer under the purchase agreement) will enter into a collateral assignment of the purchase agreement in favor of the financing party. The collateral during construction will not include a lien, ownership, or other interest in the aircraft, because title has not passed to either the financing party or to the customer during any interim financing period. Some financing parties request that the vendor grant them a security interest in the aircraft that will become effective ("spring") if the vendor has title prior to delivery to the customer.[32]

In connection with this type of financing, the vendor will be asked to acknowledge the collateral assignment and the financing party's rights to exercise certain remedies relating to the purchase agreement upon a default by the customer under the financing documents prior to final funding. Although they will be limited by negotiation with the vendor, the remedies could include the right to assume all of the customers' rights and obligations under the purchase agreement or to further assign the customer's rights and obligations under the purchase agreement to a third party. If the financing party assumes the purchase agreement, it would have the right to (1) pay any balance of the purchase price payable under the purchase agreement with respect to the aircraft, and (2) accept delivery of and take title to the aircraft.

An alternative exit strategy may involve the financing party's assuming the customer's rights and obligations under the purchase agreement, and then terminating its right to purchase the aircraft, but receiving from the vendor a remittance of all amounts previously paid by the customer or advanced by the financing party as progress payments, a deposit, or otherwise. Any return of these amounts, however, would likely be reduced by a stipulated amount as "liquidated damages" that may be retained by the vendor according to the purchase agreement.

The financing party will also want the right to assign its assumed rights and obligations under the purchase agreement or, if not yet assumed, further assign its right to assume such rights and obligations. Aircraft vendors are reluctant to permit further assignment without imposing certain conditions. It is important to get the vendor's consent to this collateral assignment, and any further assignment, because in most cases the customer's and (as collaterally assigned) the financing party's right to further assign is usually precluded by the purchase agreement. Vendors impose conditions so that they can exert some control over the market for their aircraft, and the vendor does not want to compete with the financing party with respect to the sale of the vendor's product.

**Green Aircraft Financings**

In a green aircraft financing, the parties agree to have two or more fundings. For leases, the financing party will buy the aircraft, and the customer will accept the aircraft under the lease, but the customer takes physical delivery only briefly. After the customer confirms that it has taken delivery of the aircraft and accepted it under the lease, the vendor or third party providing the additional equipment (or otherwise "completing" the aircraft) will transport the aircraft to a completion center or other facility, so that it can be completed for final delivery at some later time.

The second closing will occur when the vendor has completed the additions, the customer determines that the additional work has been completed, and all funding conditions have been satisfied. The financing party will fund the completion work on that date, the customer will accept the additional equipment under the lease, and the parties will amend the lease documents to reflect the adjustment to the rents and other amounts as well as the additional equipment.

If the green aircraft lease is a tax lease, the financing party often hopes to begin depreciating the aircraft from and after the first closing. The financing party can begin depreciating the aircraft when it is deemed "placed in service."[33] Arguably, this occurs at the first closing because the aircraft is ready and available for use in the financing party's equipment leasing business, and in fact is producing rental income.[34] Accordingly, although the aircraft might not be completed with all of the equipment installed, being in the required configuration, or having other work to be done to cause it to conform to the delivery condition required in the purchase documents, if it is susceptible to being leased, the financing party will purchase the aircraft and subject it to the lease in its then-existing condition. Financing parties participating in green aircraft leases will typically require both that the aircraft have an airworthiness certificate and that the lessee take a test flight to demonstrate that the aircraft is operational at the first closing. There is no regulation, letter ruling, or other guidance establishing that this practice is necessary, but it is desirable.[35]

#### Like-Kind Exchange

Frequently, a customer will request that the financing party allow the customer to acquire the aircraft by using a like-kind or "1031" exchange (LKE). Generally, use of this method of acquiring an aircraft or other property is intended to avoid recognizing taxable gain upon the disposition of the old aircraft, so that the customer may invest the entire proceeds in the replacement. This tax treatment is available if property held for use in a business or for investment is exchanged for other property of "like kind" held for that purpose.[36]

There are various types of LKEs, and the elements of the contemplated LKE may have an impact on the documents, timing, and other aspects of the financing. As LKEs have become more common, financing parties have become accustomed to the jargon, additional parties, and appearance of structural risk inherent in these transactions.

A common type of like-kind exchange is a "reverse" LKE, in which the replacement aircraft is acquired before the disposition of the old aircraft. Reverse LKEs may be structured as a "front-end" reverse exchange or a "back-end" reverse exchange. In a front-end LKE, the new aircraft is acquired by the customer's LKE intermediary (sometimes referred to as a "parking company") and immediately exchanged with the customer for the old aircraft, and the parking entity holds the old aircraft until it is sold. In a back-end LKE, the new aircraft typically is acquired by a special purpose entity established by the customer's LKE advisor or intermediary, which holds title to the new aircraft until it is exchanged for the old aircraft, which is then sold immediately.

Depending on the LKE structure, it may be necessary for the parking company to be a party to the financing documents. For example, in a back-end exchange, the parking company takes title to the new aircraft, so the financing party might find it desirable to have the parking company be a co-obligor until the exchange is complete.

## THIRD-PARTY USE AND OPERATION

### Third-Party Arrangements

#### Generally

Use, operation, or possession of the aircraft by a third party creates various credit, residual, collateral, and liability risks for the lessor or lender. In some cases, the credit approval contemplates and requires the third-party arrangement because the cash flow from that arrangement will be collaterally assigned to the financing party – as credit support for the customer's obligations under the financing documents. The financing party will have addressed any risks associated with involving of a necessary third party in those transactions, to the extent practical, in the structuring and documentation of the deal.

In the past few years, however, as the customers and their counsel have become more sophisticated in their understanding of FARs or forthright about their intentions, it has become common for the customer to request the right to have the financed aircraft made available to related or unrelated third parties. The stated

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In certain transactions, the financing party, especially if it is a true lease, may want a collateral assignment of the payments under the third-party agreement. The financing party might be concerned about liability to the third party or other persons as a result of that third-party relationship.

purpose can be any of these: (1) the flexibility to have the aircraft made available to the customer's affiliates for their business transportation needs or to certain officers and directors for nonbusiness use, (2) the need to employ an unrelated third party, or to utilize a designated affiliate, to manage the maintenance and operation of the aircraft, (3) the desire to maximize the value of the aircraft or recover some of the acquisition cost, by deriving revenue from the chartering or sublease of the aircraft to third parties, or (4) the need to defer sales tax on the purchase price of the aircraft through a leasing structure.

Financing parties often consider the most significant risk of a third party's use, operation, or possession of the aircraft by a third party to be the potential impediment to the financing party's ability to recover the aircraft upon a default under the related financing transaction. This impediment would exist either because the third party is uncooperative or insolvent or because the third party alleges that its rights with respect to the aircraft are superior to those of the financing party. A third party's creditors or a bankruptcy trustee may also raise this argument if the third party files for bankruptcy.[37] This problem is exacerbated if applicable commercial law deems the aircraft to be "inventory" in the hands of the customer.[38] The customer's insolvency could also complicate the financing party's termination of the third party arrangements and recovery of the aircraft.[39]

The financing party wants to be certain (1) that the terms of any third party agreement are consistent with the financing documents and (2) that the financing party is not waiving or modifying any financing document provisions that are inconsistent with the third-party agreement. The financing party will also be concerned about any attempts by the customer to delegate important responsibilities to the third-party, such as maintenance and insurance. In certain transactions, the financing party, especially if it is a true lease, may want a collateral assignment of the payments under the third-party agreement. The financing party might be concerned about liability to the third party or other persons as a result of that third-party relationship. Lastly, any operation of the aircraft by the third party must be in compliance with all applicable legal requirements.

### Affiliate Use

Part 91.501 of the FARs contains provisions for use of an aircraft for an affiliate or pursuant to interchange or time-sharing agreements. For affiliate use, Section 91.501(b)(5) allows for

> [c]arriage of officials, employees, guests and property of a company on an airplane operated by that company, or the parent or a subsidiary of the company or a subsidiary of the parent, when the carriage is within the scope of, and incidental to, the business of the company (other than transportation by air) and no charge, assessment or fee is made for the carriage in excess of the cost of owning, operating, and maintaining the airplane, except that no charge of any kind may be made for the carriage of a guest of a company, when the carriage is not within the scope of, and incidental to, the business of that company.

As noted above, if the operation of the aircraft falls within this provision, the flight is governed by Part 91 of the FARs (general aviation) rather than Part 135 (air carriers, which are subject to more stringent licensing, operations, and maintenance requirements). Part 91.501 also permits use of an aircraft for carriage of the customer's officials, employees and guests under time-sharing or interchange agreements.[40] Although this use is permitted by the FARs, the financing party may consider collateral and other issues relating to any such "91.501 use," and preclude arrangements that convey a lien or other property right or interest in or against the aircraft. It should be noted, however, that with respect to each such permitted user, the company remains in operational control of the aircraft.

### Leases (in Loan Transactions) and Subleases (in Lease Transactions)

As previously discussed, particularly in transactions involving SPEs, customers often request the right to enter into leases or subleases either for operational flexibility or to generate revenue when the customer is not using the aircraft (thereby maximizing its value). In some cases, the customer may be relying on the rental stream under that permitted third-party lease or sublease to satisfy the payment obligations under the primary financing documents.

Generally, the customer will supply the form of lease or sublease. Often this document is an "operating" lease, with obligations that are consistent with (but not the same as) the payment and other obligations under the primary financing documents. If these secondary lease obligations are not intended to be significant collateral for the primary obligor's obligations, the required payments and term may be quite different than the payments and term of the primary financing documents.

Wet leases[41] between the customer and a third party are generally permitted without significant conditions imposed by financing parties because such an arrangement, by its nature, creates no property interest, possessory right or other encumbrance or claim that is likely to impede the financing party's recovery of the aircraft. Dry leases,[42] however, are usually subject to various conditions, including those described below in the discussion regarding third-party consents.[43]

**Management Agreements (With and Without Charters)**

Most financing parties permit arrangements between the customer and a manager, pursuant to which the manager may provide management services (e.g., flight crews and maintenance) or charter the aircraft from time to time. Arrangements with managers are often essential because the customer does not have the resources to maintain or operate the aircraft and has no desire to develop such resources.

Management agreements are generally permitted because it would be impractical to prohibit them, and because such arrangements do not typically contemplate the manager's being vested with a property interest. The manager, however, will have a possessory right, and if the customer fails to pay for any services provided by the manager, the manager might have an artisan's lien against the aircraft under applicable state law.[44]

Issues also arise if the customer and manager want to include the aircraft on the manager's hull and liability insurance policies, because the policy provisions are rarely consistent with the requirements of the financing documents. Furthermore, the manager and its broker are often extremely reluctant to afford the financing party any control over the claims process or other dealings with the insurer.

If the customer and manager agree that the manager will charter the aircraft, the financing party must address additional concerns. Specifically, the financing party should require, among other things, that the manager has a valid air carrier certificate issued under Part 135 of the FARs permitting it to engage in such operations. Any chartering and maintenance must be conducted in accordance with Part 135 of the FARs. The anticipated annual hourly use of the aircraft is likely to be accounted for when pricing the financing transaction and when determining the compensation or other rights of the financing party if the actual hourly use of the aircraft exceeds the anticipated use. If applicable, the depreciation schedule might be extended from five to seven years.[45]

Lastly, the minimum liability insurance amounts should reflect the additional liability risk associated with this use. Because chartering is essentially similar to wet leasing of the aircraft by the manager to a third party, financing parties do not typically require any consent or other similar multiparty acknowledgment from the person or entity chartering the aircraft from the manager.

There is some risk that the management agreement might constitute a lease under commercial law.[46] This risk may exist, for example, if the management agreement requires the manager to pay some compensation to the customer for the right to use the aircraft for the manager's own business purposes (e.g., chartering the aircraft and keeping all or part of the charter revenue). It is rarely the case, however, that the financing party will (1) decide to treat the management

Management agreements are generally permitted because it would be impractical to prohibit them, and because such arrangements do not typically contemplate the manager's being vested with a property interest.

The most important assurance to be given by the third party is that its interest in the aircraft is subject and subordinate to the financing party's repossession and disposition rights under the primary financing documents.

agreement as a lease or sublease and (2) impose the chattel paper and filing conditions imposed with respect to leases or subleases. A management agreement might need to be styled as a lease for FAA regulatory purposes[47] and for registration pursuant to the Cape Town Convention.[48] Financing parties sometimes require the manager to disclaim any leasehold or other property interest in the aircraft by entering into a consent.

Management agreements, with or without chartering, are usually subject to various conditions, set out in the financing document or in any consent (as discussed below).

**Consents**

As mentioned above, one condition to allowing third-party use may be the execution and delivery of a three-party agreement (a "consent"), among the financing party, the customer, and the third party. Requiring a consent or similar acknowledgment is typical with respect to any leases (or subleases) and management agreements (including those that permit chartering). A typical consent addresses, among other things, the financing party's concerns regarding the recovery of the aircraft and consistency between the financing documents and the arrangements with the third party. Although the consent is redundant with certain provisions of the financing documents, it is necessary: it provides assurances and agreements by the third party that may be enforced by the financing party, that are likely to be useful in any dispute between the financing party and third party.

The most important assurance to be given by the third party is that its interest in the aircraft is subject and subordinate to the financing party's repossession and disposition rights under the primary financing documents. Also, many financing parties avoid having any editorial input regarding the content of the third-party documents by having the third party agree that – irrespective of any contrary provisions in the third-party agreement – the third party will not have any rights, nor will it take any actions, that are inconsistent with the primary financing documents.

If the third party is obtaining the insurance coverages, the financing party will want the third party to grant to the financing party a power of attorney with respect to the insurance coverages, especially for settling claims and avoiding disputes regarding casualty insurance proceeds. If the third-party arrangement is important collateral to the financing party, the consent will include a granting clause. If the arrangement is a lease or sublease, the consent and related lease or sublease will be filed and recorded together at the FAA, along with a registration of the related international interest with the International Registry, to perfect the collateral assignment of the lease or sublease to the financing party and any appropriate subordinations.

Even if there is no collateral assignment of the third-party arrangement, obtaining a consent is still prudent because the third party (or its creditors or a bankruptcy trustee) can raise an objection to the financing party's recovering the aircraft, or assert any other claim that might limit the financing party's enforcement rights or encumber its interest with respect to an aircraft. The consent may not be necessary or desirable for temporary use for an affiliate of the customer under FAR Part 91.501(b)(5) or for wet leases or other arrangements that are merely contractual (i.e., where there is no actual or apparent conveyance of a property interest, possessory right or control).

In addition to the conditions set forth above, some financing parties also require customer and third party to (1) enter into and deliver FAA recording documents, Cape Town Convention registrations, and UCC financing statements and (2) take other actions to protect, perfect, or give priority to the financing party's interest in the aircraft or other collateral. Most financing parties also require that the customer reimburse the financing party for any and all costs incurred in connection with any third-party arrangement. The customer should also acknowledge that none of the permitted dispositions will reduce any of its obligations under the financing documents, and that all of its obligations will remain primary as to the customer, and shall continue in full force and effect.

### Syndication Expectations

A few syndication issues are peculiar to aircraft financings. In the pertinent provisions of the financing document, there will be greater focus on the inclusion of both the originating financing party and the syndication party as indemnitees and additional insureds. The syndication document may be filed with the FAA, together with any amendments to the financing documents already on file. Assignments by financing parties with respect to transactions that close after the effective date of the Cape Town Convention should also be registered with the International Registry.[49] If anticipated before closing, the syndication may be concurrent with the closing; in that case the syndication party may be the named financing party in the documents.

Some equipment lease syndications are structured as "blind" assignments, whereby the syndicating financing party sells or assigns all or a part of its interest without providing notice to the customer. When undertaking a blind assignment, the parties to the syndication will forgo various standard protections often required by the buyer, participant, or assignee of the financing in its syndication agreement with the originator of the transaction. By way of example, the originating party will not obtain an acknowledgment by the customer of the assignment of the various payment and other rights of the assignee, nor will it require the customer to amend the financing documents or provide an insurance certificate recognizing the assignee as a beneficiary of the required insurance policies.

With blind assignments, no UCC assignments or amendments or other public filings are made, and the originator is retained as the assignee's "fiscal agent" to bill, collect, and to otherwise act (in its agency capacity) as the financing party under the financing documents.

Aircraft financings are not easily syndicated on a blind basis because of the risks inherent in aircraft transactions. An aircraft is an expensive asset, with significant liability risks and subject to federal statutes and regulations as well as the Cape Town Convention, regarding the filing and recording of documents, instruments, and registrations relating to title and lien transfers. Accordingly, most assignees, participants, and buyers of aircraft financings require that the syndication be recognized by the customer, especially as an indemnitee under the various indemnifications in the financing documents.

Equally important is recognition by the insurer, particularly if its agreement to provide coverage in favor of the lien holder or lessor under the applicable policy is conditioned on its having notice of any such assignment. For priority and other commercial law purposes, the financing party might be reluctant to be blind to other third parties and will insist on making the applicable FAA and UCC filings or CTC registrations.

Some financing party originators hoping to enter into blind assignments use a trust to own or hold the lien against the aircraft (depending on the structure of the financing) and to serve as the lessor or secured party under the financing documents. The financing party will have only a beneficial interest in the trust, and would then convey all or part of the beneficial interest to the assignee or participant, without giving notice to the customer or taking any other action that would alert the customer or anyone else to the consummation of the syndication. For reasons that are beyond the scope of this article, syndication parties might still be uncomfortable with real or perceived risks with a blind syndication of such a beneficial interest.

## CONCLUSIONS

Business aviation provides a growing and active market to potential financing parties. Although many companies are trying to enter this sector, they must be aware of the unique aspects of financing this type of equipment. Aircraft are subject to unique regulatory, tax, operational, maintenance, and perfection issues. The parties to these deals should be aware of these concerns and draft their documents to address those issues.

(continued on page 17)

With blind assignments, no UCC assignments or amendments or other public filings are made, and the originator is retained as the assignee's "fiscal agent" to bill, collect, and to otherwise act as the financing party under the financing documents.

> The laws governing certain aircraft financings underwent a significant change when a treaty known as the "Cape Town Convention" became effective on March 1, 2006. The Cape Town Convention applies to loans, leases, contracts of sale, and certain other "associated rights."

# *The Cape Town Convention*

## INTRODUCTION

The laws governing certain aircraft financings underwent a significant change when a treaty known as the "Cape Town Convention" became effective on March 1, 2006. The treaty created a system for the creation, perfection, priority, assignment, subordination, and enforcement of "international interests" in airframes that can carry at least eight people (including crew), jet aircraft engines with at least 1,750 pounds of thrust, turbine aircraft engines with at least 550 takeoff shaft horsepower, and helicopters capable of carrying at least five people (including crew). This summary pertains only to "aircraft objects" that meet these criteria.

The Cape Town Convention applies to, among other things, secured loans, leases, contracts of sale, and certain other interests and "associated rights." The United States has ratified this treaty, as have certain other nations, including Ireland and Panama (together with the United States, the "affected nations"). By ratifying the Cape Town Convention, the laws of the affected nations now include the treaty's provisions, which will be applied by their courts to (1) sales and financing transactions involving airframes, and helicopters that are registered in affected nations, and (2) to aircraft engines, airframes and helicopters sold, mortgaged, or leased by parties that are "situated" in an affected nation (i.e., organized under its laws or having a principal place of business there). The application of these new international laws to leases and secured financings of aircraft is described below.

## WHAT THE TREATY MEANS FOR LESSORS AND LENDERS

Lessors, secured parties, buyers under contracts of sale, and other "creditors" now require additional provisions in standard documents to reflect the terms of the treaty and the resulting change in the law.

The most significant practical change for parties to financing transactions is that, in addition to the typical filings at the Federal Aviation Administration (FAA) (or other applicable civil aircraft registry), the parties will be making filings with the new International Registry to comply with the Cape Town Convention if it is applicable to the financed aircraft. This filing is required to protect the creditor's rights in the aircraft and certain related collateral. The International Registry is fully electronic and accessible 24 hours per day, seven days a week.

The Cape Town Convention does not require that full copies of each financing document be registered with the International Registry. Instead, with respect to transactions involving airframes registered in the United States, parties will file a new AC Form 8050-135 (entry point filing form) with the FAA, together with the financing documents. The FAA will issue a unique "authorization code" for the transaction.

Special FAA counsel or a qualified title company or other professional user entity in Oklahoma City, Oklahoma, will then register the related international interest, sale, or other interest with the International Registry by computer. This electronic registration will contain merely the aircraft information and the names and addresses of the parties to the transaction. Accordingly, financing parties will require that all pertinent interests be registered with the International Registry, to protect their interests in pertinent airframes, aircraft engines, or helicopters.

As mentioned above, this significant change in the law has resulted in changes to standard aircraft finance documents. These revisions include: (1) confirmations that the seller, borrower (or other party mortgaging the aircraft), or lessee is (or will at closing be) registered with the International Registry, so that the related transactions can be noted on the registry, (2) various document references to the Cape Town Convention (including the remedies provided in the treaty), and (3) closing procedures that require searches, filings, and electronic registrations (with respect to the International Registry) showing that the collateral is free and clear of other unpermitted interests. FAA and UCC searches will remain pertinent to U.S. transactions.

## WHAT THE TREATY MEANS FOR FINANCING CUSTOMERS

Financing customers in domestic aircraft transactions will be affected by the Cape Town Convention in several ways. First, the sale of an airframe, aircraft engine, or helicopter can be registered with the International Registry if the seller is situated in an affected nation. If the seller is not situated in an affected nation, the sale of the engines does not create an international interest.

The sale of an airframe or helicopter that is registered with the FAA (if in the United States) or other applicable foreign aviation authority of an affected nation at the time of the sale is now registerable with the International Registry. This may not be true for sales of engines, however. For example, if the seller is incorporated in Delaware, the buyer can register the contract of sale at the International Registry with respect to both the airframe and the engines. If, however, the seller is not organized or otherwise situated in an affected nation, but the aircraft is registered in an affected nation, the sale of the airframe (but not the engines) can be registered at the International Registry.

Another significant matter for financing customers is that they each must register with the International Registry to become a “transacting user entity.” Any party to a transaction that is to be registered with the International Registry must be a transacting user entity. The International Registry will merely “endeavor” to approve a new user within 48 hours of its application. Therefore, financing customers must go to the International Registry website (www.internationalregistry.aero) early in the transaction process to become a transacting user entity. Term sheets and proposal letters may now require the customer to do so concurrently with, or shortly after, signing that document.

Each financing customer must designate an “administrator,” who will be the primary contact person for that company with respect to the International Registry. The administrator must be the person who signs on to the International Registry website, provides the necessary information and pays the fee with a credit card ($200 for a one-year subscription and $500 for a five-year subscription). He or she does not need to an employee of the customer, so the financing customer’s outside counsel can serve in this capacity.

Financing parties will require their customers to designate a “professional user entity.” In U.S. financing transactions, this entity will likely be the financing party’s special FAA counsel in Oklahoma City. The professional user entity will be authorized by the administrator of the customer to effect and consent to international registrations in connection with the transaction. The customer will need to pay an additional fee for its professional user entity (again, $200 for a one-year subscription and $500 for a five-year subscription).

Each financing customer will register with the International Registry to become a “transacting user entity.” Each financing customer must designate an “administrator.” Lastly, creditors will require their customers to designate a “professional user entity.”

Closings of lease or loan financings of U.S.-registered aircraft will proceed, in large part, in the same manner as before the treaty became effective. Original documents will continue to be pre-positioned in Oklahoma City for filing with the FAA.

## PROSPECTIVE INTERNATIONAL INTERESTS

The Cape Town Convention allows parties to register certain "prospective" sales and international interests at the International Registry prior to closing. For airframes registered in the United States, the transaction contemplated by the prospective sale or international interest must be consummated (i.e., final documentation filed with the FAA) within 60 days of registration for the prospective international interest to remain valid.

The parties to a transaction must consider whether they will file a prospective sale or international interest. Term sheets and proposal letters may now address this issue. The advantage to filing a prospective sale or international interest is that the date for priority purposes will be the date of the related filing – meaning that the financing party can establish its priority position early in the transaction process, even before registration of the sale.

## NEW CLOSING PROCEDURES

Closings of lease or loan financings of U.S.-registered aircraft will proceed, in large part, in the same manner as before the treaty became effective. Original documents will continue to be pre-positioned in Oklahoma City for filing with the FAA. Some additional steps, however, will be added to the closing procedures. First, a form AC 8050-135, the entry point filing form, will need to be filed with the FAA. Second, Special FAA counsel, a qualified title company or other professional user will need to register the international interest(s) with the International Registry. Third, all parties must remain on the closing call to authorize their professional user entities to consent to the registration of all of the related registerable interests, unless the parties have established a written procedure in advance.

### Further Information

For further information, go to the website of the International Registry (www.internationalregistry.aero). On this website, parties can sign up to become transacting user entities, conduct searches, access copies of the treaty itself, and review the procedures and regulations. This website also provides information on the technical requirements for preparing a computer for use with the International Registry.

***This paper is for informational purposes only and is provided merely as a courtesy and a quick reference tool. It is not intended to, nor does it, provide formal legal advice. Customers should consult with their own counsel for a complete explanation of the Cape Town Convention and its requirements.***

***Notice Regarding Tax Advice: The IRS has issued regulations setting forth detailed requirements as to the scope and content of written advice that may be relied upon as a defense to the imposition of penalties that may be applicable under the Internal Revenue Code. This communication does not satisfy those requirements. Accordingly, the discussion of Federal tax consequences set forth herein is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed.***

*(continued from page 13)*

A financing party that chooses to participate in the competitive business aviation financing arena must not only seek to protect its own investment and other interests but also remain sensitive and accommodating to the tax, regulatory, and operational needs of its customer, be it the high net worth individual, the midsize company, or the multinational corporation.[50]

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## Endnotes

1. Convention on International Interests in Mobile Equipment (the "convention") and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (the "global protocol"), adopted on Nov. 16, 2001, at a diplomatic conference held in Cape Town, South Africa (hereinafter, collectively, the Cape Town Convention or CTC).

2. Registerable international interests are created if the subject agreement meets the "formalities" requirements of Cape Town Convention Art. 7 and Aircraft Protocol Art. VII.

3. CTC Art. 16 and Protocol Art. III. For the sake of brevity, references in this article to "aircraft" or "airframes" in the context of the convention shall also, where applicable, include helicopters.

4. The following will be subject to the Cape Town Convention: jet aircraft engines that have at least 1,750 pounds of thrust or its equivalent; turbine-powered or piston-powered engines with at least 550 rated takeoff horsepower or its equivalent; airframes type certified to transport at least eight people (including crew) or goods in excess of 2,750 kilograms; and helicopters type certified to transport at least five people (including crew) or goods in excess of 450 kilograms. Protocol, Art. I. But these aircraft objects are not covered if they are used in military, customs, or police services. Protocol Art. 1. As of the writing of this article (April 2006), Ethiopia, Ireland, Malaysia, Nigeria, Oman, Pakistan, Panama, and Senegal have also ratified the Cape Town Convention (although it will not enter into force with respect to Senegal until May 1, 2006).

5. CTC Art. 3(1) and Protocol Art. IV.

6. An aircraft can be registered in only one country at a time (although it can change its nationality and registration). Convention on International Civil Aviation, signed at Chicago Dec. 7, 1944, 61 Stat. 1180, 15 U.N.T.S. 295, Art. 18.

7. Note, however, that the Cape Town Convention does not apply to propellers.

8. See generally Dean N. Gerber, "Aircraft Financing," Chap. 17 in *Equipment Leasing – Leveraged Leasing*, ed. Ian Shrank and Arnold G. Gough (New York: Practising Law Institute, 2004).

9. See generally The Legal Advisory Panel of the Aviation Working Group, Contract Practices under The Cape Town Convention 2-3 (2004) (published by the Uniform Law Foundation). A debtor is "situated" in a contracting state to the Cape Town Convention when it organized (e.g., incorporated), has its registered office or center of administration, or has its principal place of business in that country. Convention, Art. 4(1). However, until parties have had a chance to enforce remedies under the CTC in a particular country, there could be some reluctance to rely on these anticipated benefits.

10. 14 C.F.R. Sec. 47.3(b)(1).

11. See 14 C.F.R. Sec 1 et seq.

12. Aircraft owned by non-U.S. citizen corporations (including corporations organized in the United States but which fail the U.S. citizen ownership test) but based and primarily used in the United States are also eligible for registration. See 49 U.S.C. Sec. 44102(a)(1)(C) and 14 C.F.R. Sec. 47.9. This article, however, does not examine this type of registration.

13. 49 U.S.C. Sec. 40102.

14. 49 U.S.C. Sec. 40102(a)(15)(C).

15. A "corporation or association organized under the laws of the United States or a State, the District of Columbia, or a territory or possession of the United States, of which the president and at least two-thirds of the board of directors and other managing officers are citizens of the United States, and in which at least 75%

of the voting interest is owned or controlled by persons that are citizens of the United States." Essentially, the test examines the organization, management, and ownership/control of the company. A recent amendment also requires "actual control" be held by a U.S. citizen.

16. The lessee of an aircraft under a contract of conditional sale is considered the owner and is required to register the aircraft. 14 C.F.R. Sec. 47.5(d).

17. The trust agreement should be submitted to ACC for review and approval well in advance of closing.

18. See 49 U.S.C. Sec. 44102(a)(1)(C) and 14 C.F.R. Sec. 47.9. Financing parties might be unwilling to risk de-registration, among other things, relating to any noncompliance with these registration regulations.

19. In order to take advantage of certain benefits under U.S. tax laws, and to be eligible to operate under Part 91, the SPE must have a purpose and business operations other than simply owning and operating an aircraft. Most financing parties are mindful of the importance of the tax savings to the customer and are willing to accept the more complicated and speculative bankruptcy exposure that might exist because the lessee or borrower is a "multipurpose" entity. This article does not address any FAA or other regulatory issues with respect to SPE's holding title to aircraft, nor does it provide any in-depth tax analysis. Aviation and tax counsel should be consulted with respect to these matters.

20. By way of example, using the SPE as the acquirer and direct obligor under the financing documents will avoid the application of the consumer leasing provisions of Article 2A of the UCC if the transaction is a true lease. *See* UCC Sec. 2A-1-3(1)(f).

21. See supra, note 18.

22. For example, an affiliate may hold and operate all of the parent company's transportation assets.

23. The underwriting or final closing documents should show factually that the guarantor is solvent after giving effect to all its contingent liabilities, has reasonable capital for its business, is able to pay its debts as they mature, and, most significantly, has received a reasonable equivalent value for the guaranty. See, e.g., 11 U.S.C. Sec. 548. For a thorough academic survey of the 10 years since the U.S. Supreme Court ventured into this topic, see M.T. Reilly, "A Search For Reason In 'Reasonable Equivalent Value' after BTP v. Resolution Trust Corp.," 13 Am. Bankr. Inst. L. Rev. 261 (2005).

24. If the contemporaneous transaction documents (or actual facts) do not persuade a bankruptcy trustee of the sufficiency of the subject consideration, then the guarantor's bankruptcy trustee and other creditors will scrutinize the realities of the transaction with the full benefit of "20/20 hindsight." The creditor's full recovery could be imperiled by gaps in the documentation. The relationship between the secondary obligor and the primary obligor will also be an important enforceability issue. An inadequate relationship between the secondary obligor and the primary obligor weakens the factual persuasiveness of the equivalent value received for the guaranty, but a lack of independence between these obligors raises the specter of substantive consolidation. For a recent discussion of substantive consolidation of guarantors with an underlying primary obligor in a large bank group facility, see *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005) (substantive consolidation of guarantor affiliates was improper on its facts) (reversing district and bankruptcy court decisions).

25. This security agreement will be filed with the FAA and the related international interest and registered with the international registry established pursuant to the Cape Town Convention (the "International Registry") for recordation, perfection, and prioritization of the financing party's security interest. See 14 C.F.R. Sec. 49.17 and Convention, Art. 32. Whichever of the obligor parties that has an interest in the aircraft, whether an ownership or a leasehold interest, will need to register with the International Registry to become a transacting user entity, appoint an administrator and designate a professional user entity. Because each of the related acquisition and financing transactions will be registered with the International Registry, each of the related obligor parties must be a "transacting user entity." Consider any related subrogation and subordination issues under the CTC, or guaranty or other credit support is anticipated. Convention Art. 38.

26. See 49 U.S.C. Sec. 44102(a)(1)(A) and 14 C.F.R. Sec. 47.2.

27. See generally 14 C.F.R. Part 47.

28. Aircraft Protocol, Art. VII. Occasionally, a customer will want to change the N number of an aircraft prior to taking delivery of a new or pre-owned aircraft and will ask the manufacturer or the seller to make such a request in advance of the sale. From the moment of the request, it will take six to eight weeks to make such a change.

29. Specifically, obtain an export certificate of airworthiness, if required, and address any customs matters.

30. Note that if the aircraft is to be registered at the FAA, both the prospective and eventual sale of the aircraft will create a registrable interest in the airframe that could be registered at the International Registry; but, as to the engines, the seller must be "situated" in a

nation that has ratified the Cape Town Convention (i.e., organized under its laws or having a principal place of business there), so that the treaty will apply to the registration of the prospective and actual sale of the engines. Sellers will likely resist the registration of a prospective sale until just prior to the wiring of the purchase price.

31. For example, the financing documents will include UCC remedies that are very similar to all of the other middle market equipment finance forms used by the financing party, and will have default and remedy provisions that are consistent with either UCC-2A (if a lease) or UCC-9 (if a nontrue lease or secured financing), equitable principles and other laws that will be relied upon to recover possession of the aircraft. Recently drafted forms also address the application of the remedies afforded by the Cape Town Convention, if applicable.

32. Applying the Cape Town Convention, the purchaser's prospective sale may be registered with the International Registry prior to consummation of the sale (although the airframe and/or engine must have been assigned a serial number). *See* Convention, Art. 16, and Aircraft Protocol, Art. V. Manufacturers may not, however, permit such filings, and existing creditors may prohibit them as well. This article does not fully address this issue as it remains to be seen how this practice will evolve.

33. Internal Revenue Service Regulations, 26 C.F.R. Secs. 1.168(f)(8)-6(b)(2)(i) and 1.167(a)-11(e)(l)(i).

34. This position is based on certain cases and private letter rulings, the discussion of which is beyond the scope of this article.

35. The discussion regarding the tax treatment of "green" aircraft financings, and any other discussion relating to taxes, specifically or otherwise, is subject to the general and other disclaimers and limitations provided elsewhere in this article. Some lessors require that the referenced test flight be conducted for business purposes.

36. Internal Revenue Code of 1986 Sec. 1031, as amended.

37. All rights of the third party in possession, but especially the right of possession itself, become property of the third party's bankruptcy estate protected by the automatic stay. See 11 U.S.C. Secs. 541(a), 362(a)(3). The third-party debtor in possession may use the aircraft in the ordinary course of its business. See Sec. 363(c)(1). The third party, its bankruptcy trustee, its creditors' committee, and any other party in interest may object to the financing party's claim or motion to recover the aircraft. See Secs. 323, 502(a), 1103, 1107, 1109(b); F.R. Bankr. P. 3007.

38. U.C.C. Sec. 9-102(a)(48) (defining "inventory") and Secs. 9-317, 9-320 (establishing priority of buyers).

39. If the insolvent customer is not using the aircraft, a question could be raised whether the customer has received reasonable equivalent value. If not, then the obligation itself may be challenged. See, e.g., 11 U.S.C. Sec. 548(a)(1)(B)(i). While the ultimate recovery of the equipment would be very likely, the delay and recovery expense could be substantial.

40. Section 91.501(c) of the FARs defines "interchange agreement" as "an arrangement whereby a person leases his airplane to another person in exchange for equal time, when needed, on the other person's airplane, and no charge, assessment, or fee is made, except that a charge may be made not to exceed the difference between the cost of owning, operating and maintaining the two airplanes." The same FAR provision defines "time-sharing agreement" as "an arrangement whereby a person leases his airplane with flight crew to another person, and no charge is made for the flights conducted under that arrangement other than those specified in paragraph (d) of this section." The costs that the operator can recover include fuel, oil, crew travel expenses (e.g., food and lodging), hangar, insurance for the specific flight, landing fees, in-flight food, and an additional charge equal to 100% of the fuel costs. In both cases, the company remains in operational control of the aircraft notwithstanding the use of the term "lease." These are the only "wet leases" permitted under Part 91.

41. In a "wet lease" the lessor supplies the aircraft with the crew, maintenance, and insurance.

42. In a "dry lease" the lessor supplies only the aircraft. The lessee must provide the crew, perform the maintenance, and procure insurance.

43. It is important to note that such leases and subleases may give rise to international interests under the Cape Town Convention. The treaty will apply to the airframe if it is registered in the United States and will cover the airframe and engines if the lessee/sublessee is "situated" (e.g., incorporated) in the United States (as provided in Article 4 of the convention). If the creditor is taking a collateral assignment of the lease or sublease, the parties to the leasing arrangement should register both the lease/sublease and the assignment with the International Registry.

44. This lien could relate to, among other things, unpaid hangar rent or repairs made by the management company.

45. Airplanes used in the "commercial and contract carrying of passengers and freight" have a depreciation recovery period of seven years; otherwise, the recovery

period for airplanes is five years. IRS Revenue Procedure 87-56, 1987-2 C.B. 647.

46. U.C.C. Sec. 2A-103(1)(p) (2005). Whether any such characterization is legally supportable remains to be seen.

47. Due to some increased FAA scrutiny of charter/management arrangements, it is likely that many such arrangements will soon include a lease to the management company so it is clear that the manager has operational control and will be using its own pilots.

48. If a management agreement allows the manager to charter the aircraft, and provides that the lessee or borrower will receive revenue from such chartering, the arrangement may be deemed a "lease" for purposes of the Cape Town Convention. Under the treaty, a "leasing arrangement" is "any agreement by which one person grants to another a right to possession or control of an object in return for a rental or other payment, whether or not the transaction would be characterized by national law as a leasing agreement, though under Article 2(4) it is left to the applicable law to determine whether the agreement is to be characterized as a leasing agreement or a s security agreement." Professor Sir Roy Goode, Official Commentary (Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment (2002). The FAA, however, does not generally record "management" agreements that are not stylized as "leases." Note that leases with Part 135 operators are not subject to the "truth in leasing" provisions of the FARs.

49. Convention, Arts. 31 and 32. If the CTC is applicable to the syndication transaction, the syndication documents and closing procedures must conform to the formalities and other requirements imposed by the CTC with respect to assignments of "associated rights" and international interests in aircraft, including waivers of any available defenses and set-offs with respect to the assigned associated rights, and consents to the contemplated syndication. Convention Art. 31(4) and Protocol Art. XV. It will be especially important to have the customer's agreement to cooperate with the registration of the assignment with the International Registry, including signing up as a "transacting user entity" again and redesignating a "professional user entity" if the customer's subscription to the registry has expired. Convention Art. 20(1).

50. This article is for informational purposes only. It is not intended to, nor does it, provide formal legal advice. Financing parties should consult with their own counsel for a complete explanation of the legal issues regarding business aviation financing. Notice regarding tax advice: The IRS has issued regulations setting forth detailed requirements as to the scope and content of written advice that may be relied upon as a defense to the imposition of penalties that may be applicable under the Internal Revenue Code. This communication does not satisfy those requirements. Accordingly, the discussion of federal tax consequences set forth herein is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed.

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