

Strategic issues in operating leases

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The lease agreement for a commercial aircraft is a complex document that is usually drafted to balance the often conflicting requirements of the airline for operational flexibility with the lessor's need to protect its investment in the aircraft.

Although the typical aircraft operating lease resolves many issues beyond just the rent and term, this article will briefly examine four such issues that recently have increased in significance:

- Subleasing takes on a new dimension of risk given the list of new, start-up airlines throughout the world that can be candidates for subleasing and because of their geographic diversity, who add to the group of airlines who might participate in pooling arrangements with the sublessee.
- Lessor transfers have been given more attention as lessors become a more diverse group that includes private equity funds and that demands greater liquidity for their investment in the aircraft and greater flexibility to obtain financing in a market characterized by a harsh lack of available financing.
- So-called power by the hour maintenance contracts have become increasingly popular as an alternative to more ordinary maintenance reserve clauses, but they may offer less protection to the lessor.
- PMA parts that airlines see as a cost savings opportunity but that some lessors see as having an adverse impact on the value of the aircraft.

Subleasing. Lessees often want broad rights to sublease the aircraft. But the lessor and its lender may have several issues about subleasing including:

- Who is the sublessee and what is its creditworthiness and experience?
- In what countries will the sublessee

operate the aircraft and will reregistration of the aircraft be required? Will the country of reregistration afford the lessor and its lender the same repossession rights as under the law that governs the head lease? Are the lessor's ownership and lender's mortgage interests protected and noted on the public record to all third parties? Can the sublessee or lessee obtain political risk insurance in such country if deemed necessary by the lessor or lender?

- Are there withholding or other tax issues regarding the payment of rent and other sums under the sublease and will the rent and other payments be made directly by assignment to the lessor or lender?

Depending upon the negotiating positions of the parties, the lessor may want to prohibit subleasing without the prior written consent of the lessor. As a compromise, specific requirements to subleasing can be included in the lease such as:

- A list of permitted sublessees, either specifically identifying the air carriers by name or requiring that they are certified by a specific aviation authority.
- A list of countries in which the aircraft is permitted to be (or is prohibited from being) reregistered or operated. Such provisions often permit the lessor to make changes to these lists as circumstances warrant.
- Net worth requirements with respect to the sublessee or at least the requirement that the sublessee not be insolvent or in bankruptcy.
- The requirement for the sublease to be subject and subordinate to the lease, meaning that in the event of a default by lessee under the head lease, the lessor may terminate the sublease

and repossess the aircraft.

- An opinion from counsel in the country of reregistration (if reregistration is permitted) covering such issues as reregistration, recognition of the interest of lessor as owner and lessor of the aircraft, lessor's right to repossession and perfection or recognition of a security interest of any lender, as well as any tax issues.
- General further assurance provisions as to registration of the interests of the lessor and any lender in the aircraft on any registry where the aircraft or lease and mortgage (if any) is permitted to be reregistered and filings under applicable local law or Cape Town registrations, as applicable.
- A general requirement that the sublease include provisions with respect to such matters as maintenance, possession, operation, indemnity and insurance on the same terms as the lease and otherwise be in form and substance acceptable to the lessor and its lender.
- A requirement that the sublease not relieve the lessee of its obligations under the lease.

Lessor transfers. Generally, lessor transfers are either (i) a sale or transfer by the lessor of its title to (or beneficial ownership interest in) the aircraft to a third party (an "outright transfer"), subject to the terms of the lease; or (ii) a pledge or security assignment of the lessor's interest (a "security transfer") in the aircraft and lease to the lessor's lender as a means to secure the lessor's obligations under its financing arrangements with its lender. The lessor often will want the unrestricted right to sell or pledge its interest to any third party or lender.

However, an outright transfer may raise certain concerns for the lessee, who



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may want certain transfer requirements to be included in the lease, including:

- A net worth requirement as to the transferee, especially if the lessor holds and will continue to hold maintenance reserves and/or a security deposit.
- Prohibiting a transfer to any competitor of the lessee.
- United States citizenship requirements (for aircraft registered in the US) or requiring that such transfer will not negatively impact the continued registration of the aircraft.
- A requirement that the transferee is experienced in commercial aircraft leasing.
- A requirement that any transferee expressly assume the obligations of the lessor under the lease and agree to be bound by all the provisions of the lease applicable to the lessor as of the transfer time.
- Protection that no such transfer will increase the lessee's obligations (including under any indemnity) or adversely affect the lessee's rights under the lease.

In a security assignment, the lessor's lender is likely at a minimum to require the following:

- That the lessee will include any financing party as an additional insured and loss payee and indemnitee for all purposes of the lease and will agree to furnish insurance certificates which include the financing parties as additional insureds and loss payees.

- Further assurance provisions in which the lessee agrees to take all action reasonably requested by the lender in order to perfect or protect the lender's interest in the aircraft and lease.
- An agreed-upon notice and consent to the lease assignment, including language customarily found in an estoppel certificate.
- An agreement by the lessee to recognize the lender's rights as assignee of the lessor's interest under the lease, which is generally given by the lessee in exchange for an express recognition by the lender of the lessee's right of quiet enjoyment.

Power by the hour. Maintenance has always been of key importance in the operating lease. A common way for lessors to ensure that the lessee will have sufficient funds available with which to perform routine maintenance procedures is to require the payment of maintenance reserves as supplemental rent.

The aggregate of reserve payments should provide a sufficient fund for the payment of specified maintenance procedures. Separate reserve payments are usually required for specified airframe checks, engine overhaul or performance restoration, landing gear and APU overhauls and engine LLP replacements.

In light of the sophistication of some of the newer engines in service, lessees sometimes request the application of reserves for performance restoration or replacement of a module or component of the engine such as the high-pressure

compressor, combustor, high- or low-pressure turbine or gearbox.

Increasingly, maintenance contracts provided by a third party known generically as power by the hour ("PBH") programmes¹ have become popular. However, these maintenance contracts present certain issues for the lessor and its lenders.

First of all, the hourly charges under such contracts are paid to the maintenance provider, not the lessor. A three-way negotiation is likely to result over various issues, including whether the lessor will have any say in the work scope for which the lessee will be paying, and what protection, if any, the lessor will have in case the lessee fails to make any of the required payments under the maintenance contract or defaults under the lease.

A lessor may want the right (but not the obligation) to pay any amounts that the lessee fails to pay in order to keep the contract in force, and the right to succeed to the position of the lessee under the maintenance contract either as a third-party beneficiary or under an express agreement if the lessor repossesses the aircraft from the lessee.

The maintenance provider might resist such lessor rights because the pricing of the maintenance contract may not be available to the lessor after a lessee default if it is based on the utilisation profile of the existing lessee.

A subsequent operator may operate the aircraft in a different environment or

with a different hours:cycle ratio than the defaulted lessee operator. But the lessor may reply that any differential in pricing (it could be a decrease, not necessarily an increase) can be negotiated, but the differential should not preclude the lessor from having rights under the maintenance contract, and all monies paid through the date of the lessee's default should not be forfeited as a windfall to the maintenance provider with the result that the lessor will bear the full financial responsibility for the hours and cycles of operation by the lessee of the engine.

PMA parts. Will the installation of PMA (parts manufacturer approved) parts be prohibited, expressly permitted, or will the lease or third-party maintenance contract be silent on the issue?

Increasingly, lessees want the flexibility to use PMA parts especially in older aircraft, as they can be less expensive than OEM (original equipment manufacturer) parts.

Advocates of PMA parts contend that they are approved and certified by the aeronautical authority (the FAA in the United States) and that PMA parts are

subject essentially to the same rigorous testing and are expected to have the same lifespan as OEM parts.

Lessors and lenders argue, on the other hand, that even if the PMA parts are the equivalent of OEM parts, the installation of PMA parts adversely affects the value of the airframe or engine because of a contrary market perception.

Lessors voice concern not only that PMA parts are not the equivalent of OEM parts, but that PMA parts require more frequent inspections or replacements or adversely affect performance or longevity of other parts of the engine and, therefore, the savings of installing them are illusory.

Lessors may resist installation of PMA parts because the airline saves on the reduced cost to purchase the part, but the lessor or lender sustains any diminution in value that may result from the installation of the PMA part.

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Mr Karesh and Ms Berns are part of the firm's commercial aviation practice group and each has over 20 years' experience representing lessors, lenders, operators and equity investors in a wide variety of domestic and cross-border aviation financing and operating lease transactions and in all aspects of the enforcement of creditors' and lessors' rights, and in workouts and bankruptcies. Mr Karesh has written articles relating to the enforcement of creditors' and lessors' rights and is a frequent speaker at air finance conferences.

Note:

- 1 These include Rolls-Royce's Total Care Agreement, GE's Maintenance Cost Per Hour Agreement and Pratt & Whitney's Long Term Cost Plan. Such contracts are also offered by other third-party providers.

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