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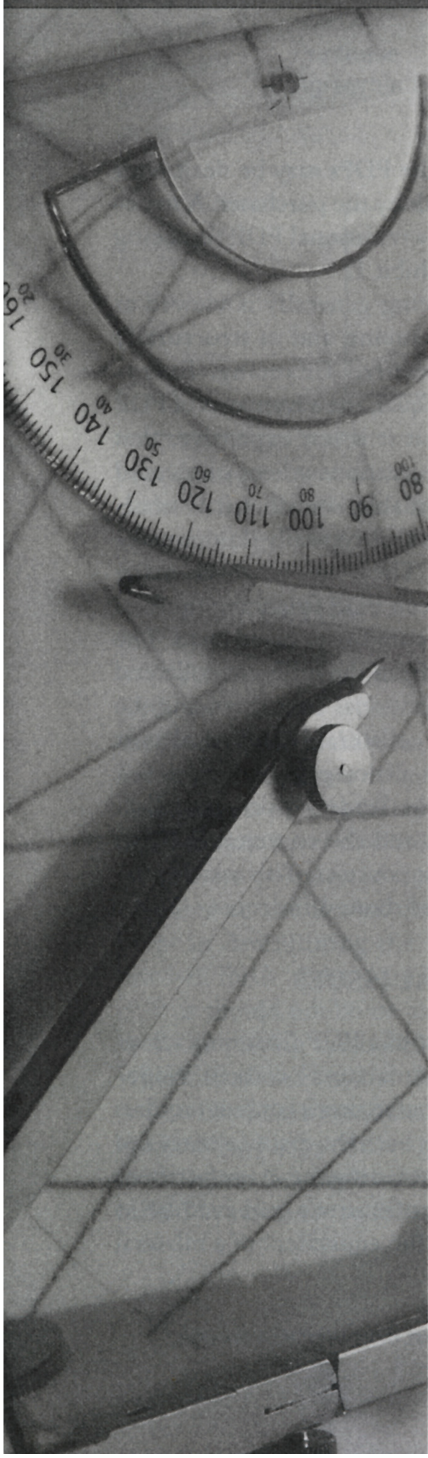

Aircraft Pre-Delivery Payment Financing Transactions

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This article analyzes key contractual and bankruptcy aspects of pre-delivery payment financing transactions for aircraft. It steps through the basics of pre-delivery payment financing and then discusses the bankruptcy "claw-back" issue, considering current and possible future structures that may help lenders and manufacturers better address bankruptcy problems affecting many existing structures.

Pre-delivery payments—or PDPs—are progress payments that a purchaser makes to a manufacturer while new aircraft are being built. They represent a significant cash expense for the purchaser, on average amounting to as much as 30% of the price of finished aircraft. Purchasers commonly finance that cash expense using PDP financing.

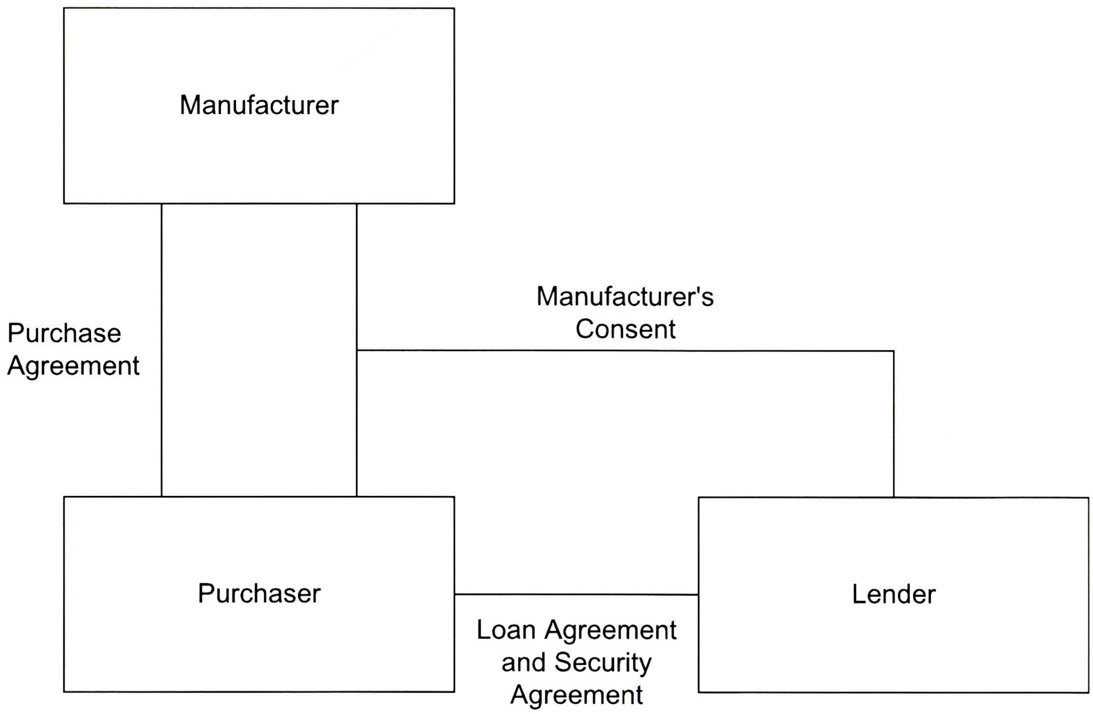
In a traditional PDP financing, the lender finances a percentage of PDPs by making a secured loan to the purchaser. Interest is payable throughout the term of the loan and principal is repayable upon delivery of each aircraft that is the subject of the loan. As collateral, the purchaser grants a lien in favor of the lender over its rights in the aircraft purchase agreement.[1] The purchaser also arranges a tripartite agreement with the manufacturer (a manufacturer's consent).[2] This includes the manufacturer's acknowledgment of the lender's lien and certain contractual agreements as to how the parties' rights to the aircraft and the PDPs may be dealt with following a default by the purchaser. A structure diagram for a traditional PDP financing is included as Exhibit 1.

PDP financing generally is viewed as secured asset financing and as structurally superior to unsecured financing. Everything else being equal, the advantages of PDP financing are that it is less expensive, that it is available in situations where unsecured loans are not available, and that it is available from sources that typically do not make unsecured loans. There are, however, many differences between PDP financing transactions and other secured asset-based loans. The differences stem from the different collateral involved: in a traditional asset financing the lender's primary collateral is a physical asset that is subject to a mortgage, whereas in a PDP financing the lender's primary collateral is a contract and the contractual rights flowing from that contract. This article analyzes the effects of those differences.

CONTRACTUAL ISSUES

At the heart of a PDP financing transaction lies the manufacturer's consent. Negotiation of the manufacturer's consent requires compromise from both the manufacturer and the lender. In negotiating the manufacturer's consent, the manufacturer's goal is to be in a position that is the equivalent of a bilateral

Exhibit 1
Typical PDP Financing Strucutre



purchase agreement with no PDP financing. The lender desires a bundle of rights that amount to the equivalent of a traditional asset-based financing.

Purchase Price

First and foremost, the manufacturer's consent sets forth the price for which the manufacturer agrees that the lender can purchase an aircraft if the lender steps in following a purchaser default.[3] The purchaser's final purchase price is the manufacturer's proprietary information and is almost never disclosed to the lender; it is redacted from those portions of the purchase agreement made available to the lender. As such, the lender's starting point in determining the value of its collateral is the price set forth in the manufacturer's consent.

It should not come as a surprise to those familiar with the pricing methodology of purchase agreements with manufacturers that the purchase price is unlikely to be a fixed dollar amount. Consistent with the pricing methodology in purchase agreements, the purchase price in the manufacturer's consent will probably be determined by reference to the month in which the purchase agreement was executed (for example, $30 million in March 2009 dollars), and then escalated until delivery in accordance with an agreed formula. The lender may or may not be able to cause the manufacturer to agree to an escalation cap, which, if available, gives the lender some comfort as to the maximum amount that the aircraft may cost.

The purchase price may also be impacted by configuration or specification changes and by changes to buyer-furnished equipment that occur during production. Because such changes could materially increase the price of an aircraft, but not necessarily its value, the lender has a legitimate interest in managing them. To neutralize the effect of the increased costs on the lender's collateral, the typical solution is for the purchaser to agree to notify the lender if there is going to be an increase in the cost of the aircraft, and to agree either to prepay the manufacturer the amount of the increased cost, to prepay the loan in the amount of the increased cost, or to place the amount of the increased cost on deposit with the lender.

The bottom line for lenders and their counsel in terms of the purchase price is to ascertain, as far as possible, an agreed final purchase price (or a maximum purchase price) for each aircraft if the lender steps in as purchaser. Complications with airline and lender pricing methodologies, the impact of escalation, configuration, and specification changes, buyer-furnished equipment, and (possibly) a less-than-transparent pricing methodology provided by the manufacturer can make this aspect of the transaction challenging, but not impossible, to resolve.

In addition to the purchase price, the lender needs to be aware that future changes in the market value of the aircraft underlying the contract may impact its security position, as the lender needs to remarket the aircraft, or the right to purchase the aircraft, in order to realize its collateral. This is an important consideration, particularly given that default is more likely when the industry, and aircraft values, are stressed.

The lender also has to decide what percentage of PDPs it will finance. PDPs funded by the borrower form an important part of a lender's collateral. The key for borrower-funded PDPs is to have the manufacturer's agreement that those PDPs can be applied towards the final purchase price if the lender steps in (subject to the "claw-back" issue, discussed below). Typically the borrower's portion of the PDPs is paid in one of two ways. Either 1) the borrower pays an initial percentage of PDPs (say, for example, the first 40%), and once that first portion is paid, remaining payments are financed by the lender, or 2) the borrower and the lender share each PDP in accordance with an agreed percentage. The first approach obviously gives the lender better protection, as the full amount of the borrower's portion of the PDPs can be applied towards the purchase of the aircraft regardless of when the lender steps in. The second approach only allows the full amount of the borrower's portion of the PDPs to be applied towards the purchase of the aircraft if the lender steps in after all of the PDPs have been paid.

Importantly, the manufacturer will also agree in the manufacturer's consent not to set off any PDPs against any of the purchaser's obligations to the manufacturer that are unrelated to the aircraft being financed. This is a key part of the manufacturer's consent, as it overrides the manufacturer's set-off rights that will be contained in the (likely redacted portions of the) purchase agreement.

So far, so good. In terms of the purchase price, there are no insurmountable documentary or structural problems. The lender can get adequate comfort from the manufacturer as to the price it will have to pay for an aircraft if it steps in following a purchaser default. The lender also gets comfort that the manufacturer will apply the PDPs paid by the lender and the purchaser towards that price (again, this is subject to the "claw-back" issue discussed below). Externalities that may affect the lender's position are no worse than a lender would face in a typical aircraft financing. Importantly, increased costs and configuration changes can adequately be addressed following notification by the purchaser, placing the lender in no worse position than it would be in financing a physical asset where, for example, the lender relies on its customer or on the lessee for aircraft maintenance. Similarly, valuation issues are manageable, possibly even more so in a PDP financing where asset values have to be projected over a shorter period than in a long-term financing of a physical aircraft.

Purchase Right

Having secured a purchase price, the next key point for the lender is to ensure that it has a right to purchase the aircraft if it steps in as buyer under the purchase agreement. Manufacturers' consents are structured such that, following either a termination of the purchase agreement or an event of default by the purchaser, the lender has the right, but not the obligation, to deliver a notice to the manufacturer that the lender has chosen to step in and replace its borrower as purchaser of the aircraft.[4] Such notice typically has to be given by the lender not more than 20 to 30 days following receipt of notice from the manufacturer or the purchaser that the purchase agreement has been terminated or that a loan event of default has occurred. In traditional PDP financing, the consequence of not giving this notice is either 1) in the strong form, the lender loses its rights to its already-funded PDPs and its rights in the collateral, or 2) in the weak form, the lender loses its rights in the collateral, but receives a contractual right from the manufacturer that allows PDPs funded by the lender to be recoverable following remarketing and delivery of the aircraft by the manufacturer and recovery by the manufacturer of its costs and profit on the new sale.

Both the strong-form consequence and the weak-form consequence present the lender with a difficult choice. It must either step in and be responsible for all of the obligations of the purchaser under the purchase agreement—including an obligation to pay an amount to take delivery of the aircraft that is many times the amount of the PDPs funded by the lender—or walk away from all or a significant portion of its collateral. A lender facing this choice rationalizes that it will step in if the aircraft can be resold for more than the purchase price agreed upon with the manufacturer. It will do this knowing that if there is upside in the aircraft—if the aircraft is remarketable for a higher amount than the agreed final purchase price—and it does step in, it will likely be bought out by the manufacturer (see discussion of the manufacturer's purchase option, below). If there is not a significant upside then the lender will either 1) agree to step into the shoes of the borrower and make payment on the remaining PDPs if valuations show that this option is economical, or 2) walk away if valuations say it is not.

The purchase right mechanism gives the lender some protection, but falls short of the lender's PDP financing "gold standard" of having the transaction essentially be the equivalent of an asset-based transaction. If the lender has accurately projected the value of the aircraft and has ensured that the purchaser has contributed sufficient equity towards the PDPs, then the lender will have sufficient collateral to make stepping in worthwhile. The key difference with an asset-based transaction, however, is that if the lender has overestimated the value of the aircraft, then in a PDP financing, the lender's collateral may completely disappear if stepping in is not worthwhile.

From the manufacturer's perspective, the purchase right mechanism provides some assurance that if the purchaser defaults, a ready buyer (the lender) may still be prepared to purchase the aircraft. Given that defaults are likely in a down market, the lender's involvement therefore provides the manufacturer with a legitimate hedge against falling aircraft prices. If prices fall too much, however, the lender will not exercise its purchase option. In this scenario, a PDP financing with a strong-form consequence for the lender not giving notice does not disadvantage the manufacturer, which remains in the same position as it would be in an un-funded PDP transaction; the manufacturer can take the PDPs that have been made and is free to remarket the aircraft for the full purchase price. In contrast, a weak-form consequence of not exercising the option places the manufacturer in a worse position than it would have been in had the PDP financing not occurred, as the manufacturer will not collect all windfall profits resulting from being able to keep the PDPs and remarket the aircraft, but rather has to pay a portion of the windfall profits to the lender.

From a lender's perspective, the existence of the PDP financing provides the manufacturer with the advantage of a fall-back customer who will take a limited first-loss in the event of the purchaser's default. The trade-off is that the manufacturer should therefore surrender the windfall gain that it would achieve if it had the strong-form consequence and should accept the weak-form consequence as a matter of fairness.

At present, in most manufacturer's consents, manufacturers either look for the strong-form consequence in all situations or try bifurcating the weak-form consequence and the strong-form consequence; the weak-form consequence applies where the lender's step-in right arises from the manufacturer terminating the purchase agreement, and the strong-form consequence applies where the lender's step-in right arises from an event of default under the lender's financing documents. Lenders should continue to question this status quo and to request that the weak-form consequence apply. If this point becomes something that lenders require from their purchasers to finance transactions, then manufacturers may well become more accommodating.

Assignment

The next key issue for the lender in a PDP financing is the right of assignment. If the lender steps in, it will want the ability to dispose immediately of its collateral, which is effected in the PDP financing context by the lender assigning its right to purchase the aircraft from the manufacturer. From the lender's perspective, the right of assignment is necessary as it is gives the lender—typically not in the business of owning aircraft or rights to buy them—the same right to dispose that the lender would have if it foreclosed on a physical aircraft. With an assignment right, a lender will not have to wait a number of years and make all remaining payments before it has collateral that is remarketable. To this end, most manufacturer's consents include an assignment right.

Manufacturers' consents do, however, restrict the assignment right in order to protect certain key interests of the manufacturer. The manufacturer has legitimate legal interests to protect; it needs to be legally allowed to contract with the assignee, and the assignee should properly be bound by the purchase agreement following an assignment. The manufacturer also has commercial interests to protect; the assignee should be creditworthy enough to complete the purchase, and the lender should not be able to undermine the manufacturer's marketing efforts by remarketing the aircraft in competition with the manufacturer's own sales program.

Lenders often disagree with this last point. They argue that the manufacturer's remedy to protect its order book is to exercise the manufacturer's purchase option (which is discussed further below) and remove the lender from the deal. The lender argues that the manufacturer's consent to an assignment should be limited to matters that protect the manufacturer's legal interests and protect the manufacturer's need to have a creditworthy purchaser, but the right to consent to an assignment should not fetter the ability of the lender to compete with the manufacturer for sales (which is necessarily what the lender will be doing if it steps in).

A relatively unfettered assignment right for the lender (offsetting its difficult step-in obligation) may or may not be achievable because of contractual limitations that are ultimately imposed by the manufacturer, and because of the bankruptcy "claw-back" risk discussed later in this article. The lender therefore often has to settle for a right of assignment that is subject to the consent of the manufacturer, but with the agreement of the manufacturer that such consent will not be unreasonably withheld.

Manufacturer's Purchase Option

The key protection of the manufacturer's commercial position in a manufacturer's consent is the manufacturer's purchase option. The manufacturer's purchase option gives the manufacturer the right, but not the obligation, to step in and buy out the lender's rights to the PDP financing during an agreed exercise period that commences either following default by the purchaser or enforcement by the lender of its lien on the purchase agreement. It gives the manufacturer the ultimate right to prevent the lender from assuming the purchaser's right to buy aircraft and then to compete with the manufacturer in the market.

Consistent with the principles of asset-based lending, in most early PDP transactions the price at which the manufacturer exercises its option (the option price) is initially a "make-whole" amount for the lender that would be equal to the lender's outstanding principal, accrued interest, breakage costs, and other amounts payable by the purchaser as borrower under the loan documents. More recently, however, the manufacturers have pushed lenders to accept something less than a make-whole. The recoverable amount is now more often limited to principal, accrued interest (sometimes at a lower rate than the rate payable on the loan) for a specified number of days (say, 90 days), and intra-period LIBOR or similar breakage costs (as opposed to breakage on a swapped amount).

The rub of the manufacturers' approach for lenders and purchasers is that 1) the lender must accept that its collateral can be taken back by the manufacturer without the lender being made whole (certainly, a built-in haircut is not something asset-based lenders would expect to see), 2) the lender and the purchaser have changed the economics of some PDP transactions to fit within the caps being imposed on amounts the lenders can recover if the manufacturer's purchase option is exercised (for example, deals that were once swapped deals based on three-month LIBOR became one-month LIBOR floating-rate deals to better fit within the limitation on accrued interest and the exclusion of breakage from what can be recovered), and/or 3) the purchaser must fund a security deposit with the lender to cover any gap.

From a structuring perspective, the lenders' preference for make-whole seems more convincing than the manufacturers' rationale for limiting the amount that they pay. For manufacturers, the buy-out is an option that, acting rationally, they will exercise only if they consider it advantageous to take the aircraft back and remarket it themselves, presumably for a profit. It is not readily apparent why lenders would or should accept a loss in this situation. As with the assignment issue, this seems to be an area where the lenders' and the borrowers' rights are being stretched too far from those they would expect to receive in a secured asset financing.

Contract Issues

Fleshing out the above contractual terms gives some insight as to how the PDP lenders' deal has become, in some ways, less like a secured asset-based deal and more like a corporate financing transaction, supported by limited manufacturer comfort. Lenders can look to the purchaser's credit to fill only so many gaps before the deal moves from an asset-based financing into the realm of a corporate loan.

BANKRUPTCY ISSUES

Beyond the purely contractual issues, bankruptcy issues create still more differences between PDP financing and secured asset-based financing. The differences start, once again, with the nature of the collateral. The purchase agreement is a contract and is not an aircraft, and as such it is treated differently in bankruptcy proceedings.

First, in the United States, most commercial aircraft financed for airlines are subject to Section 1110 of the Bankruptcy Code, which, in addition to other protections, requires that an air-carrier debtor keep current on its obligations under an aircraft financing or lose the protection of the automatic stay 60 days after the commencement of a Chapter 11 bankruptcy case.[5] The lender in a PDP financing does not benefit from Section 1110 of the Bankruptcy Code.

Second, the purchase agreement is a contract in which both the manufacturer and the purchaser have material unperformed obligations. As such, under the Bankruptcy Code the purchase agreement would be classified as an "executory contract." In bankruptcy, a debtor has three options for dealing with an executory contract: it can 1) reject, 2) assume, or 3) assume and assign the contract. A debtor-purchaser is likely to reject a purchase agreement in bankruptcy where the aircraft that are the subject of that purchase agreement are not worth the remaining amounts payable to have them delivered. Rejection creates risks for both the manufacturer and the lender. In a manufacturer's consent, the risk to the lender of rejection is usually addressed by having the manufacturer agree that in the event of rejection the manufacturer will enter into a new contract with the lender on the same terms as the rejected contract and that it will give the lender credit for PDPs paid under the rejected contract.

A debtor-purchaser is likely to assume the purchase agreement where the value of the aircraft exceeds the remaining amounts payable to have them delivered. In the assumption scenario, most bankruptcy issues do not apply, as the assumed contract will remain in place and the original purchaser will remain obliged to continue to make payments and accept the aircraft when they are delivered.

The hardest scenario to quantify is where the debtor-purchaser seeks to assume and assign its rights under the purchase agreement. This third scenario creates risks for the manufacturer as to the creditworthiness and identity of the new assignee. Also, the manufacturer must manage the risk of losing marketing control over new aircraft as the debtor-purchaser attempts to sell them itself. A hostile assumption and assignment dispute could raise numerous costly and contentious issues that need to be addressed by manufacturers and lenders; dependent on the facts or circumstances, these could include 1) whether the assignee can provide "adequate assurance of future performance"[6] and 2) the ability of the purchaser to sell collateral free and clear of liens.[7]

A further key risk for lenders in the bankruptcy of the purchaser is that PDPs already paid to the manufacturer could be restructured. A debtor-purchaser can seek to restructure its loan obligations as an asset of the bankrupt estate, including by providing a lender with the "indubitable equivalent" of its present economic rights.[8] In the context of a PDP financing, this could mean that the lender's security interest in the purchase agreement, and the benefit of the PDPs, could be substituted with an interest in unrelated assets of the bankrupt purchaser. Such a restructuring has the potential to create havoc and adds uncertainty for any lender (and indeed any manufacturer) entering into a PDP financing transaction. PDP lenders should be aware of the risk of collateral substitution, a risk that is absent in traditional aircraft financings with the benefit of Section 1110.

An even worse result for lenders arises in the event of a manufacturer's bankruptcy, which potentially destroys the lender's collateral, leaving the lender with an unsecured loan to the purchaser. Although the risk of manufacturer bankruptcy is generally not considered a problem for PDP financings with major manufacturers, it is certainly a relevant consideration for transactions with smaller manufacturers.

Because of these risks, lenders should always remember that PDP financings are not equivalent to financings of physical aircraft in bankruptcy, and by their very nature carry additional structural risks.

Claw-Back

One such difference that is currently a headline issue for lenders and manufacturers is the so-called "claw-back" issue. It arises in the context of a purchaser insolvency or bankruptcy, where the debtor or administrator of the purchaser's bankrupt estate claims that the manufacturer must repay the PDPs made by the purchaser. This would happen where the PDPs are characterized by a bankruptcy court to be a security deposit made by the purchaser. Dependent upon the wording of the contract and the intent of the parties, in bankruptcy, the security deposit could then be considered by the court to be "cash collateral" of the purchaser. If aircraft values are higher than the purchase price under the purchase agreement, a bankruptcy court may then consider that 1) the lender is oversecured due to the intrinsic value of the purchase agreement, and 2) the lender's lien on the purchase agreement "adequately protects" the lender's interests. Based upon these findings, a court could require that the PDPs be disgorged by the manufacturer and returned to the debtor-purchaser, as the manufacturer's and the lender's interests are "adequately protected" within the meaning of Section 363 of the Bankruptcy Code.

In the context of a PDP financing this causes huge problems. The value of the lender's collateral is the right to pay the balance of the final purchase price and take delivery of the aircraft. If pre-delivery payments are required to be disgorged by the manufacturer before delivery of an aircraft, then either the lender (under the terms of an indemnity contained in the manufacturer's consent) may be forced to pay the PDPs to the manufacturer a second time, or the manufacturer (in the absence of such indemnity) may be forced to deliver an aircraft for which it has not been fully paid.[9] Either way, the lender or the manufacturer will lose out.

Staying true to the principles of asset-based lending, this problem was fixed for the lenders in early PDP financing transactions. Early manufacturers' consents had the manufacturer agree to apply all pre-delivery payments towards payment of the final purchase price. There was no mention of what would happen in case the PDPs had to be disgorged in the purchaser's bankruptcy, and by default in most transactions the risk of disgorgement rested with the manufacturer, which generally had an absolute obligation to apply the PDPs that it received towards the final purchase price. The view at the time was that there was no real risk of disgorgement and this was the only way to fix what would otherwise have been seen as a structural flaw with the "asset" being financed.

As the PDP financing market evolved, manufacturers became more concerned by the risk of claw-back and of purchaser bankruptcy. Lender arguments that the manufacturer was already carrying the risk of its purchaser's insolvency before the lender joined the arrangement did not quite ring true; if PDPs were clawed-back without a lender being involved, the manufacturer could keep the aircraft, and the purchaser would lose its right to purchase. The manufacturer would, in theory, be able to find another purchaser for the aircraft and still sell it for a market price. If a lender were able to force a manufacturer to deliver an aircraft even though the manufacturer had disgorged payments back to a purchaser's bankruptcy estate, the manufacturer could be forced to honor pre-delivery payments that it no longer holds and deliver an aircraft at a below-market price.

On this basis, manufacturers started revisiting the claw-back protection that they offered in PDP financing transactions. The current approach being taken by manufacturers falls into two main categories. 1) The core claw-back approach (the full claw-back) has the manufacturer refusing to honor any and all disgorged PDPs and requires that the lender indemnify the manufacturer for any PDPs that the manufacturer must disgorge (whether advanced by the purchaser, or financed PDPs). 2) In contrast, the partial claw-back (or purchaser claw-back) applies only to those disgorged PDPs paid by the purchaser, and financed PDPs are honored.

The partial claw-back approach has gained more traction with lenders. Purchasers still have "skin in the game" (as there is no certainty that the payments will be clawed back), and depending on the final purchase price, escalation, the lenders' view of the market, and the other factors in the transaction, some lenders have managed to get comfortable that the economics work for them even if they are not able to rely on the purchaser's portion of funded PDPs as collateral.

For example, in a transaction where 30% of the final purchase price is the subject of PDPs, and the lenders advance 60% of the PDPs, the purchaser's funded portion of the final purchase price (the amount liable to be disgorged) amounts to 18% of the final purchase price. If the purchaser can obtain an aggressive final purchase price for the lenders (i.e., something 18% better than the lenders' valuations project), then even assuming that the lenders have to repay the PDPs funded by the purchaser, the collateral may still be adequate. Of course, the math also can work where the lenders are taking risk on a full claw-back—it is just harder to get there.

Regardless of the approach, claw-back risk is still a bitter pill for lenders to swallow. For some lenders, the issue has drawn the asset-based lending analogy too thin, and they have retreated from the market. Many more are being asked to enter into transactions where the final purchase price does not quite add up in the event of a purchaser claw-back (or a full claw-back).

Existing Claw-Back Structures

In some recent transactions, manufacturers and lenders have each accepted claw-back risk if a "bankruptcy-remote" structure is used. The rationale is that using such a structure reduces the likelihood of the purchaser becoming bankrupt to such an extent that the allocation of claw-back risk becomes theoretical.

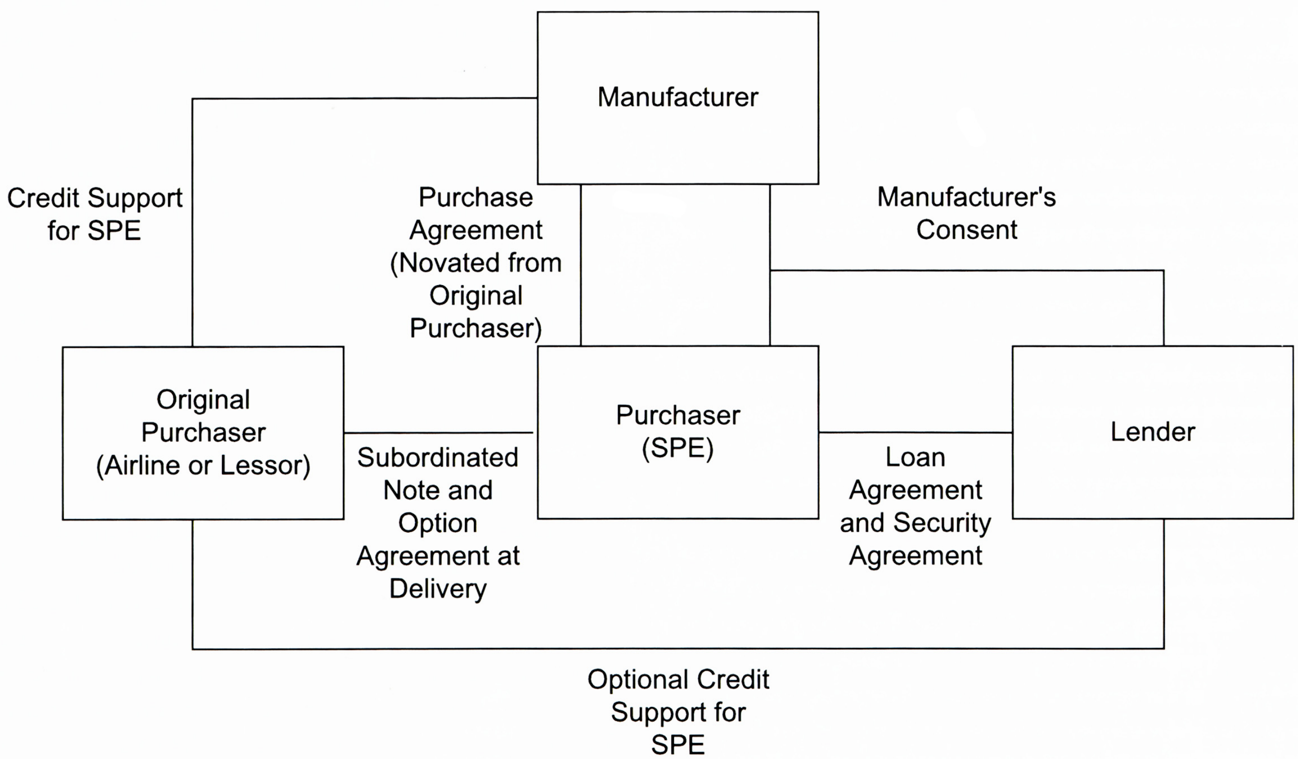
In a typical bankruptcy-remote structure for a PDP financing, the rights of the airline or the leasing company that is the purchaser are transferred to a new special purpose entity (or SPE). The SPE is either an "orphan" company—an entity the parent of which is a trustee company that holds the entity's shares for the benefit of a charitable or purpose trust—or it remains a subsidiary of the airline or leasing company but has other features that allow it to be considered bankruptcy-remote.[10] The exact nature of the requirements for bankruptcy-remoteness will depend upon the jurisdiction of the SPE, applicable market practice, and the advice received from local counsel.

Once the SPE is established, the purchase agreement is transferred to the SPE, usually by means of a novation (a transfer of all of the rights and obligations under the purchase agreement to the SPE) or a true sale in the U.S. context.

As part of the transaction, the airline or leasing company that is the purchaser enters into a subordinated note or similar arrangement with the SPE. This gives the SPE access to capital so that it can pay 1) the equity portion of its PDPs, 2) any amounts necessary in the event of specification changes or similar events under the purchase agreement, and 3) interest and fees to the lenders. The structure usually also includes a mechanism for the SPE to sell aircraft back to the original purchaser (or a nominee) as and when they are delivered. The mechanism comprises a put option, giving the SPE the right, but not the obligation, to sell the delivery position back to the original purchaser and a call option giving the original purchaser the right, but not the obligation, to purchase the delivery position from the SPE. The consideration for the sale will be a repayment of the capital contributed to the SPE. A structure diagram outlining a bankruptcy-remote PDP financing is included as Exhibit 2.

EXHIBIT 2

PDP Financing Structure Using Bankruptcy Remote Special Purpose Entity



In this form, the structure is analogous to the financing of a SPE in the context of a leveraged aircraft leasing transaction. Parties form a view that the SPE cannot be drawn into a bankruptcy of the parent airline or leasing company and therefore feel that they can accept the bankruptcy claw-back risk. However, as set out above, arrangements in a PDP financing are different from a leveraged aircraft lease. In addition to the legal difference in the collateral noted previously, key factual differences result from the differing functions of the SPE.

In a leasing transaction, the SPE is basically a self-sustaining and essentially economically independent entity. It collects rent from its asset, can service its debt, and can pay a servicing fee. In the context of a PDP transaction, the SPE is different. It is created solely to own contractual rights to delivery slots, its equity is funded by its original purchaser, and it is wholly dependent on the original purchaser for survival—albeit on documented terms suggesting an arm's-length contractual arrangement. This dependency of the SPE on its parent in the absence of an income-generating asset necessarily makes it less separate than in a typical asset-based leasing transaction. While the parties may still be able to obtain a separateness opinion in many jurisdictions, the nature of PDP financing makes true separateness problematic in a typical transaction.

Separateness may be further reduced if the manufacturer in a PDP financing requires that 1) the parent remain responsible for the obligations of the SPE to perform under the "novated" purchase contract (through a guarantee and indemnity), 2) the SPE's novated purchase agreement be cross-defaulted with other purchase agreements that the purchaser (or its other SPEs) may have with the manufacturer, and 3) as between manufacturer and purchaser, the manufacturer retain the ability to set-off PDPs under the novated purchase agreement with amounts owing under the purchaser's other purchase agreements with the manufacturer.

For the entity accepting the claw-back risk—either the manufacturer or the lender—this structure, from a high level, appears to retain a risk of consolidation in the event of a purchaser's bankruptcy. Although it is beyond the scope of this article to discuss the specific bankruptcy risks in the various jurisdictions in which a SPE may be established for the purpose of financing the PDPs, a high-level observation of the facts outlined above is that separateness of the SPE could be problematic in jurisdictions where courts look to the substance of a transaction in considering whether consolidation is appropriate. Bankruptcy-remoteness is more tenable in jurisdictions where courts look solely to formal, documented separateness of the original purchaser and the SPE in considering whether they should be consolidated.

Alternative Structures

In light of the possible consolidation risk affecting "bankruptcy-remote" PDP structures in some jurisdictions, it is worthwhile for the parties to consider alternative financing structures that further mitigate their risks. For some time, market participants have been discussing alternative structures that reduce claw-back risk even more than the SPE structures.

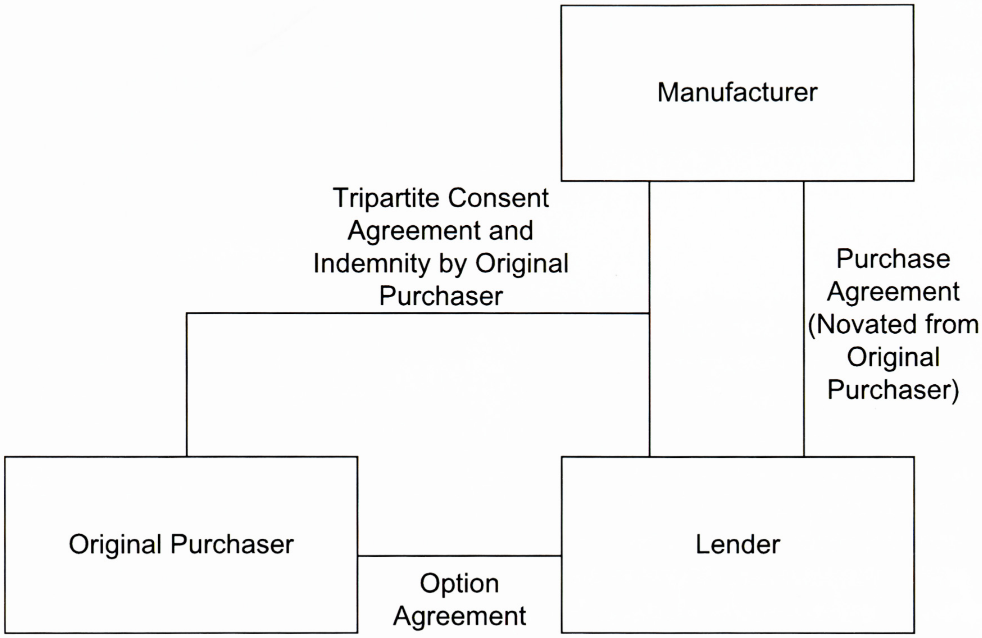
The most commonly considered alternative structure is the "lender contract" approach. Here, the purchase agreement for the financed aircraft is transferred and sold either to the lender or to an entity controlled by the lender, so that the purchase agreement becomes an arrangement between the lender and the manufacturer.

The lender then enters into an option agreement with the purchaser—similar to the agreement of the SPE outlined above—that gives the purchaser the right to call for the aircraft at delivery and that gives the lender the right to put the aircraft to the purchaser at delivery. The option price is payable by the purchaser progressively to cover the various costs of the transaction such as 1) the purchaser's equity portion of PDPs, 2) any amounts payable to the manufacturer under the purchase agreement from time to time, and 3) interest, fees, and other amounts payable to the lender. The purchaser retains the right to manage the purchase agreement from day to day with the manufacturer and indemnifies the manufacturer in the event of a breach by the lender of its obligations under the manufacturer's consent. Importantly, the manufacturer agrees that its recourse to the lenders will be limited to the amount of the PDPs funded by the lenders, unless the lenders elect to step in following a purchaser default. A structure diagram outlining a lender contract type of PDP financing is shown in Exhibit 3.

The substance of this arrangement is very similar to a conventional PDP financing. However, it removes a number of bankruptcy-related risks for the lender and for the manufacturer. Importantly, the structure removes

Exhibit 3

PDP Financing Structure Using Lender Contract



the purchaser's ability to claw back the financed PDPs, which are paid from the lender to the manufacturer under an arrangement not involving the purchaser. Secondly, the collateral of the lender is no longer an executory contract that can be manipulated in a purchaser's bankruptcy. The executory contract of the purchaser is, instead, the put and call option agreement, which—if cancelled—will not affect the lender's rights under the assigned purchase agreement.

The lender also has comfort that, instead of having the rights of a secured party in the event of the purchaser's bankruptcy, the lender is a principal under the assigned purchase agreement with the manufacturer. This removes, for example, the purchaser's ability to substitute collateral for the purchase agreement in a bankruptcy.

The structure is not, however, without limitations. The purchaser retains the ability to claw back the equity portion of the PDPs paid to the lender (a risk that can be structurally minimized, but which will necessarily remain in respect of the portions of the purchase price paid by the purchaser). Also, the structure may potentially put other amounts payable by the purchaser to the lender under the put and call option agreement at risk. From the purchaser's perspective, the structure reverses the traditional risk and puts the purchaser's delivery positions at risk in case of a financier's bankruptcy, a risk that purchasers consider more real than ever in today's market. The structure may also have regulatory or tax implications for the lender that arise as a result of changes from traditional PDP financings.

Despite these limitations, the main reason that the structure has not gained popularity is the reluctance of the airlines and operating lessors to agree to it, primarily because the structure removes their ownership of a key strategic asset: the right to future deliveries.

With that said, it is a common view that this type of structure adds value from a risk perspective because it replaces, in many ways, the purchaser's bankruptcy risk with the bankruptcy risk of the lender. While for some lenders there are regulatory or similar matters that would need to be addressed before such an arrangement could be implemented, this structure offers material enhancements that improve the position of both manufacturer and lender in the event of a purchaser bankruptcy.

Another solution that manufacturers have started to adopt in their purchase agreements is to eliminate all property interests of the purchaser in the PDPs. Specifically, many purchase agreements now have language that vests all property rights in the PDPs with the manufacturer. This contractual language appears to seek to stop the debtor-purchaser from claiming any cash collateral rights in and to the PDPs in a bankruptcy situation. No courts have addressed whether such contractual language modifications will protect the manufacturer and the lender from disgorgement risk, and as such an evaluation of the efficacy of such mechanisms cannot be made at this time.

CONCLUSION

PDP financing continues to evolve. There are a number of open, contentious issues that are common to many PDP financing transactions. To solve these, the parties must understand each others' core needs. Lenders need to have a purchase price that underpins the value of their collateral, a right to be compensated if their collateral is taken away, and a right to deal with their collateral following enforcement. Manufacturers need to have the ability to manage the people with whom they do business and should not have an obligation to deliver an aircraft unless it has been paid for. Purchasers want efficient financing and need to retain access to the deliveries for which they have bargained.

Uncertainty surrounding bankruptcy issues continues to create confusion in the PDP financing marketplace. Absent clear legal precedents in relevant jurisdictions that assure the parties that one structure or another will properly give effect to a business deal negotiated by the parties in the event of a purchaser bankruptcy, there will continue to be problems agreeing to risk allocation, in particular in relation to the so-called claw-back issue.

ENDNOTES

[1]Instead of granting rights in the aircraft purchase agreement, some agreements instead grant a security interest in specific rights under the purchase agreement. Typically assigned are: 1) the rights of the purchaser under the purchase agreement to purchase, take delivery of and, upon payment of the purchase price for the aircraft, be named as "buyer" under the bill of sale; 2) the rights in pre-delivery payments that have been made, including a right of reimbursement and the right to have the pre-delivery payments applied towards satisfaction of the purchase price; 3) the right to warranties and certain manufacturer indemnities; and 4) the right to compel performance by the manufacturer of the foregoing rights.

[2]Often separate consents are provided by each of the airframe manufacturer and the engine manufacturer. For simplicity, this article refers generically to "the manufacturer."

[3]The price may be a composite of pricing and concessions from the airframe manufacturer and the engine manufacturer. For simplicity this article describes pricing as a single amount agreed by the manufacturer.

[4]It is a point for negotiation as to whether the lender has the right to step in for "any or all" of the aircraft or "all or none" of the aircraft. Such discussion is, however, beyond the scope of this article.

[5]*See* 11 U.S.C. § 1110(a)(2).

[6]*See* 11 U.S.C. § 365(f)(2)(B).

[7]*See* 11 U.S.C. § 363(f).

[8]*See* 11 U.S.C. § 1129(b)(2)(A).

[9]In a related context, in a recent bankruptcy the manufacturer, lenders, and debtor consensually agreed to unwind a PDP financing arrangement. By consensually unwinding the PDP financing, $11.5 million of PDPs were returned to the debtor. See Disclosure Statement for Debtors' Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at § 4.3(i)(3), *In re* Frontier Airlines Holdings, Inc., No. 08-11298 (Bankr. S.D.N.Y. filed July 20, 2009).

[10]It is beyond the scope of this article to discuss the requirements for bankruptcy-remoteness generally.