VEDDERPRICE®

Chicago ■ New York ■ Washington, D.C.

EFG
EQUIPMENT FINANCE GROUP

May 2010

Commercial Aviation Review

Legal Updates in Equipment Finance

From the Chair of the Vedder Price Equipment Finance Group

Dear Friends:

Welcome to the first installment of the Vedder Price Equipment Finance Group's quarterly newsletter. While this issue focuses on aviation finance, future newsletters will cover maritime, rail and equipment finance generally. We trust you will find these updates informative and useful. Please feel free to contact me or any of the other members of the Equipment Finance Group to discuss these topics or to suggest future articles of interest.

Dean N. Gerber

* * *

Single-Purpose Entities and Independent Directors: Does the *General Growth* Ruling Change Structured Finance?

A recent Delaware bankruptcy court decision[1] on the ability of "bankruptcy remote" single-purpose entities emphasizes the complicated nature of the bankruptcy process and the issues that need to be considered when using "bankruptcy remote" entities in funding structures. Given the prevalence of such entities, this is an important decision for all participants in the structured finance industry.

Executive Summary

General Growth Properties, Inc. ("**General Growth**"), the owner of shopping center properties across the United States, filed a voluntary bankruptcy petition, as did its subsidiaries, many of which were structured as bankruptcy remote single-purpose

> if structured appropriately, a parent bankruptcy filing should not impair the fundamental protections of the SPE structure, which include avoiding substantive consolidation

entities ("**SPEs**"). Certain creditors of the SPEs filed motions to dismiss arguing, among other things, that the SPE bankruptcies were filed in bad faith. The *General Growth* court denied such motions, allowing the SPE voluntary bankruptcies to stand. The *General Growth* ruling with respect to

In this issue...

the bad faith filing motions has attracted a lot of attention in the structured finance industry but, as the ruling relates to the special-purpose structure, it confirms what was already known – bankruptcy remote is not bankruptcy proof. Despite attempts to isolate the assets of an SPE from a bankruptcy filing of the parent (sponsor) of the SPE (the "**Parent**"), a bankruptcy filing of the Parent may result in the bankruptcy of the SPE. However, if structured appropriately, a parent bankruptcy filing should not impair the fundamental protections of the SPE structure, which include avoiding substantive consolidation.

Typical Use of SPE and Independent Director in Equipment Finance

In a typical[2] structured finance transaction of equipment that involves a bankruptcy remote entity, the Parent creates a subsidiary whose purpose is limited to acquiring equipment (and related leases) to be financed and undertaking ancillary obligations. The SPE acquires the equipment and enters into a financing arrangement that is nonrecourse to the Parent, pledging the equipment and the leases as collateral. Some of the customary features of a bankruptcy remote entity are (i) organizational documents that limit the entity's business to a single, specific and narrow purpose (generally speaking, acquiring, leasing, financing, refinancing and eventually liquidating the equipment), (ii) organizational documents and financing documents that contain "separateness" covenants that require the subsidiary to be managed and operated in a manner that is distinct from the assets and business of the Parent (among other entities), and (iii) the appointment of one or more independent managers or independent directors of the SPE ("**Independent Directors**") who meet certain requirements that provide some comfort to financing parties that the Independent Director is not overly sympathetic to the interests of the Parent. The Independent Director's favorable vote or consent is typically necessary for the SPE to approve a voluntary bankruptcy filing, to consent to an involuntary bankruptcy or to conduct other specified organic changes that may be detrimental to the SPE's lenders. Due to the proliferation of single-purpose financings in recent years, companies now provide "professional" Independent Directors ("**Professional Independent Directors**") for a fee.

In connection with your typical financing transaction, counsel to the Parent and SPE provides a reasoned legal opinion related to the "true sale" of the assets to the SPE, the "non-consolidation" of the SPE into the bankruptcy estate of the Parent and "non-rejection" by the Parent of the leases assigned to the SPE by the Parent in a Parent bankruptcy.

In re General Growth Properties, Inc. – Motion to Dismiss and Ruling

On April 16, 2009, General Growth together with its SPE subsidiaries filed voluntary petitions under chapter 11 of the U.S. Bankruptcy Code. General Growth owns shopping center properties, many of which (if not most) are financed through the use of bankruptcy remote SPEs. Despite their bankruptcy remoteness, the General Growth SPEs were among the subsidiaries that filed voluntary bankruptcy petitions.[3]

Motions to dismiss the bankruptcy filings of certain SPEs as "bad faith" filings were presented by certain creditors of the SPEs. The motions argued, among other things, that the filings were *ultra vires* and unauthorized because General Growth caused the termination of many of the Independent Directors, who were Professional Independent Directors, prior to the bankruptcy filings.[4] The Independent Directors were replaced with Independent Directors who were experienced in corporate restructuring, who reviewed General Growth's restructuring outlook and who voted in favor of the SPE bankruptcies.

The organizational documents of the General Growth SPEs attempted to alter the fiduciary duty of the Independent Directors and require that the Independent Directors, to the extent permitted by law, consider the interests of the SPEs, *including their respective creditors*, when voting on matters related to bankruptcy filings. The bankruptcy court concluded that the Independent Directors are required to take the interests of the shareholders into account when exercising their fiduciary duties. The court also stated that:

> ... if Movants believed that an "independent" manager can serve on a board solely for the purpose of voting "no" to a bankruptcy filing because of the desires of a secured creditor, they were mistaken. As the Delaware cases stress, directors and managers owe their duties to the corporation and, ordinarily, to the shareholders.[5]

There are two important parts of the court's decision. First, in allowing the SPEs to file for bankruptcy, the court noted that all cash generated by the SPEs was automatically swept out of lockbox accounts on a daily basis and then used to fund General Growth's day-to-day operations. If the SPEs were not allowed to file for bankruptcy protection, the SPEs' creditors would be able to cut off this cash flow. Cutting off the cash flow in turn would cut off General Growth's funding (and consequently its ability to operate) and essentially prevent an effective restructuring. The financiers were aware that their financing structure and cash flow model funded the SPEs and General Growth as an integrated enterprise and the court was unwilling to allow the financiers to disregard the essential nature of the General Growth business model in the bankruptcy.

Second, even given the essential nature of allowing the SPEs' cash flow to fund General Growth's ongoing operations in order to allow an effective restructuring, the court only allowed General Growth's continued use of such cash flow after the financiers were given "adequate protection" for their collateral position. It appears that there were extensive negotiations with the financiers with respect to the collateral provided to satisfy the adequate protection requirement and the financiers were able to negotiate reasonable terms.

While the ruling on the fiduciary duty of the Independent Director may cause some concern in the structured finance industry (the court having acknowledged that the creditors of the SPEs have been "inconvenienced"[6] by the SPE filings), the court also concluded that:

> [t]he salient point for purposes of these Motions is that the fundamental protections that the Movants negotiated and that the SPE structure represents are still in place and will remain in place during the Chapter 11 cases. This includes protection against the substantive consolidation of the project level Debtors with any other entities.[7]

Conclusions

The denial of the motions to dismiss the SPE bankruptcies in the *General Growth* case was an important development for lenders in SPE structures, but the ruling as it relates to Independent Directors and their fiduciary duties should not be considered a change from existing law. It reminds us that bankruptcy remote is not bankruptcy proof. While structured finance transactions properly utilizing SPEs can reduce the risk of substantive consolidation in the event of a Parent bankruptcy, this risk cannot be entirely eliminated. If the SPEs are not substantively consolidated into a Parent's bankruptcy estate, as is the case in with General Growth (at least so far), a first-priority fully secured creditor of a properly structured SPE that files under Chapter 11 should not suffer significant adverse consequences, other than those attendant to delays in realizing on collateral.

> the ruling as it relates to Independent Directors and their fiduciary duties should not be considered a change from existing law

Finally, it is worth noting that "best practice" in Delaware already has developed to address the issues raised by General Growth. In the most recent LLC Operating Agreements, the parties have minimized the provision regarding the managers' fiduciary duties to any persons other than as explicitly agreed amongst the transaction parties. Although not yet tested in court, such changes will strengthen the creditors' ability to keep SPEs out of their Parents' bankruptcies.

If you have any questions regarding this ruling, please contact **John T. Bycraft** (312-609-7580).

[1] Memorandum of Opinion, *In re General Growth Properties, Inc.*, No. 09-11977 (Bankr. S.D.N.Y. August 11, 2009).

[2] Describing "typical," "standard" or "customary" terms and provisions in structured finance is a dangerous endeavor because custom and practice vary depending on the type of structure and the asset class, among other things. This summary describes what we have seen in parent-sponsored SPE transactions (as was the case with General Growth) of "big ticket" equipment finance (railcar and aircraft primarily), as opposed to other asset classes and "orphan" trust structures, among other structures.

[3] Importantly, the SPEs did not file as part of a "consolidation."

[4] Creditors also argued that certain SPEs' bankruptcy filings were premature because the SPEs were not (yet?) in financial distress and filed bankruptcy to benefit General Growth and not the applicable SPE. All motions to dismiss failed.

[5] Memorandum of Opinion, *In re General Growth Properties, Inc.*, No. 09-11977 (Bankr. S.D.N.Y. August 11, 2009), at 33.

[6] *Id*. at 42.

[7] *Id*.

Collateralization of Swap Obligations in Leveraged Financings

Loan documents for leveraging operating leases often include interest rate swaps that convert a borrower/lessor's floating rate loan obligations into fixed rate obligations to match rental receivables. This article discusses our recent experience of lenders requiring counterparties to collateralize those swap obligations.

"Collateralization" of a swap transaction refers to a situation where either or both parties to a swap are required to offer security or credit support for the risk that their counterparty is taking on the transaction at any given point in time. This risk arises if the then mark-to-market (or other) value of the swap transaction would cause one party to have an exposure to the other if the swap transaction were terminated.

The concept of requiring swap transactions to be collateralized is not new. Since 1994, ISDA has published its "Credit Support Annex", which provides multiple options for collateralizing swap transactions, including interest rate swap transactions. Swap desks at most financial institutions have been using Credit Support Annexes and have been managing the posting of collateral under such arrangements for many years.

Recently, the market has been reminded of the very real nature of counterparty risk by the collapse of Lehman Brothers and Bear Stearns, and the frenzy of activity caused by AIG's near demise

Recently, the market has been reminded of the very real nature of counterparty risk by the collapse of Lehman Brothers and Bear Stearns, and the frenzy of activity caused by AIG's near demise. We also have seen ratings downgrades suffered by many financial institutions, which have in turn trigged obligations for the downgraded financial institutions to post collateral under their structured finance transactions. Across the financial services industry, including in equipment finance, these developments have focused attention on swap counterparty risk.

As a result, our recent experience has been an increased incidence of lenders requiring that swap transactions be collateralized in leveraged operating lease transactions. In particular, there has been a marked increase in collateralization requirements in "non-recourse" operating lease transactions (i.e., transactions with recourse strictly to the assets the subject of the transaction) and in syndicated transactions with external, third-party swap providers.

Conventionally, lenders in "non-recourse" or "limited-recourse" transactions have formed a view that they are protected from swap breakage exposure by the excess value of their collateral over and above the balance of their underlying loan and possibly also by parent guarantees of breakage costs.

Collateralization of such transactions offers the additional protection of cash collateral (or any other agreed collateral) to cover the exposure of the lenders. Collateralization is effected in the context of conventional fixed rate financings by building in the equivalent of an ISDA mark-to-market mechanism into the loan agreement to calculate the amount of collateral required and then incorporating applicable rules. These are typically rules that determine (i) the frequency of testing whether the counterparty should post collateral, (ii) the thresholds at which collateral is required to be posted, (iii) the minimum transfer amounts if collateral is required to be posted, (iv) requirements for delivering and returning collateral, and (v) the type of collateral that can be posted, which is typically cash.

In a different context, lenders in syndicated transactions with external, third-party swap providers (which may be one of the lenders) recently have been requiring the swap bank, as the borrower's counterparty, to post cash collateral. This is not a requirement because of any risk that the borrower's collateral may not be sufficient, but is rather required to manage the borrower's—and through the borrower's, the lender's—counterparty risk on the swap bank. These collateralization arrangements reflect typical credit support arrangements that would be entered into by bank trading desks (and in this type of arrangement are likely to be negotiated, at least on the part of the swap bank, by its swap desk). Arrangements are likely to be documented by an ISDA Credit Support Annex, and posting is likely to be contingent upon a downgrade of the swap bank below an agreed threshold credit rating.

Including a requirement for the swap bank to collateralize its position raises some interesting questions. If a swap bank is required to post collateral, should the borrower also be required to post collateral in some situations? What level of access should the swap bank have as a secured party to the lenders' collateral if it also has access to collateral posted by the borrower under the swap? Also, if the swap bank posts collateral to the borrower, then what should happen to that posted collateral in the event of a borrower default under the swap agreement and/or the borrower's loan documents?

While exploring these points is beyond the scope of this note, suffice it to say that these types of questions, while raising the complexity of a transaction, may have to be answered if swap exposure is a concern.

The summary for lenders and borrowers is that swap transactions remain an important part of many equipment finance transactions. While market practice very much remains for fixed rate loans to be documented without additional credit support for swap positions, we have noticed some market participants paying further attention to the additional risk that swaps create. As a result, some participants have tried to manage that risk, specifically by requiring that their swaps be collateralized.

If you have any questions regarding this article, please contact **Cameron A. Gee** (212-407-6929).

The Emissions Trading Scheme in European Airspace Takes Shape—Can the United States Be Far Behind?

One of the most talked-about issues in the ongoing climate change debate is cap-and-trade regimes. Cap-and-trade is a regime designed to reduce greenhouse gas emissions by requiring covered entities to observe restrictions (in the form of allowances) on greenhouse gas emissions. The allowances limit or "cap" permitted greenhouse gas emissions and allow entities to sell or "trade" unused allowances. The United States is considering various forms of legislation, including cap-and-trade regimes, to reduce greenhouse gas emissions. The European Union, on the other hand, has enacted regulations to implement a cap-and-trade regime.

On June 26, 2009, the US House of Representatives passed H.R. 2454, entitled the

Waxman-Markey American Clean Energy and Security Act. On September 30, 2009, the Environment and Public Works Committee of the US Senate introduced a comparable bill, S. 1733, entitled *The Clean Energy Jobs and American Power Act*. The goal of both bills is the reduction of US emissions of greenhouse gases by means of a cap-and-trade scheme. Both proposed bills are complex and include provisions under which the federal government will establish a cap on greenhouse gas emissions allowed for all "covered entities" and require generally that a covered entity must hold an allowance for every ton of greenhouse gas it emits. Both bills set the cap for 2012 at 97% of the emission levels during 2005, and at 58% of 2005 levels in 2020 and at 17% of 2005 levels in 2050. The emissions allowances can be bought and sold in an open market.

The United States is considering various forms of legislation, including cap-and-trade regimes, to reduce greenhouse gas emissions

The legislation is not clear as to the extent, if any, to which airlines or aircraft engines will be affected, however, as of February 23, 2010, the legislation is intended to be applicable to the airline industry.

Both proposed bills call for emissions standards for aircraft and aircraft engines, but contain few details on how the as yet un-chosen administrator of the legislation will impact the aviation industry. For example, under the House bill, the Administrator will have the authority to establish standards applicable to banking and trading of greenhouse gas emissions allowances across several classes or categories of covered entities, including aircraft and aircraft engines, to the extent that such Administrator "determines appropriate."

Commentators have been critical of the currently proposed legislation and its future is uncertain. Politicians in Washington continue to work on a variety of alternatives with both minor and major differences to the current legislation. Given the general political atmosphere in Washington, it is impossible to predict when, or even if, any emissions control legislation will be enacted.

Given the general political atmosphere in Washington, it is impossible to predict when, or even if, any emissions control legislation will be enacted

Europe is ahead of the United States in implementing cap-and-trade regulations. Through Directive 2003/87/EC, the European Commission created a cap-and-trade emissions trading scheme ("ETS") within the European Community, which includes aviation activities. All operators, lenders and lessors of aircraft traveling to, from and within Europe need to understand the implications of the EU ETS requirements on such operations.

EU ETS regulations apply to *all* "affected aircraft operators"—operators of all flights that depart from or arrive into *any* airport in a EU Member State, including flights within the European Community—regardless of the operator's nationality (subject to some exceptions not related to commercial aviation). Thus, beginning in January 2010, aircraft operators who fly to, from and within any EU member country are required to monitor and report all annualized carbon emissions and greenhouse gas emissions arising from their aircraft activities. Total emissions are calculated by multiplying an aircraft's fuel consumption by its emission factor.

EU ETS regulations also require affected aircraft operators to calculate their free allowances based on flights to, from or within Europe (in metric tons). This calculation is important for calculating free allowances for flights regulated by the EU ETS, and because it creates a construct which purportedly regulates carbon emissions released during flight through non-EU airspace. When other regions, including the United States, implement their own regimes, the EU regime creates the possibility of double regulation (and consequently taxation), as the regions in which a flight both originates and concludes may both purport to regulate the operator and its emissions.

Each operator of aircraft within EU Member States has been assigned to one specific Member State which is responsible for the administration and regulation of such operator's activity within the European Community. For example, American Airlines, Continental Airlines and United Airlines, three large commercial US airlines, have been assigned to the United Kingdom, while Delta and US Airways have been assigned to Germany.

All operators, lenders and lessors of aircraft traveling to, from and within Europe need to understand the implications of the EU ETS requirements on such operations

From January 1, 2010, affected aircraft operators must have in place monitoring and reporting systems relating to their carbon emissions for each year. The EU Member State's appropriate authority will evaluate the operator's monitoring plan report to determine whether or not it meets all requirements. Proper plans are necessary to avoid civil penalties for non-compliance in the future. Additionally, aircraft operators cannot apply for free allowances once cap-and-trade begins without having first submitted a monitoring plan for their operating and emissions data.

Under the 2008 Directive, affected aircraft operators will be required to reduce and account for all their annualized carbon emissions and to surrender emissions allowances to the European Union's regulatory authority each year. Beginning January 1, 2012, the total quantity of emissions allowances for the 2012-year will be equivalent to 97% of the "historical aviation emissions" or, in other words, 97% of the annual average of greenhouse gasses released into the atmosphere by aircraft in the years 2004 through 2006. From 2013 onwards, barring any future amendments, the annual cap on these emissions will be reduced from 97% to 95%.

Although it remains unclear whether administration of and compliance with the EU ETS requirements will be consistently applied across country lines, it is necessary for all affected aircraft operators to be in compliance by 2012 to avoid civil penalties. Operators may be subject to such penalties if: (i) they exceed allowed emission caps; or (ii) they fail to provide an approved monitoring plan or required data regarding carbon emissions. Failure to comply also may lead to regulatory authorities exercising their powers of detention and sale to take possession of an aircraft or, as a last resort, the authorities could impose an operating ban on an affected aircraft operator.

In conclusion, all affected aircraft operators must ensure they meet monitoring and reporting requirements so that: (i) they are in compliance with EU ETS regulations by 2012; and (ii) they are able to "trade" when mandatory cap-and-trade begins in Europe. To do so, control systems—proper monitoring and reporting policies—must be implemented immediately to mitigate risks, such as misstatements regarding emissions, possible civil penalties and potential detention. The prudent affected aircraft operator will use both internal and outsourced procedures to review data, as well as management of all necessary competencies and responsibilities. An evaluation of an operator's equipment is necessary as well since older model aircraft and engines will produce more emissions than their modern counterparts.

If you have any questions regarding these issues, please contact **John I. Karesh** (212-407-6990) or **Douglas Ochs Adler** (202-312-3325).

Chi-Stat

Celebrating Chicago's Commercial Aviation Presence

16th Annual Chi-Stat Reception

Chicago
Wednesday, June 9, 2010

Navy Pier Chicago
Crystal Gardens

Sponsored by VEDDER PRICE P.C.

Your Chi-Stat Hosts
Harold Kugelman–AAR Corp.
Greg May–Q Aviation
Nick Popovich–Sage-Popovich
Michael Stern–Stern Consulting Group
Stan Chmielewski–Aircastle Advisor
Chris Cox–Blue Star Aviation
Randall Crain–United Airlines
Thomas Heimsoth–Willow Aviation Services

For more information: ***www.chi-stat.com***.

VEDDERPRICE®

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
312-609-7500 FAX: 312-609-5005

1633 BROADWAY, 47th FLOOR
NEW YORK, NEW YORK 10019
212-407-7700 FAX: 212-407-7799

875 15th STREET NW, SUITE 725
WASHINGTON, D.C. 20005
202-312-3320 FAX: 202-312-3322

www.vedderprice.com

Equipment Finance Group

The attorneys in the firm's Equipment & Aircraft Finance Group represent lessees, lessors, financiers, equity investors and related parties, both domestic and international, in a broad range of equipment finance transactions, including those involving aircraft, railcars, locomotives, vessels, computers, medical equipment, industrial production equipment, satellites, cars and trucks.

About Vedder Price

Vedder Price P.C. is a national business-oriented law firm with offices in Chicago, New York and Washington, D.C. The firm combines broad, diversified legal experience with particular strengths in commercial finance, corporate and business law, financial institutions, labor and employment law, occupational safety and health, general litigation, environmental law, securities, investment management, tax, real estate, intellectual property, estate planning and administration, health care, trade and professional associations and not-for-profit organizations.

We welcome your suggestions and comments. Please contact Dean N. Gerber in Chicago at 312-609-7638, Ronald Scheinberg in New York at 212-407-7730 or Edward K. Gross in Washington, D.C. at 202-312-3330.