

# Solving issues with third-party maintenance contracts

**John Karesh** at Vedder Price sets out the issues arising from maintenance contracts where, instead of paying engine reserves to the lessor, the lessee pays a maintenance provider based on the hours or cycles of operation in exchange for engine overhauls.

**T**he main issue for a lessor is that, when the lease expires, it holds no reserves to apply towards the next engine overhaul, presumably when the aircraft will be operated by a new lessee whose lease will require the lessor to pay the portion of the cost of the next overhaul attributable to engine use before the new lease began. There are a number of ways to address this issue. None of them satisfies all the parties all the time, and each raises its own issues.

## 1. LEASE RESERVE PAYMENTS

One solution is to require the lessee to pay reserves under the lease without regard to the maintenance contract. Another is to require the lessee to pay lease reserves only to the extent they exceed the monthly payments under the maintenance contract. These solutions typically require the lessor to pay the lessee an amount equal to the paid-in reserves upon the successful completion of an overhaul under the maintenance contract, but enable the lessor to retain the reserves paid after the

last overhaul and before lease expiry or termination. Lessees often resist these solutions as duplicate maintenance payments and as depriving them of the benefit of advantageous pricing under the maintenance contract.

## 2. LEAVE IT FOR RETURN

In support of this solution, lessees argue the engines will be maintained and overhauled under the maintenance contract in a manner consistent with the corresponding lease requirements and that any deficiency can be addressed upon return of the aircraft at lease termination or earlier expiry under the return condition clauses of the lease. A financial adjustment, for example, would compensate for an engine with greater-than-allowed accumulated hours or cycles or that otherwise does not comply with all return conditions. But lessors often encounter difficulty recovering return condition payments, especially in cases of airline bankruptcies. Top credit airlines that would not pay reserves anyway argue the maintenance contract is not even relevant to the lessor.

The above two solutions do not involve much negotiation with the maintenance provider. Discussed below are other solutions that seek more middle ground, but that do require the maintenance provider's agreement.

## 3. REFUND

The lessor's key objective should be to avoid a forfeiture of the unexpended maintenance payments paid under the maintenance contract. To accomplish this, the maintenance provider and lessee can agree that if the maintenance contract is terminated with regards to the lessor's engines for any reason, including expiration or termination of the lease, the maintenance provider will refund to the lessor all (or an agreed portion) of the unexpended payments it holds on the basis that the maintenance provider will have been paid for an overhaul it no longer has to perform. If the refund is less than the reserves that would have been paid under the lease, the lessee can pay the difference.

The maintenance provider might resist this approach because it might



view maintenance payments as its property or as security for lessee obligations. It could claim that the maintenance payments form part of a pool to pay for overhauls on a fleet of engines, that it will be damaged by the premature termination of the contract because it anticipated a certain workflow, or that it 'over-built' the engine at the last overhaul to reduce its projected cost under the contract.

#### 4. OVERHAUL COST SHARE

The maintenance provider might agree to contribute to the cost of the next overhaul the amount of unexpended maintenance payments attributable to the lessor's engine held at the time of contract termination. The contribution may be limited to overhauls performed in its shop and/or within a limited period of time, or to the payment of a percentage of the cost of the next overhaul based on the ratio of the number of hours or cycles for which the maintenance provider is holding payment and the total number of hours or cycles accumulated by the next overhaul.

Since the next overhaul will usually

occur after further operation of the engine by a new lessee, the maintenance provider might resist contributing to the cost of the next overhaul if differences in the use profile or maintenance practices of the new lessee could increase its obligation. A financial adjustment could solve this problem.

#### 5. CURE OF LESSEE DEFAULTS

Curing lessee defaults under the maintenance contract to avoid termination might not adequately address the concerns of the lessor or the maintenance provider. A cure can be expensive and would only make sense if the maintenance provider has agreed to overhaul the engines for the lessor or a new lessee and otherwise to continue performing under the contract as long as the lessor makes the cure payments notwithstanding any other default by the lessee under the maintenance contract. If the lessor elects not to cure, or if the maintenance provider refuses to accept a cure, the maintenance contract should require the maintenance provider to refund to the lessor all unexpended maintenance payments in its possession attributable to the lessor's engines.

#### 6. ASSIGNMENT

A right to assign the maintenance contract to a new lessee is often contentious and might be of limited use to the lessor. Offering an assignment of the maintenance contract to a new lessee could, in certain circumstances, enhance the lessor's efforts to re-market the aircraft. But the new lessee might not want the contract if it is too expensive or burdensome, or if it has its own maintenance programme.

The maintenance provider might object to an assignment on the basis that the monthly maintenance fees and workscope were agreed with the existing lessee based on factors, such as its use profile and assumed quantity of work, that do not apply to the new lessee. However, these factors should only affect pricing, not the agreement to assign. Some assignees might simply be unacceptable to the maintenance provider, such as a competitor.

#### 7. SECURITY INTEREST

The lessee could grant the lessor a security interest in the lessee's rights under

the maintenance contract to secure its performance under the lease, so if the lessee defaults under the lease, the lessor could seek to enforce the maintenance contract for its benefit. However, as a general rule, absent agreement from the maintenance provider, it would not have to perform for the benefit of the lessor if the maintenance contract contains a provision generally that it is not assignable, and in any event, the maintenance provider's obligation to perform an overhaul or refund payments would be limited to what is required under the maintenance contract. Moreover, the lessor could be stayed from enforcing its security interest if the lessee were to file a petition under Chapter 11 of the Bankruptcy Code.

#### 8. WHOLE NEW AGREEMENT

The best option. The best way to address the concerns of each party is a separate, three-party agreement among the maintenance provider, lessor and lessee providing that, following a lessee default under the maintenance contract or the lease, the lessor can elect to require the maintenance provider either to make a refund, or to overhaul the engine with costs shared, or to permit the lessor or next operator or purchaser of the engines to step into the lessee's shoes under the maintenance contract.

The three-party agreement should also provide that the maintenance provider will: (a) notify the lessor immediately upon a material breach by the lessee under the maintenance contract; (b) following such breach or a default under the lease, follow the direction of the lessor to the exclusion of the lessee in relation to the lessor's engines; (c) give copies to the lessor of any notice it gives or receives under the maintenance contract; (d) not modify the maintenance contract including by means of a private letter ruling, DER repair or other exemption, exclusion or alternative means of compliance, without the lessor's consent; and (e) not pledge, assign or encumber its rights (including its right to payment) under the maintenance contract.

The lessor should agree to notify the maintenance provider upon the occurrence of a lease event of default.

The lease should include provisions that: (a) prohibit the lessee from (i)



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assigning, pledging or encumbering its rights under the maintenance contract and (ii) modifying or waiving any provision of the maintenance contract without the lessor's consent; (b) make a lessee default under the maintenance contract a default under the lease; (c) require the lessee (i) to hold the lessor harmless if the refund or credit of maintenance payments or contribution to the cost of the next overhaul from the maintenance provider is less than the amount the lessor would have been holding had traditional maintenance reserves been paid under the lease, and (ii) to indemnify the lessor for any loss resulting from a lessee default under the maintenance contract, including any cure payment made by the lessor; and (d) require the lessee to pay as additional rent (i) any amount by which traditional maintenance reserves payable under the lease exceed the maintenance payments payable under the maintenance contract or (ii) full, traditional maintenance reserves at any time when the maintenance contract is not in effect together with a 'catch-up' payment if full maintenance reserves become required under the lease. The lease security deposit should be adequate

(or supplemented) to cover the lessee's obligations described in (a)–(d) above.

#### OTHER LESSOR ISSUES

A number of other clauses in maintenance contracts can also create issues for lessors:

**Confidentiality:** The lessor needs to know the provisions of the maintenance contract to determine if any them (including those discussed below) affect the lease, and should be willing to maintain such confidentiality. Even pricing of the maintenance contract can be important for the lessor to determine if it risks being 'under-reserved' or if the amount of a refund becomes relevant.

**Conditions precedent:** Most maintenance contracts will excuse performance by the maintenance provider or permit it to terminate the maintenance contract if the lessee fails to make payment or perform other obligations. This is particularly troublesome if the maintenance contract contains a cross-default clause to other agreements with the maintenance provider or an affiliate.

**Workscope:** The lessee might argue the workscope is not relevant to the lessor's interests because the lessee will remain obligated at its expense and risk to perform all maintenance and meet all return conditions required under the lease, and the lessor will have a claim for damages in case the lessee fails to do so.

**Replacement engines:** The maintenance contract should permit the lessee to induct a replacement engine into the maintenance programme if a leased engine is replaced, for example, due to an event of loss. The lease should obligate the lessee to pay any required induction charge. If the replacement engine is not inducted, the maintenance contract should require the maintenance provider to refund the amount of unexpended maintenance payments attributable to the replaced engine, and the lease should obligate the lessee to make any necessary 'catch-up' payment in case the refund is less than the reserves that would have been paid by the lessee under the lease in respect of the replaced engine absent the maintenance contract.

**Engine withdrawals:** If the lessee has the right to withdraw the lessor's engines from the maintenance programme (especially in contemplation of return

under the lease), then upon withdrawal: (a) the maintenance provider should pay to the lessor all unexpended maintenance reserves attributable to such engines; and (b) the lessee either should be required to (i) induct the engines into another acceptable maintenance programme or (ii) commence paying reserves under the lease and make any catch-up payment described above, and pay any termination fee due under the maintenance contract.

**Artisans' liens:** Such liens (sometimes known as mechanics' liens) are generally limited to the agreed price and reasonable value of the labour and parts furnished by the maintenance provider for the improvement of the particular engine. Sometimes, the maintenance provider will waive its artisan lien rights on the theory it has already been paid for the cost of the overhaul by the lessee's periodic maintenance payments. But some maintenance contracts purport to give the maintenance provider a consensual lien on the lessor's engine to secure all obligations under the maintenance contract, including for unrelated engines. The lessor should seek a waiver of these liens.

#### WHERE AND BY WHOM CAN THE OVERHAUL BE PERFORMED?

The lessor should verify that the maintenance provider remains liable for the work performed by its subcontractors or designees and that any subcontracted work is covered by the maintenance provider's indemnity and warranty.

**Warranty:** All warranties of the maintenance provider should be assignable to the lessor or new lessee.

**PMA parts:** Any lease restriction on the use of PMA parts should be consistent with the maintenance contract.

**Replacement parts:** The maintenance contract should provide that title to replacement parts will vest in the lessor, subject to the lease and the lien of a lender, if any.

#### CONCLUSION

Third-party maintenance contracts are here to stay, and are growing in importance. They can be of great benefit to the lessee, and in many instances to the lessor as well. But they raise issues that the parties can effectively resolve if they cooperate reasonably in the process.