Lowering risk in pre-delivery transactions

The claw-back risk is of importance to everyone involved in pre-delivery (PDP) transactions yet few understand its risk or how it might affect a transaction. **Cameron Gee**, shareholder at Vedder Price, de-mystifies the claw-back risk in the US.

IN RECENT YEARS 'CLAW-BACK' RISK has been an important issue for participants in aircraft pre-delivery payment (PDP) transactions. PDPs are progress payments that a buyer makes to a manufacturer while new aircraft are being built. They represent a substantial cash expense for the buyer, on average 20 to 30 per cent of the price of the aircraft.

Claw-back (in the context of a US bankruptcy proceeding) refers to the situation in which the buyer (the airline or lessor) wishes to retrieve their PDP. In US bankruptcy cases, security deposits are considered to be a type of cash collateral paid by the purchaser (who is then considered and referred to as the 'purchaser-debtor'), and can be returned to them subject to a ruling by the court.

As such, an airline or lessor, as the purchaser-debtor, has the legal right to request that the OEM re-pay the cash collateral. However, the airline requesting bankruptcy court approval also has the burden of proving that each entity with an interest in the collateral (i.e. the lender and the manufacturer) is adequately protected.

Although there is no reported bankruptcy case that addresses the use of cash collateral comprised of PDPs under an aircraft purchase agreement, the analysis regarding whether a bankruptcy court would allow PDPs to be used by a purchaser-debtor is the same as for other types of security deposits. The first prerequisite is for the bankruptcy court to view the PDPs as a security deposit. If or when that characterisation is

made, details of the 'equity cushion' will be decided. Here, a bankruptcy court would examine whether the interests of the manufacturer and the lender – the two parties having an interest in the PDPs – are being protected.

Exactly what constitutes 'adequate protection' is decided on a case-by-case basis, with the focus being that the aggregate secured creditor's interests should be protected from any drop in value during the US bankruptcy process.

In most circumstances, a debtor looking to use such cash collateral will seek to show that each creditor is protected by the equity cushion – i.e., the creditor's other collateral has a value greater than that of the debt owed to it.

Although there is no easy rule, most bankruptcy courts require an equity cushion of at least 15 to 20 per cent with the exact amount dependent on the facts and circumstances of each case. Adequate protection can also be provided by other means including replacement liens on other assets and/or required periodic payments.

For both the manufacturer and lenders collateral is comprised of the PDPs that were paid to the manufacturer, and the intrinsic value of the purchase agreement. The value of the purchase agreement is determined by comparing the purchase price of the aircraft with the projected values for aircraft at the time of scheduled delivery.

If the projected value is higher than the purchase price, the equity cushion would cover the excess amount. If the equity cushion provided by the intrinsic value of the purchase agreement is sufficient, a bankruptcy court could then order some or all of the PDPs to be returned to the purchaser-debtor.

In theory, this type of order would not be detrimental to the manufacturer or the lender because the bankruptcy court has determined that they remain fully secured. In practice, however, this system is problematic for lenders for two main reasons. Firstly, a bankruptcy court will second-guess the lender's assessment of aircraft values and projected values – and may not agree with the lenders calculations.

Secondly, the bankruptcy court can only estimate the projected values. It is far from a perfect process and creates risk that a bankruptcy court may inaccurately assess the intrinsic value of the purchase contract.

If a purchaser-debtor decides to reject the purchase agreement and not purchase the aircraft, its ability to recover the PDPs may be very problematic as in doing so it reduces the overall value of the collateral and exposes both the manufacturer and the lender to collateral risk. This risk is what is referred to as the claw-back risk.

Yet, the risk of claw-back is remote. In practise, a claw-back exists only when future aircraft values remain high (or the debtor has sufficient alternative collateral to provide adequate protection), but the debtor rejects the purchase agreement; this situation rarely occurs.

Usually, a debtor will decide to reject its aircraft purchase

agreements in economic downturns – during which the values of aircraft are dropping. In such a situation, a debtor will have difficulty showing that the purchase agreement alone provides a sufficient equity cushion to justify its use of the PDPs. Accordingly, claw-back seems unlikely in the most probable scenario.

Furthermore, the legal basis for a claw-back faces numerous hurdles. Manufacturers will use precise and considered language in their purchase agreement to minimise the chances that the PDPs are characterised as security deposits; rather, the manufacturer uses express contractual terms stating that the PDPs, once paid, are the property of the manufacturer as compensation for the cost of the construction of the aircraft.

Under the terms of most aircraft purchase agreements, the PDPs are described as absolute and unconditional payments –

as such only the manufacturer has an interest in the PDPs, not the purchaser.

Based upon the express terms of the purchase agreement, a purchaser-debtor may have difficulty either characterising the PDPs as a security deposit or other interest in which it has any reversionary interest. If the manufacturer's interpretation of the agreement is upheld the claw back of the PDPs should not occur.

The claw-back risk described here is also mitigated in PDP financings where there is little risk of a purchaser-debtor becoming the subject of a US bankruptcy case. Where the bankruptcy laws applicable to the debtor do not include similar concepts for a purchaser-debtor to recapture PDPs then US claw-back analysis will not apply. However, there may be other claw-back concepts that apply in the jurisdiction of a purchaser-debtor.

The effect of the claw-back risk analysis in the US has been that different lenders have taken various approaches to PDP financing transactions. Some lenders accept claw-back risk as a necessary part of doing business because of the remote chance it will occur, the protection the contract provides and the legal impediments in place.

Some will proceed with the transaction but either discount the value of their collateral to protect against the risk, have their transactions approved on an unsecured basis or require that structural features be included to minimise their risk.

Yet there are some who will reject the risk and the deal because of the potential severity of the consequences – a claw-back could completely eliminate the value of their collateral.

The variety of approaches is a result of mixed advice on the likelihood and potential effect of a claw-back. With a clearer understanding of how claw-back risk affects PDP transactions it is hoped that all parties will be able to better determine an approach that works for their specific circumstances. ■

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