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Wells Fargo v. US Airways—Redelivery Certificates Protect Lessees from Unspecified Discrepancies

A commercial aircraft operating lease typically sets forth a two-step process for redelivery of the aircraft upon lease expiry. First, the lessor inspects the aircraft and related documentation to confirm that the lessee has fulfilled its obligation to return the aircraft to the lessor in accordance with the redelivery conditions set forth in the lease. Second, upon satisfactory completion of its inspection, the lessor executes a redelivery certificate confirming that the aircraft and related documentation complies with such redelivery conditions, or noting discrepancies from such redelivery conditions together with any remedial actions or other resolution of such discrepancies as agreed by the lessor and the lessee. Upon execution of the redelivery certificate, the lease is terminated, and possession of the aircraft is transferred from the lessee to the lessor. In *Wells Fargo Bank Northwest, N.A.* (Wells Fargo) *v. US Airways, Inc.* (US Airways), a New York appellate court confirmed that execution of a redelivery certificate shields a lessee from liability if the lessor discovers after redelivery that the aircraft did not meet the redelivery conditions.

Background

US Airways acquired three 737-3G7 aircraft from Boeing in 1991, each with a maximum takeoff weight (MTOW) of 124,000 pounds. Subsequently, US Airways entered into an agreement with Boeing that permitted it to operate the aircraft at an increased MTOW of 138,500 pounds. US Airways' right to operate the aircraft at this increased MTOW was not transferable to third parties.[1] In 2005, Wells Fargo purchased the aircraft from US Airways and immediately leased them back to US Airways for a three-year term. The purchase agreements specified that the MTOW of each aircraft was 138,500 pounds. Nothing in the purchase documentation mentioned US Airways' arrangement with Boeing. Furthermore, one of the redelivery conditions in each lease agreement provided that the "operating weights of the aircraft will be as at delivery and will be freely transferable."

At the end of the term of each lease, Wells Fargo had a team of experts inspect the aircraft. These experts identified a number of discrepancies, each of which was resolved prior to redelivery. The MTOW of the aircraft was not the subject of any discussion or listed as a discrepancy. Wells Fargo accepted redelivery of the aircraft, and the parties executed redelivery certificates as provided for in each lease.

After redelivery and termination of the leases, Wells Fargo learned for the first time of the 124,000-pound MTOW and the nontransferable arrangement between US Airways and Boeing for the increased MTOW. In order to satisfy the requirements of a follow-on lessee with respect to MTOW, Wells Fargo paid Boeing $544,400 so that its new lessees could operate the aircraft at an MTOW of 138,500 pounds.

The Claims

Wells Fargo brought an action seeking rescission of the redelivery certificates and damages for breach of contract. Wells Fargo moved for partial summary judgment on its breach of contract claim, arguing that as a matter of law US Airways had violated the leases' requirement that at redelivery the MTOW would be "as at delivery" and freely transferable.

In opposing summary judgment, US Airways argued that Wells Fargo had waived any right to claim non-compliance with the leases when it executed the redelivery certificates. US Airways also contended that the term "delivery" as used in the leases was susceptible to two distinct meanings: when the term was capitalized,

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it referred to delivery of the aircraft by Wells Fargo to US Airways, but when not capitalized, it referred to the delivery from Boeing to US Airways. Thus, when the leases stated that the aircraft were to be redelivered to Wells Fargo with an MTOW "as at delivery", they referred to an MTOW of 124,000 pounds.

The lower court rejected both arguments by US Airways and granted Wells Fargo's motion for partial summary judgment.

Analysis – Redelivery Certificates

Before addressing the appellate court decision, it is worth noting the key provisions in the redelivery certificates, which are industry standard redelivery certificates. The redelivery certificates stated that US Airways had redelivered the aircraft to Wells Fargo in the condition required by the lease agreements, except for scheduled discrepancies. They also mandated that upon execution, the leases terminated except with regard to the provisions (i) that survived by their own terms, (ii) related to scheduled discrepancies, or (iii) related to scheduled rent and redelivery compensation. Finally, the redelivery certificates provided that Wells Fargo's acceptance of the aircraft was without prejudice to either party's rights and obligations under the leases, and all risks in the aircraft passed from US Airways to Wells Fargo.

The appellate court found that execution of the redelivery certificates without reference to the MTOW discrepancy precluded Wells Fargo from raising or seeking relief for that breach. By executing the certificates, Wells Fargo certified that US Airways had fully performed its obligations under the leases and that the aircraft had been redelivered in compliance with the requirements of the leases. Wells Fargo's right to seek enforcement of the leases ceased upon its execution of the redelivery certificates, at which time the leases terminated except for the three categories of provisions stated to survive in such certificates. In reaching its decision, the appellate court held that the lease provision requiring that the MTOW at redelivery be the same as at delivery did not fall into any of those categories. It did not contain survival language, and there was nothing that distinguished the MTOW from the other redelivery conditions, which were explicitly considered satisfied if not listed as discrepancies.

The appellate court also held that the "without prejudice" language in the redelivery certificates did not allow Wells Fargo to assert a breach of the lease redelivery conditions. That language preserved rights granted by the leases that did not conflict with the terms of the redelivery certificates, such as clauses that expressly survived lease termination. It did not permit Wells Fargo to sue for a belatedly realized breach of the lease redelivery conditions after the lease had been terminated. Such an interpretation would have rendered meaningless the certification that the aircraft had been redelivered in the condition required by the leases, except for noted discrepancies.[2]

The appellate court compared the case to its prior ruling in *Jet Acceptance Corp. v. Quest Mexicana S.A. de C.V.*, 87 A.D.3d 850 (2011), in which the court observed that once the lessee executed an acceptance certificate, it effectively waived any claim that the aircraft was not in the required delivery condition. As in *Jet Acceptance*, the appellate court found that the redelivery certificates and the leases established a method for Wells Fargo to object to the condition of the aircraft at the time they were presented and before accepting redelivery. The time for Wells Fargo to identify deficiencies in the aircraft was not after it had executed the redelivery certificates. By executing those certificates, Wells Fargo expressly confirmed that US Airways had fully performed all of its obligations up to that point, including furnishing aircraft that materially conformed to redelivery requirements under the leases.[3]

Conclusions

This holding will be welcomed by aircraft lessees as emphasizing that redelivery certificates have the clear effect that lessees desire—after lease redelivery, any residual risk related to the condition of the aircraft and aircraft documentation, undetected or otherwise, rests with the lessor. This holding also highlights the importance of lessors carefully inspecting not only the aircraft, but also the aircraft documentation, so as to be absolutely satisfied that the lessee has complied with the required redelivery requirements.

If you have any questions about this article, please contact Adam Beringer at +1 (312) 609 7625 or aberinger@vedderprice.com, or Mark Ditto at +1 (312) 609 7643 or mditto@vedderprice.com.

1 This arrangement commonly is referred to as "leasing" the upgrade. It is prevalent in commercial aviation and it is extremely difficult for a lessor or buyer to determine whether an upgrade is leased or owned.

2 The court's view that redelivery conditions that are not identified as discrepancies are deemed satisfied upon execution of a redelivery certificate is consistent with the fact that these lease redelivery requirements are fashioned as "conditions" as opposed to affirmative "covenants". In this sense, these requirements are merely conditions precedent that must be satisfied by the lessee (or waived by the lessor) before the lessor is obligated to execute the redelivery certificate. This view is consistent with the recent ruling in *ACG Acquisition XX LLC v. Olympic Airlines S.A.* [2012] EWHC 1070 (Comm), a case out of England that drew considerable attention in the aircraft leasing industry. In ACG, the Commercial Court held that execution

of an acceptance certificate at delivery of an aircraft at the commencement of a lease prevented the lessee from alleging that the aircraft did not comply with the required delivery conditions under the lease on the theory that these requirements are merely conditions precedent that must be satisfied by the lessor (or waived by the lessee) and that upon execution of the acceptance certificate, the lessee effectively waives any unsatisfied conditions and accepts the aircraft in "as-is, where-is" condition (together with any hidden defects). A discussion of the ACG case can be found in the July 2012 edition of the *Vedder Price Global Transportation Finance Newsletter*.

3 While the issue was not germane to its holding, the appellate court agreed with the lower court that the use of the term "delivery" was not ambiguous. Indeed, each use of that term, regardless of whether the "d" was capitalized, referred to the delivery of the aircraft from Wells Fargo to US Airways except where otherwise qualified, as in "first aircraft delivery" and "at new delivery". The appellate court also found it unreasonable to suggest that a lease between Wells Fargo and US Airways, having nothing to do with Boeing, would use the term "delivery" to refer to a transaction that occurred 14 years before Wells Fargo purchased the aircraft.

Limits to Financiers' Claims for Losses and Damage to Insured Property Resulting from Theft by Insured

It is often reported that a struggling carrier will sometimes take equipment from a grounded aircraft in order to support its operational fleet. This practice, sometimes referred to as "robbing" or "cannibalizing", has serious ramifications for the financier of the grounded aircraft, as such acts can cause enormous harm to collateral value and may make repossession of such equipment considerably more difficult to effect. In such situations, a financier might consider seeking redress under hull insurance policies due to the loss sustained. A recent case heard before a federal court in New York determined that such redress was unavailable under the existing insurance coverage.

The *Highland Capital Management, L.P. v. Global Aerospace Underwriting Managers Limited*[1] decision clarifies that financiers (both secured lenders and lessors) of aircraft do not have insurable claims under the airline's hull insurance policy for a loss of aircraft parts, when the loss was suffered as a result of the airline's intentional misconduct in cannibalizing parts from aircraft and engines that were subject to such financing arrangements.

Facts of the Case

Fleet Business Credit, L.L.C. (Fleet) leased an aircraft to Tower Air, Inc. (Tower), and Highland Capital Management, L.P. (Highland) made a loan to Tower, secured by an aircraft owned by Tower. In connection with these transactions, both Fleet and Highland were listed as additional insureds under Tower's Airline Hull, Spares and Liability Policy (the Policy).[2] The Policy covered "Physical Damage," defined in the Policy as the "direct and accidental physical loss of or damage to the aircraft sustained during the Policy Period," to airframes and engines purchased by, or leased to, Tower.[3]

As Tower struggled financially, Fleet and Highland tried to recover the equipment covered by their respective lease and security arrangements, only to realize that the covered aircraft and engines were missing certain of their essential components and parts.[4] Evidence at trial revealed that Tower had been cannibalizing the aircraft and engines that were owned by Fleet and financed by Highland. Furthermore, Tower failed to maintain proper records regarding the whereabouts of the missing parts, which ultimately resulted in both Fleet and Highland suffering losses.[5] Fleet and Highland, as loss payees under the Policy, filed claims for these losses, which were denied by the insurers because the losses arose from Tower's intentional misconduct and were not fortuitous losses under the Policy.[6] Fleet and Highland in turn sued the insurers asserting that their claims were wrongfully denied. Following a bench trial, the U.S. District Court for the Southern District of New York granted partial summary judgment and judgment in favor of defendant insurers. Fleet and Highland appealed to the U.S. Court of Appeals for the Second Circuit.[7]

Second Circuit's Analysis

On appeal, the only issue in dispute was the district court's holding that Fleet's and Highland's losses were not covered by the Policy because their losses were not fortuitous, as defined under New York insurance law, which defines a "fortuitous event" as "any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party."[8] The district court held that the losses were not fortuitous because they arose from the intentional misconduct of Tower (the named insured) in cannibalizing the aircraft and engines, which misconduct was imputed to the other insureds having an interest in the relevant aircraft.

The appellate court affirmed the district court's ruling.[9] The court reasoned that because the losses suffered by Fleet and Highland resulted from the intentional misconduct of Tower, and because Fleet, Highland and Tower must be treated jointly in determining whether or not the plaintiff coinsureds' losses were fortuitous, the losses suffered were not fortuitous as to Fleet and Highland. Fleet and Highland raised the "innocent coinsured doctrine," which provides that misconduct on the part of one insured should not bar a recovery by other innocent co-insureds. However, the appellate court held that this argument did not trump the plain language of the Policy, which provided that the insured parties were to be treated jointly as regards All Risks coverage.[10]

Implications

The decision in *Highland Capital* has two key implications. First, the court based its decision in part on the express language of the Policy, which covered "accidental physical loss." In the context of the insured stealing parts off an aircraft, the court's ruling excluding theft from accidental loss makes sense. However, the court's broader reasoning, that intentional misconduct is not accidental, may create unintended consequences. Most particularly, the court's exclusion of intentional misconduct raises the question of whether other actions by an operator that potentially constitute intentional misconduct, such as failing to properly maintain an aircraft, could lead to an exclusion from coverage.

Second, the case highlights the dangers of having aircraft on the ground that are not in operation. Aside from maintenance issues that often arise from a nonoperational aircraft, such aircraft often become parts pools supporting other aircraft in the operator's fleet. Since it is often difficult to chase removed parts from one aircraft to another (due to local law considerations and/or faulty record keeping), serious collateral degradation can result from such removals and, as is clear from the *Highland Capital* case, recovery under the insurances would likely be unavailable. Financiers would be well served to keep close tabs on all financed aircraft on the ground and conduct in-person inspections to be certain that components and parts remain installed.

If you have any questions about this article, please contact Geoff Kass at +1 (312) 609 7553 or gkass@vedderprice.com.

1 *Highland Capital Management, L.P. v. Global Aerospace Underwriting Managers Ltd.*, 2012 U.S. App. LEXIS 13421 1, No. 11-3318-cv (2d Cir. 2012).

2 *Id.* at 2.

3 *Id.*

4 *Highland Capital Mgmt., L.P.,* 2012 U.S. App. LEXIS 13421, No. 11-3318-cv at 2.

5 *Fleet Bus. Credit, L.L.C.,* 812 F. Supp. 2d at 347-49.

6 *Id.*

7 *Id.* at 1.

8 N.Y. INS. LAW § 1101(a)(2) (2012).

9 *Highland Capital Mgmt., L.P.,* 2012 U.S. App. LEXIS 13421, No. 11-3318-cv at 5.

10 *Id.* at 4.

The European Union's Emissions Trading Scheme: A Brief Pause at the Edge of the Enforcement Cliff?

After initially refusing to budge from its April 30, 2013 deadline despite objections by governments, aircraft manufacturers and aviation industry advocacy and trade groups around the world, the Commission of the European Union (the Commission) has agreed to postpone the enforcement of European Union Emissions Trading Scheme (EU-ETS) requirements relating to flights into and out of the EU for a period of one year.[1] The one year delay is intended to allow the International Civil Aviation Organization (ICAO) to continue its work toward a global aviation sector emissions reduction and trading scheme. However, it is still unclear whether autumn 2013 will bring consensus on a comprehensive global scheme to curb aircraft emissions or find the world exactly where it is now—bitterly divided on how to achieve an otherwise generally accepted goal of environmental protection.

EU Holds Fast, Then Pauses (Some) Enforcement

Despite vocal demands from around the world to defer or set aside EU-ETS in favor of a global sectoral scheme developed by ICAO, the Commission until this week stood firm in its plan to proceed on schedule with the scheme in its current form. The Commission views EU-ETS as the EU's method of complying with its binding obligations under the Kyoto Protocol to the United Nations Framework Convention on Climate Change to address the steady increase in worldwide greenhouse gas (GHG) emissions, filling a void left to date by ICAO's failure to devise a global scheme. All the while, the Commission has maintained that EU-ETS would be adapted to work in concert with any global scheme ultimately established through ICAO, as most recently evidenced by the decision to temporarily suspend EU-ETS enforcement in relation to international flights.[2]

At this point, the monitoring, reporting and allowance surrender requirements of EU-ETS will not be enforced against international flights until (at the earliest) autumn 2013, after the next meeting of the ICAO general assembly.[3] However, the logistics of administering this suspension at the EU member state level have yet to be determined, and the measure must still be ratified by the EU member states and the European Parliament.[4] Moreover, the scheme will remain unchanged and be enforced in its present form as to all flights originating and ending within the EU.[5] In the meantime, the aviation marketplace will turn its focus to ICAO.

All Eyes on ICAO

ICAO's task of developing a global framework for limiting aviation CO2 emissions will likely be difficult and time consuming. Reaching consensus on a methodology among ICAO's 191 member states will be challenging in itself. Timing also will be significant; while draft plans could be under informal consideration as early as next spring, the full ICAO assembly does not meet until autumn 2013 and, absent a final agreement at that point, it could still take several months (even years) before a final scheme is agreed and implemented worldwide. It remains unclear exactly what form a global sectoral scheme would take (i.e., either a single, unified system or a collection of systems functioning simultaneously), and whether any system will be state-based or airline-based,[6] though early speculation appears to favor a system of global emissions trading or offsetting.[7] Meanwhile, the longer it takes or more difficult it proves to achieve consensus in ICAO, the more likely the Commission will revert to EU-ETS in its present form in autumn 2013, which would then likely reignite the political and economic tensions currently being felt around the world. In that event, renewed pressure may be brought against the Obama administration by U.S.-based aviation industry groups to initiate dispute resolution proceedings against the EU under Article 84 of the Chicago Convention, seeking a determination that EU-ETS violates the Chicago Convention.

Conclusion

The suspension of EU-ETS compliance requirements as to international flights is only temporary. It merely increases the pressure on ICAO to devise a suitable global framework, which will be no easy task for a variety of reasons. If consensus is not achieved by autumn 2013, will the EU reinstate the current EU-ETS requirements against all flights into and out of the EU? How close must ICAO be in order to avoid reversion to the current situation? How soon would all of the costly consequences of non-compliance be staring aircraft operators in the face? In the absence of a global scheme and a fully reinstated EU-ETS, what are operators to do if their own domestic laws prohibit them from participating? These are all crucial questions to be answered in the coming year.

If you have any questions about this article, please contact Jordan Labkon at +1 (312) 609 7758 or jlabkon@vedderprice.com.

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1 Under the current format of the EU-ETS, all covered commercial and private aircraft operators worldwide would have been required, by March 30, 2013, to report carbon dioxide (CO_2) emissions from all of their flights to, from and within the European Union (EU) during calendar year 2012. By April 30, 2013, covered operators would have been required to surrender allowances corresponding to the metric tonnage of their 2012 aircraft CO_2 emissions to the relevant EU-based regulator. For a more detailed description of the EU-ETS regulations, please see the April 2012 edition of the *Vedder Price Global Transportation Finance Newsletter*.

2 The directive establishing EU-ETS provides that flights to the EU from a country that has enacted "equivalent measures" to reduce GHG emissions may be exempt from the scheme. (Directive 2003/87/EC of the European Parliament and of The Council of 13 October 2003 (consolidated version with amendments) (Directive 2003/87/EC) (establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC). With no bright-line test to determine what constitutes an "equivalent measure," the Commission is left to its own discretion to decide. The 2008 directive formally linking aviation to EU-ETS suggests that such a measure should aim to reduce the impact of aviation emissions on climate change to the same degree as EU-ETS and be operationally compatible (through bilateral agreement or otherwise) with EU-ETS. (Directive 2008/101/EC of the European Parliament and of The Council of 19 November 2008 (amending Directive 2003/87/EC to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community); *see also* Renee Martin-Nagle, "Aviation Emissions: Equitable Measures under the EU ETS," October 15, 2012, at 13.) While countries such as Australia, New Zealand, South Korea and Mexico are at differing stages of developing industrial emissions trading schemes (some of which cover domestic aviation), and some have begun exploring linking their respective schemes with EU-ETS, none of these systems are ready at this time to link with EU-ETS for international flights. (Martin-Nagle, *supra* at 16-18.) China has made broad strides within the past few months on various initiatives, including a proposed tax against passengers and airlines to fund aviation emissions reduction programs (*see, e.g.*, Yi Liu, "Outcry Over New Passenger and Airline Levy," Run Ming Law Office, May 16, 2012, *available at* http://www.internationallawoffice.com/newsletters/Detail.aspx?g=74987887-448a-4e2e-8803-c5053af9db98; Brian F. Havel and John Q. Mulligan, "What Does China's Emissions Reduction Proposal Mean for EU ETS?," Aviation Law Prof Blog, Apr. 19, 2012, *available at* http://lawprofessors.typepad.com/aviation/2012/04/what-does-chinas-emissions-reduction-proposal-mean-for-eu-ets.html.), creation of city- and province-level emissions trading programs, entry into a cooperation agreement involving direct EU financial investment and technical assistance with creation of carbon-reduction programs and emissions trading schemes and, in October 2012, announcement of plans to establish a nationwide emissions trading scheme. (Martin-Nagle, *supra* at 17-18.) Notwithstanding recent progress by various countries, however, none of these measures have yet been formally declared "equivalent measures" by the Commission, and it remains unclear whether or when any of these measures will become effective. (Dickon Harris, "Can ICAO Deliver an Alternative?," *Airfinance Journal*, Oct. 2012, at 32-33.) Certainly, these countries (along with the rest of the world) are monitoring ICAO's work toward developing a global sectoral scheme, although the scope, mechanics and timing of such a system are all undetermined at this point. ICAO's progress will go far in determining whether states continue pursuing equivalent measures on their own.

3 *See, e.g.*, Anne Paylor, "EU Suspends Aviation Inclusion in ETS for International Flights," ATW Online, Nov. 12, 2012, *available at* http://atwonline.com/international-aviation-regulation/news/eu-suspends-aviation-inclusion-ets-international-flights-1112; Ewa Krukowska, "EU To Freeze Enforcement of Carbon Curbs on Foreign Flights," Bloomberg Business Week, Nov. 12, 2012, *available at* http://www.businessweek.com/news/2012-11-12/eu-to-stop-enforcement-of-carbon-curbs-on-foreign-flights.

4 *Id.*

5 *See* Paylor, *supra* note 3; *see also* Barbara Lewis, "EU Commission Freezes Airline Carbon Emissions Law," Reuters, Nov. 12, 2012, *available at* http://www.reuters.com/article/2012/11/12/us-eu-airlines-ets-idUSBRE8AB0HB20121112.

6 Valerie Volcovici and Barbara Lewis, "EU Sees Progress on UN Airline Emissions Deal," Reuters, Nov. 11, 2012, *available at* http://www.reuters.com/article/2012/11/11/uk-airlines-eu-us-co-idUSLNE8AA00I20121111.

7 Harris, *supra* note 2, at 33.

Global Transportation Finance—Team Members

Chicago

Shareholders

Jonathan H. Bogaard .... +1 (312) 609 7651
Dean N. Gerber, *Chair* .... +1 (312) 609 7638
Timothy W. O'Donnell .... +1 (312) 609 7683
Geoffrey R. Kass .... +1 (312) 609 7553
John T. Bycraft .... +1 (312) 609 7580
Theresa Mary Peyton .... +1 (312) 609 7612
Joshua D. Gentner .... +1 (312) 609 7887
Jordan R. Labkon .... +1 (312) 609 7758
Adam R. Beringer .... +1 (312) 609 7625
James P. Lambe .... +1 (312) 609 7567

Counsel

Ronald J. Rapp .... +1 (312) 609 7895
David S. Golden .... +1 (312) 609 7686

Associates

Robert J. Hankes .... +1 (312) 609 7932
Mark J. Ditto .... +1 (312) 609 7643
Michael E. Draz .... +1 (312) 609 7822
Clay C. Thomas .... +1 (312) 609 7668
Antone J. Little .... +1 (312) 609 7759
Milos Kovacevic .... +1 (312) 609 7604
Christopher J. Shalvoy .... +1 (312) 609 7635
Kristen J. Chmielewski .... +1 (312) 609 7676
Michael P. Keeley .... +1 (312) 609 7688

New York

Shareholders

John I. Karesh .... +1 (212) 407 6990
Francis X. Nolan, III .... +1 (212) 407 6950
Denise L. Blau .... +1 (212) 407 7755
John E. Bradley .... +1 (212) 407 6940
Ronald Scheinberg .... +1 (212) 407 7730
Jeffrey T. Veber .... +1 (212) 407 7728
Cameron A. Gee .... +1 (212) 407 6929

Counsel

Amy S. Berns .... +1 (212) 407 6942

Associates

Ji Woon Kim .... +1 (212) 407 6922
Christopher A. Setteducati .... +1 (212) 407 6924
Elliott Klass .... +1 (212) 407 6966
Cristina María Ana Richards .... +1 (212) 407 6999
Olga Miller .... +1 (212) 407 6962
Robert G. Gucwa .... +1 (212) 407 6953

Washington, DC

Shareholders

Edward K. Gross .... +1 (202) 312 3330
David M. Hernandez .... +1 (202) 312 3340

Associates

Kathleen G. Oliver .... +1 (202) 312 3342

London

Partners

Gavin Hill .... +44 (0)20 3440 4690
Derek Watson .... +44 (0)20 3440 4692

Counsel

Claire Mathew .... +44 (0)20 3440 4696

Solicitors

Natalie Chung .... +44 (0)20 3440 4695
John Pearson .... +44 (0)20 3440 4693
James Kilner .... +44 (0)20 3440 4694

VEDDER PRICE®

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
+1 (312) 609 7500 | +1 (312) 609 5005 • FAX

1633 BROADWAY, 47TH FLOOR
NEW YORK, NEW YORK 10019
+1 (212) 407 7700 | +1 (212) 407 7799 • FAX

1401 I STREET NW, SUITE 1100
WASHINGTON, D.C. 20005
+1 (202) 312 3320 | +1 (202) 312 3322 • FAX

4 COLEMAN STREET
LONDON EC2R 5AR
+ 44 (0)20 3667 2900 | + 44 (0)20 3667 2901 • FAX

www.vedderprice.com

Global Transportation Finance Team

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