

# Global Transportation Finance Newsletter

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## Aircraft Securitizations and the Proposed Rules for Credit Risk Retention

Securitization is an attractive method for financing portfolios of leases and loans relating to transportation equipment, including aircraft and aircraft engines. In a typical securitization transaction, a lender or lessor (the originator) sells loans or leases (and the related equipment) to a special-purpose entity that finances the purchase through the issuance of securities backed by the cash flow from the loans or leases. During the recent financial crisis, investors in securitization transactions involving certain types of assets (primarily residential mortgage loans) incurred substantial losses. These losses have been largely attributed to poor underwriting of the underlying assets. Commentators have argued that the poor underwriting was the result of a securitization process that created incentives for originators (primarily mortgage loan originators) to acquire and sell loans without regard to whether the loans were properly underwritten, since the originators did not expect to bear the risk of borrower default. The originators received cash up front for selling loans but had little ongoing economic interest (also known as skin in the game) relating to the future performance of the loans.

In 2010, in an attempt to address the “skin in the game” concern in securitization transactions, the U.S.

Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 941 of the Dodd-Frank Act amended the Securities Exchange Act of 1934 by adding a new section 15G, which requires a securitizer to retain at least 5 percent of the credit risk of the assets collateralizing the securitization transaction. Section 15G also generally prohibits the party that is supposed to retain credit risk from circumventing the risk retention requirement by hedging or otherwise transferring the credit risk. As part of the Dodd-Frank Act, Congress directed the applicable U.S. regulators to jointly implement credit risk retention requirements for securitization transactions.<sup>1</sup>

Although three years have passed since the Dodd-Frank Act was enacted, the U.S. regulators have not implemented risk retention rules for securitization transactions. In April 2011, the U.S. regulators published

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*U.S. News & World Report -  
Best Lawyers 2014*

Equipment Finance Law Firm of the Year  
(awarded to one law firm nationally)

Ranked as one of the top firms in National  
Admiralty & Maritime Law in the U.S.

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*Chambers UK Guide 2014*

Ranked as one of the top  
Aviation Finance firms in the UK

"[Vedder Price] is practical and deeply  
knowledgeable across the board in asset finance,  
in both the UK and the USA."

a joint notice of proposed rulemaking relating to credit risk retention. After receiving numerous comment letters from interested parties on the joint notice of proposed rulemaking, the U.S. regulators decided to try again. In August 2013, the U.S. regulators issued a second joint notice of proposed rulemaking for the risk retention requirements of the Dodd-Frank Act (the proposed rules).<sup>2</sup>

### ***What Type of Securitization Transaction Is Covered?***

The Dodd-Frank Act's risk retention provisions apply to the issuance of asset-backed securities (ABS). The definition of ABS includes "a fixed-income or other security collateralized by any type of self-liquidating asset (including a loan, a lease, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset...."<sup>3</sup> The risk retention requirements apply to all ABS offerings, even if the ABS offerings are not registered with the Securities and Exchange Commission. This means that the risk retention rules will apply to ABS issued in private placement transactions, including private placements structured as Rule 144A/Regulation S bond offerings.

This article briefly summarizes certain aspects of the proposed rules that may affect the securitization of loans and leases relating to aircraft and aircraft engines. This article does not discuss the application of the proposed rules to loans and leases relating to any other assets.

### ***Who Must Retain the Credit Risk?***

The risk retention requirements of the Dodd-Frank Act apply to the sponsor of the ABS transaction. A "sponsor" is defined as the party that "organizes and initiates" a securitization transaction "by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." Many securitization transactions have more than one sponsor. For these transactions, while the risk retention rules may be satisfied by the risk retained by the sponsors collectively, each sponsor is individually responsible for making sure that the risk retention requirements are complied with, whether or not that sponsor is itself retaining any of the risk.

### ***How Much Risk Must Be Retained, and What Are Permissible Forms for Holding the Required Amount of Risk Retention?***

The proposed rules require the sponsor to retain an economic interest of at least 5 percent of the aggregate credit risk of the assets collateralizing a securitization

transaction. There are several permissible options to hold the required amount of risk retention.

#### **Vertical Risk Retention Option**

A sponsor may elect to satisfy the 5 percent risk retention requirement through a "vertical" risk retention option. This means that the sponsor would hold at least 5 percent of the fair value<sup>4</sup> of each class of securities issued as part of the securitization transaction. For example, if three classes of ABS interests were issued in an aircraft lease securitization transaction, including a senior class of notes, a subordinated class of notes and an E certificate (representing the residual, or equity, interest in the transaction), a sponsor using the vertical risk retention approach would have to retain at least 5 percent of the fair value of each such class or interest.

An alternative method for a sponsor to satisfy the vertical risk retention option is to hold a separate "single vertical security" issued by the issuing entity. This type of security would entitle the sponsor to 5 percent of the principal and interest paid on each class of ABS interests issued in the securitization transaction. In an aircraft lease securitization transaction, a new class "V" might be issued to the sponsor, which would represent a single vertical security for risk retention purposes.

#### **Horizontal Risk Retention Option**

A sponsor may elect to satisfy the 5 percent risk retention requirement through a "horizontal" risk retention option. This means that the sponsor would retain a first-loss risk exposure in an amount equal to at least 5 percent of the fair value of all of the ABS interests in the transaction. "ABS interests" are defined to include all types of interests or obligations issued by the issuer in the securitization transaction, including any note, certificate or residual interest, the payments on which are primarily dependent on the cash flows of the loans or leases held by the issuing entity.

In order to satisfy the requirements for horizontal risk retention, the sponsor would be required to hold the most subordinated claim to payments of principal and interest from the issuing entity. The holder of a horizontal residual risk may receive a share of prepayments, but only to the extent that other, more senior classes of interests first receive their share of such prepayments.

Subordinated classes of securities are not unusual in aircraft securitization transactions. For example, in a recent securitization of aircraft engine leases, the issuer issued Series X Notes, Series A Notes and a Series E Certificate. The Series A Notes were subordinated to the Series X Notes, and the Series E Certificate was subordinated to the Series X Notes and the Series A Notes. The Series E Certificate represented the right to receive cash flow at the bottom of the securitization

payment waterfalls, and may be the type of security that could be used for purposes of satisfying the horizontal risk retention option of the proposed rules.

### **Cash Reserve Fund Option**

A third option for a sponsor is to fund a cash reserve account in an amount equal to the horizontal residual risk that the sponsor otherwise could have held. The cash reserve account would need to be held by a trustee for the securitization transaction. Amounts in the cash reserve account may be invested only in short-term government securities or in fully insured deposit accounts. Cash may be released from the reserve account to satisfy the issuing entity's obligation to make payments of interest and principal on the notes or other securities issued in the securitization transaction.

Reserve accounts are not unusual in securitization transactions. For example, the deposit accounts that were part of a recent aircraft engine lease securitization transaction included a maintenance support account and a liquidity facility reserve account. It would be relatively simple to add a cash reserve account to an aircraft securitization transaction in order to satisfy the horizontal risk retention option.

### **Combined Option**

The proposed rules allow the sponsor to satisfy its risk retention requirements by holding a combination of a vertical interest, a horizontal interest or a cash reserve account.

## ***Transfer of Risk Retention***

### **Allocation to Originators**

The proposed rules permit a sponsor to reduce its risk retention by allocating a portion of any risk retention to an originator of the applicable loans or leases that agrees to assume that risk retention. Under the proposed rules, an "originator" is the original lender or lessor of the loan or lease that is the collateral for the securitization transaction. The risk retention allocated to an originator can equal an amount up to that originator's pro rata share of the assets in the transaction (based on the amount of assets acquired from that originator). However, the proposed rules permit risk retention to be allocated only to originators that originated at least 20 percent of the loans or leases collateralizing the securitization transaction.

In a future aircraft securitization transaction, an issuing entity might acquire 50 percent of the aircraft leases from one originator, 35 percent of the aircraft leases from a second originator, and 15 percent of the aircraft leases from a third originator. The sponsor could allocate up to 50 percent of its risk retention to the first originator and up to 35 percent of its risk retention to the

second originator, but would not be able to allocate any of its risk retention to the third originator (since the third originator is providing fewer than 20 percent of the leases to be securitized).

### **Transfer to Affiliates**

The proposed rules allow a sponsor to transfer all or any portion of its risk retention obligations to one or more affiliates that are majority-owned by the sponsor.

### **Restriction on Hedging**

Under the proposed rules, a sponsor is not allowed to hedge the credit risk it is required to retain except in limited circumstances. These hedging restrictions also apply to an originator or an affiliate of a sponsor that has accepted the transfer of some or all of the sponsor's risk retention obligations. The proposed rules would allow a sponsor, an originator or an affiliate of the sponsor, as applicable, to enter into a hedge that is not materially related to the credit risk of the particular securitization transaction. For example, a sponsor would be able to enter into a hedge against currency exchange rates without contravening the proposed rules.

The proposed rules also prohibit a sponsor (or the applicable affiliate or originator) from pledging as collateral for a loan or other financing transaction the ABS interest that the sponsor is required to retain, unless the loan or other financing transaction has full recourse to the sponsor (or such affiliate or originator). U.S. regulators view a limited recourse loan secured by the sponsor's retained interest as a potential disguised transfer of the retained interest because any payment default by the sponsor under the limited recourse loan will undoubtedly result in the lender's foreclosing upon the pledged retained interest. As a result, the sponsor would no longer own the retained interest and would cease to have the required "skin in the game" relating to the transaction.

### **Expiration of Restrictions on Transferring and Hedging of Risk Retention**

The proposed rules reflect a belief that any credit losses on loans and leases due to poor underwriting will tend to occur in the first few years of a securitization transaction, and that defaults may occur less frequently as the underlying loans and leases are seasoned. As a result, the proposed rules provide that the restrictions on transferring and hedging of risk retention expire on the date that is the last to occur of the following: (1) the date on which the total unpaid principal balance of the securitized assets is less than or equal to 33 percent of the original unpaid principal balance at the closing of the securitization transaction; (2) the date on which the total unpaid principal obligations under the bonds and other ABS interests issued in the securitization transaction are

less than or equal to 33 percent of the original unpaid principal obligations of the ABS interests at the closing of the securitization transaction; and (3) two years after the closing of the securitization transaction.

### **Exception for Certain Loans**

The proposed rules exempt certain types of loans on the theory that risk retention to promote sound underwriting is less relevant in the case of loans that meet specified underwriting standards or loans that have been performing for an extended period of time.<sup>5</sup>

Under the proposed rules, if a securitization transaction is collateralized by qualifying commercial loans, those loans may qualify for a zero percent risk retention requirement. A loan is a “qualifying commercial loan” if the originator has analyzed the borrower’s ability to service all of the borrower’s outstanding debt for the next two years, and the originator has determined that, after giving effect to the loan, the borrower would have (i) a total liabilities ratio of less than or equal to 50 percent, (ii) a leverage ratio of not more than 3.0, and (iii) a debt service coverage ratio of at least 1.5. A qualifying commercial loan also must satisfy additional criteria, including that the loan payment amount must be determined based on straight-line amortization over a term not in excess of five years from origination. This exception from the risk retention rules could be available for a securitization of aircraft loans if the borrowers of the underlying loans and the terms of the underlying loans satisfy the criteria described above.

The proposed rules also exempt from the risk retention requirements securitization transactions collateralized solely by seasoned loans. For this purpose, a “seasoned loan” is a loan that (i) has not been modified since its origination, (ii) has never been delinquent for 30 days or more, and (iii) has been outstanding for at least two years or, if later, until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance. This seasoned loan exemption might be useful for securitizations that involve the repackaging of previously issued aircraft loans. In a recent transaction, a Delaware statutory trust was established to acquire an aircraft loan made to one of the major U.S. airlines that had been outstanding for more than ten years. The Delaware trust raised funds to acquire the aircraft loan by “tranching” credit exposure to the aircraft loan: the trust borrowed a senior loan from a bank lender secured by the aircraft loan, and the trust also issued subordinate certificates to third-party investors in a private placement. If the outstanding principal balance of the underlying aircraft loan had been less than 33 percent of its original principal

balance, the transaction would have had a zero-risk-retention requirement.

### **Effective Date of Proposed Rules**

The risk retention requirements in the proposed rules, if adopted by the U.S. regulators, will not become effective until a transition period has elapsed. In the case of securitization transactions collateralized by loans and leases relating to aircraft and aircraft engines, the risk retention requirements will become effective two years after the date that final rules are published in the *Federal Register*.

### **Conclusion**

The proposed risk retention rules should not have a significant impact on securitizations of loans and leases relating to aircraft and aircraft engines. The issuance of subordinated securities and retained interests, and the establishment of reserve accounts, have been typical features of those securitization transactions. If and when the proposed rules become effective, the skies should still be clear for securitizations of aircraft assets.

If you have questions about this update, please contact Marc L. Klyman at +1 (312) 609 7773 or [mklyman@vedderprice.com](mailto:mklyman@vedderprice.com).

<sup>1</sup> The applicable regulators are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development.

<sup>2</sup> The comment period for the proposed rules ended on October 30, 2013. It is not yet clear when the proposed rules will be issued in final form.

<sup>3</sup> This article uses the terms “ABS” and “securitization” interchangeably.

<sup>4</sup> “Fair value” will be determined in accordance with U.S. generally accepted accounting principles.

<sup>5</sup> The proposed rules do not include a similar exemption for leases.

## **Lessons for Financiers and Lessors from *Alpstream v. PK Airfinance***

*Alpstream v. PK Airfinance*,<sup>1</sup> a recent decision of the English Commercial Court, highlights the duties of financiers in the context of aircraft repossessions and the associated power of sale in default scenarios. The case garnered significant mainstream media attention principally because the claimants are controlled by Russian billionaire Alexander Lebedev, who holds controlling interests in newspapers in both Russia and the United Kingdom.

## Facts of Case

Alpstream leased seven Airbus A320s (the Aircraft) to Blue Wings, a German airline that filed for insolvency in 2010. The Aircraft were financed by PK Airfinance Sarl (PK). The financing for the Aircraft was cross-collateralized to the financing of certain other aircraft leased to Olympic, a Greek airline (the Caelus Aircraft). Alphastream, an affiliate of Alpstream, has an equity interest in the Caelus Aircraft.

As a result of the Blue Wings insolvency, Alpstream defaulted on the financing of the Aircraft. PK repossessed the Aircraft and conducted a public auction of the Aircraft. At the auction, PK bid on the aircraft and won (there were no other bidders), and subsequently sold the Aircraft to its affiliate GECAS, which leased the Aircraft to JetBlue, a U.S. airline. Alpstream alleged that PK breached its duties as a mortgagee in possession in that it sold the Aircraft to GECAS at less than the price that PK should have achieved as a mortgagee in possession. In addition, Alphastream alleged that because PK failed to take reasonable steps to achieve the best value for the Aircraft, Alphastream's equity interest in the Caelus Aircraft was eroded. It is of note that no party wanted to void the sale from PK to (ultimately) GECAS. Both Alpstream's and Alphastream's claims against PK and GECAS were grounded in the economic tort of "unlawful means conspiracy."

## Unlawful Means Conspiracy

For PK and GECAS to be liable for the tort of unlawful means conspiracy, Alpstream and Alphastream were required to prove that:

- (a) PK and GECAS conspired to cause Alpstream or Alphastream (as applicable) some kind of harm;
- (b) the harm was caused by some form of unlawful means; and
- (c) PK and GECAS intended to cause the harm.

In *OBG Ltd v. Allan*<sup>2</sup> (*OBG*), it was suggested that the intention element (part (c) above) could be shown if the loss was "the obverse side of the coin from the gain to" the aggrieved party. That is, each of PK and GECAS could be liable if it knew its gain was achieved at the cost of Alpstream or Alphastream.

## The Court's Ruling and the Importance of Intent

The court held PK and GECAS liable for unlawful means conspiracy, ruling that:

- (a) PK and GECAS (i) caused economic loss to

Alphastream<sup>3</sup> in that its equity interest in the Caelus Aircraft was eroded because the price paid for the Aircraft was insufficient to discharge the debt, breakage costs, remarketing costs, sale costs and the cost of the works done to the Aircraft and (ii) conspired to cause the loss, when GECAS employees instructed PK to repossess the Aircraft and bid for the Aircraft within a certain price range;

- (b) PK acted with willful misconduct (unlawful means) in breach of its duty as mortgagee to Alpstream (and Alphastream) when it failed to arrange for the sale appropriately; and
- (c) the intention element had been met.

The court suggested that the intention element was satisfied in that PK and GECAS acted deliberately with knowledge that their actions would cause a loss as a result. Intention was not discussed in great detail by the judge, and this formulation is different from the "obverse side of the coin" test set out in *OBG*, as there was no reference by the judge to a gain by PK and/or GECAS. While PK and GECAS may have contemplated causing a loss to Alphastream, it might be argued that they were simply focused on acquiring the Aircraft for the purposes of leasing the Aircraft to JetBlue, while minimizing any losses to PK or GECAS. The loss to Alphastream was a consequence of PK's and GECAS's actions, but this result arose only because there was no bidder who offered a higher purchase price at the auction of the Aircraft.

The judge's decision ultimately results in Alphastream suffering a loss anyway, with its equity eroded to a lesser degree than it would have been as a result of the auctioned sale that ultimately transferred the Aircraft to GECAS. Did PK and/or GECAS really intend to cause Alphastream a worse loss than the loss Alphastream was always going to suffer following a repossession? PK and GECAS have recently confirmed that they will appeal the decision in *Alpstream*, and this may be a basis for the appeal.

## Analysis

The *Alpstream* case serves as a useful reminder of the various duties of a financier in a repossession scenario.

### A Mortgagee's Duty to the Mortgagor

First, in a standard default, repossession and sale scenario, a mortgagee's duty is "to behave as a reasonable man would behave in the realisation of his own property,"<sup>4</sup> to take reasonable care to obtain the true market value of the mortgaged property.<sup>5</sup> If there is any question as to the impropriety of any such sale, it is for the mortgagor to prove that such duty has been breached.

Where it is contemplated that, following repossession, the mortgagee will sell the collateral to a connected person, the duty to the mortgagee is heightened and the burden of proof is reversed so that there is a “heavy duty on [the mortgagee] to show that [it] used its best endeavours to obtain the *best* price reasonably obtainable for its mortgaged property”<sup>6</sup> (emphasis added).

In *Alpstream*, the judge found that this duty extended not only to Alpstream but also to Alphastream, whose interest in the residual of the cross-collateralized equity was eroded by the agreement by PK and GECAS to set a level for the purchase price. In holding PK and GECAS liable for unlawful means conspiracy, the judge did not need to make this finding, and it may be in error. This is because the “unlawful means” element of the tort need not be directed at the person who suffers the intended harm. Perhaps the judge was focused intently on finding that PK and GECAS were liable in the tort so that damages would be payable. A breach of the mortgagee’s duty to the mortgagor would otherwise have resulted in the sale being voided.

### Auctions and Sales to Connected Persons

In *Alpstream*, PK elected to proceed with the sale of the Aircraft through a public auction. The principal purpose of this, based on the evidence set out in the judgment, was (i) to have a proper, transparent process to transfer the Aircraft from PK to GECAS and (ii) to create a clean break from the debt and the equities in the Aircraft.

It should be noted that the judge found that while the auction itself was not “in any individual respect negligently conducted,” there were several factors that a mortgagee should consider when auctioning an aircraft to the public, including:

- (a) ensuring that any improvement to the expected condition of the aircraft is advertised;
- (b) targeting potentially interested parties for a sale;
- (c) pursuing or encouraging parties that have expressed an interest in the sale; and
- (d) taking independent valuation advice, which was relevant in a connected sale.

The judge determined that, in this case, the best approach would have been an indirect private sale from PK to GECAS. Had such a sale occurred, a higher price would have been paid for the Aircraft because GECAS was a willing buyer, the auction of “distressed aircraft” would have been avoided and the sale would have been conducted without the additional expense of an auction. As GECAS was a “special” or “uncommonly motivated” purchaser, it would have needed to pay and be willing to pay more than the market price.

The court’s analysis begs the question, Can a properly run auction ever be the correct course of action when there’s a connected person bidding? Perhaps yes—but only where the connected person is not uncommonly motivated and the auction is fairly run, obtaining the best price reasonably obtainable.

### Willful Misconduct

Pursuant to the relevant mortgage documents, PK was liable to Alpstream only in cases in which PK could be shown to have engaged in wilful misconduct. The judge held that the test was whether the “conduct can be characterised as intentionally doing what [PK] knew to be wrong or recklessly indifferent to whether [its] actions were right or wrong and as to whether loss would result, or whether [it] took a risk which [it] knew [it] ought not to take.”

If PK had not engaged in wilful misconduct, would Alphastream have been able to claim? As noted by the judge, *OBG* suggests that Alphastream would not have been able to claim because the unlawful means would not have been actionable by Alpstream.<sup>7</sup>

### Maintenance Works Undertaken

The *Alpstream* ruling also reinforces the right of mortgagees to perform maintenance on an aircraft to prepare it for sale and charge the costs of that maintenance to the mortgagor. Alpstream claimed on a general basis that it should not be liable for works undertaken on the Aircraft that did not “add value” to the Aircraft. This court held Alpstream liable for maintenance costs for two principal reasons:

- (a) the work was undertaken because the Aircraft were returned by Blue Wings in poor condition and not in accordance with the redelivery condition requirements, which Alpstream had agreed to indemnify;
- (b) the work was required to put the Aircraft in the condition required for the leasing to JetBlue, which was incorporated into the judge’s calculation for the correct sale price. The works were a condition of the lease, which the sale depended on; the claimants could not claim both (i) a credit for the increased price and (ii) an additional amount reflecting the works that were done to put the Aircraft in the condition required.<sup>8</sup>

### Conclusion

While *Alpstream* raises important questions about the level of intention required on the part of a defendant in the unlawful means torts, the case also serves as a

useful reminder of factors that financiers must be aware of in default scenarios:

- (a) the mortgagee's increased duty to the mortgagor when there are connected sales (from a reasonableness standard to one where best endeavours are required);
- (b) the reversal of the burden of proof in the context of a sale to a connected person;
- (c) the requirement that an auction in the circumstances of a potential connected sale, while appearing to be transparent, be run in a fashion that achieves the best obtainable price, which may include specific targeting of potential purchasers and targeted follow-up of persons who have expressed an interest;
- (d) the limiting to "wilful misconduct" of claims that are actionable against the mortgagee arising under the underlying mortgage or other transaction documents may serve to limit claims arising under the economic torts from third parties; and
- (e) it is reasonable for a mortgagee to arrange for maintenance work to put an aircraft into the redelivery condition required under the underlying lease documents (even if the works do not "add value" to the aircraft) and additional maintenance work that is reasonable in the context of a sale and onward leasing of the Aircraft.

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- 1 *Alpstream AG and others v. PK Airfinance Sarl and another*, [2013] EWHC 2370 (Comm).
- 2 *OBG Ltd and another v. Allan and others; Douglas and another v. Hello! Ltd. and others* (No. 3); *Mainstream Properties Ltd. v. Young and others* [2007] UKHL 21.
- 3 Because the debt provided to Alpstream under the financing arrangements was significantly higher than the value of the Aircraft, Alpstream was unable to show economic loss.
- 4 *McHugh v. Union Bank of Canada* [1913] AC 299.
- 5 *Cuckmere Brick Co. v. Mutual Finance* [1971] CH 949.
- 6 *Tse Kwong Lam v. Wong Chit Sen* [1983] 1 WLR 1349, PC.
- 7 The judge also noted, however, that there are older cases that suggest otherwise (e.g., *Torquay Hotel Co. Ltd. v. Cousins* [1969] 2 CH 106; *Merkur Island Shipping v. Laughton* [1983] 2 AC 570).
- 8 The court did find, however, that GECAS had used new HPT blades when it was perfectly possible to use reconditioned blades in the engines, given that the Aircraft were on the ground and there was no urgency in repairing the Aircraft. The mortgage account was increased by the difference in the price paid for new blades and the price of reconditioned blades.

## Updates

***The below information includes two updates from our previous newsletter.***

### **Section 1110 Implications of Second Circuit AMR Make-Whole Ruling**

On September 12, 2013, the U.S. Court of Appeals for the Second Circuit (the Second Circuit) affirmed the rulings of the U.S. Bankruptcy Court for the Southern District of New York (the Bankruptcy Court) in the bankruptcy cases of American Airlines and related debtors (the Debtors) holding that the Debtors do not have to pay a make-whole premium when repaying certain of their outstanding financings (the Indentures). A complete analysis of the background surrounding the case and the Bankruptcy Court's ruling can be found at [www.vedderprice.com/Make-Whole](http://www.vedderprice.com/Make-Whole).

While the Second Circuit's opinion that make-whole was not payable under the Indentures in context of debt acceleration is not surprising (under the Indentures, make-whole was not payable upon acceleration, and a bankruptcy filing resulted in automatic acceleration), the Second Circuit's ruling that the indenture trustees under each Indenture (the Indenture Trustees) could not de-accelerate the related debt amplifies the Bankruptcy Court's analysis creating potential limitations on creditors' rights under section 1110 (Section 1110) of the U.S. Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.* (the Bankruptcy Code).

In its opinion, the Second Circuit ruled that the post-petition exercise of a contractual right to de-accelerate would be a violation of the automatic stay under section 362 of the Bankruptcy Code, stating:

*As of the [petition date], American had the contractual right, pursuant to the Indentures, to repay its accelerated debt without Make-Whole Amount. We therefore agree with the bankruptcy court that any attempt by U.S. Bank to rescind acceleration now—after the automatic stay has taken effect—is an effort to affect American's contract rights, and thus the property of the estate. (Emphasis added.)*

The Second Circuit reasoned that the contract rights between a debtor and a creditor are fixed on the petition date, and any effort by a creditor to change such rights after the petition date, including by de-accelerating the debt, constitutes a violation of the automatic stay that is statutorily enjoined by section 362 of the Bankruptcy Code. The ruling, which was made without any analysis of the impact of Section 1110, fails to recognize the

special protections that Section 1110 affords aircraft financiers. Rather than freezing contractual rights as of the petition date, Congress specifically required that a chapter 11 debtor air-carrier comply with *all* contractual terms (and cure any defaults) of an aircraft financing following a Section 1110(a) election, with the only exceptions being contractual terms that are triggered by the bankruptcy or financial condition of a debtor or that constitute a penalty. A chapter 11 debtor's failure to honor any such contractual term would normally create a default, allowing a Section 1110(a) protected aircraft financier to exercise its remedies against the aircraft equipment.

Here, the Indenture Trustees possessed contractual rights to de-accelerate that should have been exercisable at any time after the Debtors made their Section 1110(a) elections. Because the Second Circuit focused upon the Debtors' contractual rights as of the petition date, instead of the Section 1110(a) contract rights that are protected on an ongoing basis, the Second Circuit's analysis is faulty. In fact, a deceleration of the debt does not "change" the contractual rights between the parties as posited by the Second Circuit—such rights are expressly fixed by the terms of the Indentures, which the Debtors agreed to comply with in making a Section 1110(a) election.

Although the Second Circuit's ruling deals only with the ability of Section 1110 protected creditors to decelerate debt to protect make-whole claims, the Second Circuit's analysis could be applied to limit the exercise of any affirmative contractual right as violating the automatic stay (e.g., inspection and insurance rights, which are oftentimes exercised post-petition). This creates a potential material limitation upon the scope of Section 1110 protections that aircraft financiers currently take for granted—a limitation that is now afforded the precedential value of a Second Circuit ruling.

If you have questions about this update, please contact Michael J. Edelman at +1 (212) 407 6970 or [mjedelman@vedderprice.com](mailto:mjedelman@vedderprice.com).

## FAA Issues Final Policy Clarification on NCTs

On June 18, 2013, following two years of industry debate, the Federal Aviation Administration (FAA) issued a policy clarification regarding the use of noncitizen trusts (NCTs) for FAA registration of aircraft. The policy clarification, which became effective on September 16, 2013, is generally consistent with the preliminary policy clarification issued by the FAA on February 9, 2012. A copy of the policy clarification can be found at: [www.gpo.gov/fdsys/pkg/FR-2013-06-18/html/2013-14434.htm](http://www.gpo.gov/fdsys/pkg/FR-2013-06-18/html/2013-14434.htm), and a discussion of the preliminary policy clarification can be found at [www.vedderprice.com/NCT](http://www.vedderprice.com/NCT).

In the policy clarification, the FAA confirms that it will treat NCT trustees the same as owner/operators from a regulatory compliance perspective and will rely on these trustees to provide information about NCT-registered aircraft, including the identity of the operator or manager of the aircraft and information regarding the location of the aircraft and its base of operations, crew and maintenance. In issuing the policy clarification, the FAA acknowledged that although contractual delegation of the informational responsibilities to an operator will not relieve an NCT trustee of its responsibilities (as was proposed by industry participants), such delegation may represent a reasonable means for NCT trustees to ensure their ability to satisfy FAA requests for information and be considered favorably by the FAA.

From a documentary perspective, the policy clarification requires NCT trust agreements to include provisions consistent with the new informational requirements, and finance parties have also begun to incorporate new covenants, default triggers, remedies and other provisions into their other transaction documents in response to the policy clarification. Not surprisingly, the presence of the new documentary requirements has resulted in increased review times at the FAA in connection with closings, which will no doubt be resolved over time through the development of documentary and other transaction precedent that is approved by the FAA.

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