Global Transportation Finance Newsletter

May 2016

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FAA Now Accepting Digital Signatures

Effective April 1, 2016, the FAA Registry began accepting documents displaying legible digital signatures as meeting the signature requirements of Parts 47 and 49. These documents currently include an aircraft bill of sale AC Form 8050-2, security documents, conditional sale contracts, leases and other filing documents. Eventually, the FAA Registry intends to make the aircraft registration application AC Form 8050-1 available in downloadable format, at which time the digital signature accommodation will extend to the registration application as well. Applicants that digitally sign the aircraft registration application AC Form 8050-1 will be required to place a second duplicate copy of the application in the aircraft as temporary authority to operate within the United States (rather than the pink carbon copy as currently required). Each digitally signed document will be reviewed by the FAA Registry to determine if the digital signature is legible and acceptable. At a minimum, the digital signature must (i) show the name of the signer and be applied in a manner to execute or validate the document, (ii) include the typed or printed name of the signer below or adjacent to the signature, (iii) show the signer's title as part of or adjacent to the digital signature when the signer is signing on behalf of an organization, (iv) show evidence of authentication of the signer's identity by a digital authentication software provider and (v) be in a font that is clearly legible and reproducible when reviewed.

Vedder Price Welcomes

Tom Zimmer joins the firm as a GTF Shareholder in the San Francisco office. Tom has counseled and represented U.S. and international clients in transactions involving aircraft, rail, vessels and other equipment and facilities for more than 20 years. He has extensive experience with leveraged leases, operating leases, cross-border transactions, portfolio acquisitions and dispositions, warehouse financings, restructurings, mergers, acquisitions and joint ventures, as well as unmanned aircraft systems (UAS) and public-private partnerships.

Prior to joining Vedder Price, Tom was a partner in the Finance group at Pillsbury Winthrop Shaw Pittman and co-leader of their Transportation Finance Group.

Kevin MacLeod joins the firm as a Shareholder and Head of the New York Capital Markets Group. Kevin represents issuers and underwriters in connection with capital markets transactions and other securities law-related matters, with an emphasis on the aircraft finance space. In this regard, Kevin has extensive experience with enhanced equipment trust certificates (EETCs), secured and unsecured high-yield notes, aircraft lease securitizations and Ex-Im Bank-guaranteed notes. In the last five years alone, he has advised issuers or underwriters on more than 135 completed securities offerings with aggregate proceeds in excess of $50 billion.

Prior to joining Vedder Price, Kevin was special counsel in the New York office of Milbank.

HONORS AND ACCOLADES

Vedder Price's Global Transportation Finance team is proud to have counseled clients in three *Airfinance Journal* 2015 Deals of the Year involving participants spanning four continents. The deals are:

OVERALL DEAL OF THE YEAR

NORTH AMERICA DEAL OF THE YEAR

AFRICA DEAL OF THE YEAR

EVENTS

May 10 • Capital Link Shipping Forum, "Shipyards, Shipbuilding & Financing", Shanghai Ji Kim, Shareholder, Moderator

May 24 • Lorman Webinar, "Financing Capital Equipment: Lease or Borrow" Denise Blau, Shareholder, and Eddie Gross, Shareholder, Presenters

June 14 • 27th Annual Canadian Airline Investment Forum, Toronto Dean Gerber, Shareholder and GTF Chair, and Kevin MacLeod, Shareholder and Head, NY Capital Markets, Panelists

June 14 • Corporate Jet Investor, "Structuring Deals in Asia—the View from the U.S.", Singapore David Hernandez, Shareholder, Presenter

VedderPrice℠

Vedder Price Sponsors the 22nd Annual Chi-Stat Reception June 8

Chi-Stat is a Chicago-based group of aviation finance, marketing and consulting professionals. In addition to boasting the significant Chicago presence in the aviation community, Chi-Stat's purpose is to provide informal networking opportunities for individuals in the industry.

Thought Leadership

Vedder Price GTF shareholders John Bradley and Ji Woon Kim authored an article discussing whether shipping interests face parallel credit risk issues in financing maritime mobile commercial assets as those addressed for aircraft in the Cape Town Convention. "Cape Town Convention for Ships: A Solution in Search of a Problem?" was published in the October 2015 issue of *Marine Money*.

Congratulations!

New York GTF team member Chris Setteducati was promoted to Shareholder in March. Chris concentrates his practice in corporate finance with a special focus on equipment finance. He represents commercial and investment banks, insurance companies and other financial institutions in a wide range of financing transactions, including operating lease financings and lease portfolio facilities, private placements, ECA-supported financings, EETCs and leveraged leases. He was selected for inclusion in the *2015 Euromoney LMG Rising Stars Expert Guide: Aviation*.

Aviation Debt Capital Markets Are Growing: An Overview of Recent Trends

Airlines and aircraft lessors are increasingly looking to the debt capital markets as a source of funding. During the past 12 months or so, near-record levels of financings were completed in the primary securities markets accessed by airlines and aircraft lessors as compared to prior periods. Market commentators have reported that approximately $17 billion of aviation-related debt securities were sold in the U.S. capital markets in 2015, which represented a more than 20% increase over 2014. In 2016 to date, aviation-related debt securities issuance in these markets is already nearing $3 billion. A number of these offerings also achieved record pricing. Airlines have been issuing enhanced equipment trust certificates (EETCs) and unsecured bonds, while lessors have been issuing unsecured bonds and sponsoring aircraft and engine asset-backed securitizations (ABS). The proceeds from these debt securities are most often used to purchase aircraft, to refinance owned aircraft, to refinance other existing debt or for other general corporate purposes. Various forecasts predict strong levels of activity for the remainder of 2016 and in the following years.

Key Trends: Air Travel Demand, Fleet Growth and Regulatory Changes

What has been driving the aviation sector's increased use of debt capital markets financing? In addition to the current low-interest-rate environment, several key trends continue to be the principal drivers: air travel demand, fleet growth/renewal and regulatory changes.

First, passenger air travel demand continues to grow steadily. IATA recently announced passenger traffic results showing that demand (measured by revenue passenger kilometers (RPKs)) increased 6.5% in 2015 compared to 2014 and reported that the ten-year average annual growth rate in RPKs has been 5.5%.

Second, airlines have been meeting this demand growth by increasing their fleets or re-fleeting, using their owned aircraft and leased aircraft. Boeing reported delivering 762 aircraft to customers in 2015 with 5,795 aircraft still in backlog, and Airbus reported delivering 635 aircraft to customers in 2015 with 6,787 still in backlog. Combining these numbers, deliveries were being made by the two major manufacturers in 2015 at a rate of nearly four aircraft per day every day of the year. Bombardier, Embraer and other leading manufacturers are also steadily rolling new aircraft off their assembly lines. Market analysts predict that more than 36,000 commercial jets and turboprops will be delivered over the next 20 years, with a list price value of more than $2.5 trillion. Many of these aircraft purchases will be financed. Debt capital markets, particularly in the United States, are a natural leading source for that financing, given the markets' depth, flexibility and familiarity with the aviation sector.

Third, regulatory changes are shifting debt financing markets and supporting increased demand for the debt capital markets instead of bank balance sheets. The reform measures of the Basel Committee on Banking Supervision, commonly known as Basel III, seek to strengthen the regulation, supervision and risk management of the banking sector. Increased capital adequacy requirements and other changes, such as the net stable funding ratio, are being phased in through 2019 and are expected to have significant effects on the loan market.

Another regulatory change has affected the market for credit backed by export-credit agencies (ECAs) which airlines and lessors use to finance their purchase of new aircraft. The revised minimum premium rates under the OECD's 2011 Aircraft Sector Understanding have increased the cost of ECA-supported financing and led airlines and lessors to look to other sources.

The depth of the U.S. capital markets for corporate debt issuance may be appreciated by looking at recent dollar volume. According to SIFMA, $1.5 trillion of new debt securities were issued by corporates in 2015, of which $1.23 trillion was investment grade and $260 billion was high yield. These markets had similar dollar volume issuance in the previous three years as well. Investors and money managers continue to search for yield, and certain aviation debt investments are providing them with opportunities to achieve attractive risk-adjusted returns.

Aviation DCM Activity in the U.S. Capital Markets: 2015 and 2016

So what have we seen in the U.S. capital markets since the beginning of 2015? Let's review the principal markets in order of U.S. dollar volume issuance during the period.

EETCs

Given the trends discussed above, it will be no surprise that aircraft-backed secured debt securities have been issued in increasingly large volume. In the EETC market, 2015 dollar issuance volume was more than double that of 2014. By year-end, more than $7 billion of EETCs had been issued by eight airlines, financing 123 aircraft. First-time offerings by Turkish Airlines, LATAM Airlines Group, Spirit Airlines and Mesa Airlines came to market as well as repeat offerings by American, Air Canada, Delta and United.

So far 2016 has seen only a $1.0 billion issuance by American Airlines, with other offerings expected.

A few developments are notable. First, advocates of the benefits of the Cape Town Convention and the related aircraft protocol,[1] as well as market observers predicting more non-U.S. EETC issuance, were cheered to see that four of the 2015 offerings were by non-U.S. carriers and relied on the remedial provisions of the Cape Town Convention and the aircraft protocol.

Second, several offerings did not use the prefunding structure customarily used in the market. Instead of prefunding future aircraft deliveries, Delta, American and United all refinanced recently purchased aircraft, in each case targeting an efficient pricing to lower the airline's average cost of debt.

Third, an important structural innovation was made to EETCs in 2015. A new "super-senior" class of certificates styled as "Class AA" with underlying equipment notes styled as "Series AA" was introduced. These Class AA certificates are characterized by a senior-most position in the payments waterfall as compared to the other classes of certificates (with the customary exception prioritizing adjusted interest on junior classes ahead of principal distributions on the more senior class) and a comparatively lower initial LTV ratio[2] than the range customarily used for structuring Class A certificates. Class AA certificates to date were generally structured to have LTVs just under 40%. These characteristics, along with the other structural enhancements typical to EETCs, allowed Class AA Certificates to obtain AA credit ratings. The Class AA offerings generally were structured with weighted-average lives of nine years or so and achieved coupons ranging from 3.45% to 3.75%.

Unsecured Notes

In the unsecured bond market, aircraft lessors and airlines were active. Lessors issued nearly $6 billion of notes in the U.S. markets since the start of 2015. AerCap, having completed its acquisition of ILFC in 2014, came to market in June and October of 2015 for an aggregate of $2 billion of gross proceeds. Air Lease Corp released $600 million five-year notes in April and in 2015 sold $1.1 billion in notes in offerings in January and August. Aviation Capital Group sold $900 million of notes in September. Aircastle recently returned to market to take advantage of tighter credit spreads. The proceeds of these offerings are being used for general corporate purposes, aircraft purchases and refinancing existing debt. Lessors tend to like this market for its pricing, depth and flexibility in term. New bonds have been issued with tenors ranging from three to ten years, with many deals structured as seven-year bullets.

Among airlines, LATAM Airlines Group came to market for the first time since LAN's association with TAM. American and Virgin Australia returned to the market. Much of the airlines' issuance has been driven by the strategy of driving down their average cost of debt and diversifying funding sources. In the business jet space, VistaJet came to market with its first unsecured offering—$300 million of high-yield notes with a five-year tenor.

Aircraft ABS

The aircraft ABS market experienced record volume in 2015 that was 50% greater than 2014 and was one of the most active periods in the market's history. In 2015, more than $4 billion of these ABS debt securities were issued, financing more than 200 aircraft. The market welcomed first-time offerings sponsored by DVB/Deucalion, Element, AWAS and BOC Aviation and a second offering by Castlelake, which had the distinction of being the first combined aircraft and engine ABS offering. To date in 2016, Apollo Aviation

Group completed its second aircraft securitization, which issued $510 million of notes backed by a fleet of 32 aircraft.

One of the notable developments in this market was the shift to the Rule 144A/Reg. S institutional investor capital markets instead of the syndicated loan market to issue the debt. This shift was driven largely by comparative pricing opportunities.

One other notable trend during this period has been that third-party investors bought most or all of the equity in many deals. Our shareholders Adam R. Beringer and Geoffrey R. Kass published an article in our previous GTF newsletter examining aspects of this trend, particularly efforts by many e-note buyers to seek additional control rights.[3]

ECA-Backed Bonds

Finally, new issuance in the U.S. market for ECA-backed debt securities related to aircraft has been comparatively light. A handful of offerings guaranteed by the U.S. Export-Import Bank were completed during this period. The lapse in Ex-Im Bank's authorization in mid-2015 brought an end to the approval of new guarantees and, although the bank has been reauthorized, its board has three empty seats. Until one additional board member is confirmed by the Senate, Ex-Im Bank will lack the quorum to approve new guarantees greater than $10 million, such as for aircraft exports.

Outlook

The outlook for the next 12 months of aviation debt capital markets issuance continues to be optimistic, with market expectations focused on increased aircraft ABS and lessor unsecured bond activity. We expect the private placement of secured debt securities, particularly EETC-like structures, may also see increased activity.

On the regulatory front, new rules under the U.S. Securities Exchange Act of 1934 related to credit risk retention and asset-backed securities developed pursuant to the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) are scheduled to come into force on December 24, 2016. The rules generally require a sponsor to retain at least 5% of the credit risk of the assets collateralizing a securitization transaction. The rules will apply to all new asset-backed securities offered and sold after the effective date, regardless of whether or not the securities offering is registered with the SEC, unless an exemption is available. As a result, these rules may influence decision-making by some aircraft lessors and other sponsors of new aircraft ABS, particularly those looking to sell all of their equity interest in the aircraft or engines that are being deposited into the structure.

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1 The Cape Town Convention on International Interests in Mobile Equipment and the related Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (together, the Cape Town Convention) was signed on November 16, 2001 and entered into force on March 1, 2006. The treaty is designed to facilitate asset-based financing and leasing of aircraft and other aviation equipment, expand financing opportunities and reduce costs by reducing a creditor's risk and by enhancing legal predictability in these transactions, including in the case of a debtor's insolvency or other default. The Cape Town Convention has entered into force in more than 60 states including Brazil, Canada and Turkey, which supported the EETC offerings by LATAM, Air Canada and Turkish Airlines, respectively.

2 For marketing purposes, the LTV is presented as the ratio of the aggregate principal amount of debt evidenced by the equipment notes underlying the class of certificates to the lesser of the mean and median appraised base values (maintenance adjusted, if applicable) of the aircraft as appraised by three ISTAT-certified appraisers.

3 See http://www.vedderprice.com/evolving-paradigm-of-aircraft-abs-and-the-purchase-of-enotes-by-third-parties/

Coming to a Financial Statement Near You: New Lease Accounting Standards

During the first quarter of 2016, after nearly a decade of planning, the Financial Accounting Standards Board (FASB), which governs U.S. generally accepted accounting principles (GAAP), and the International Accounting Standards Board (IASB), which governs international accounting standards (IAS), issued their new lease accounting standards. The new standards are designed to increase transparency and comparability among lessees by requiring them to put assets and liabilities on their balance sheets for all leases. FASB's new rules are contained in Topic 842, and IASB's new rules are in IFRS 16. FASB and IASB have adopted different lessee lease accounting models with IFRS 16 applying a single method of accounting (i.e., one modeled on current finance lease treatment), while Topic 842 utilizes a dual method of accounting that distinguishes between finance leases and operating leases. The revised standards will become effective on January 1, 2019 for IFRS users[1] and the fiscal year beginning after December 15, 2018 for public companies using GAAP. Private companies using GAAP must begin using the new standard for the fiscal years beginning after December 15, 2019.

Background

Under current GAAP and IAS standards for lessees,[2] a lease that substantially transfers all of the risks and rewards incidental to ownership of the underlying asset from the lessor to the lessee is classified by the lessee as a "capital lease"[3] and must be reported on the lessee's balance sheet. All other leases are classified by lessees as "operating leases" and are not reported on the lessee's balance sheet.[4] In 2005, the U.S. Securities and Exchange Commission estimated that its registrants held approximately US$1.25 trillion in off-balance sheet lease obligations, and the IFRS Foundation estimates that listed companies around the world have in excess of US$2.8 trillion in off-balance sheet lease obligations. As a result, analysts and investors often make adjustments to the amounts reported on a lessee's balance sheet and income statement to estimate the company's off-balance sheet lease obligations.[5] The new lessee accounting standards are expected to reduce the need for such adjustments by requiring most leases to be disclosed on the balance sheet and thus make it easier to understand and compare lessees' financial commitments regardless of how lessees choose to finance the assets used in their businesses. Lessor accounting is largely unchanged, so this article will focus primarily on the changes in lessee accounting.

Lessee Lease Accounting

Lessee Balance Sheet Accounting

Under the new rules, on the commencement date of a lease the lessee must recognize a right-of-use asset and a lease liability. The right-of-use asset is a depreciating nonfinancial asset that represents the lessee's right to use the underlying asset for the lease term, while the "lease liability" represents the present value of the lessee's obligation to make the lease payments arising from the lease.[6] At lease commencement, (i) the lease liability's cost is the present value of the lease payments not yet paid, discounted at the discount rate for the lease, and (ii) the right-of-use asset's cost consists of (x) the initial measurement of the lease lability, (y) any lease payments made at or before the commencement date less any lease incentives received and (z) any initial direct costs incurred by the lessee.[7] Subsequent measurements of the right-of-use asset and lease liability under Topic 842 depend on whether the lease is an operating lease or a finance lease.[8] For operating leases, (i) the lease liability is the present value of the lease payments not yet paid, discounted using the discount rate for the lease established at the commencement date,[9] and (ii) the right-of-use asset equals the amount of the lease liability with several adjustments.[10] For finance leases, (i) the lease liability is measured after the commencement date by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the lease payments made during the period, and (ii) the right-of-use asset is measured at cost less any accumulated depreciation and accumulated impairment losses. The lack of a finance lease/ operating lease distinction is especially relevant for IFRS lessees because the carrying value of the right-of-use asset for a formerly off-balance sheet lease will typically be lower than the lease liability throughout the lease term. In other words, the implementation of these rules will likely lead to an increase in both gross and net liabilities for companies with significant leased assets. This is because the right-of-use asset is typically depreciated on a straight-line basis whereas the lease liability is (i) reduced by the amount of lease payments made and (ii) increased by the interest reducing over the life of the lease, resulting in differing values for the asset and liability. On the balance sheet, lessees are required to present right-of-use assets and lease liabilities separately from other assets and liabilities.[11] Short-term leases (leases with a term of 12 months or less at the commencement date) are exempted from the new accounting requirements under both Topic 842 and IFRS 16.

Income Statement

Current IAS treatment for off-balance-sheet leases generally requires lessees to recognize lease expenses as operating expenses (typically on a straight-line basis). In contrast, IFRS 16 requires lessees to present the implicit interest rate in lease payments for these leases separately from the depreciation charge for the right-of-use asset in the income statement. Because a portion of the lease expense will now be included in financing costs instead of operating costs, EBITDA and operating profit will likely increase for companies that have material off-balance-sheet leases. Further, because the interest expense on a lease is highest at the beginning of the term and decreases over time as the lease liability gets smaller, the result is a front-loaded expense profile. For companies with evenly distributed lease portfolios.[12] IASB predicts a neutral overall income statement effect from adopting IFRS 16. In contrast, companies with unevenly distributed lease portfolios may see an impact on profit and loss from the implementation of IFRS 16. This is in contrast to the Topic 842 standard for operating leases, which requires lessees to recognize a single lease cost allocated over the lease term (generally on a straight-line basis) as an operating expense. The requirement is generally consistent with current GAAP, and thus the new GAAP standard will not likely have an impact on a company's statement of comprehensive income.

Statement of Cash Flows

Because the new accounting standards do not affect the amount of cash transferred between lease parties, there is no change to the total amount of cash flows reported in the statement of cash flows under either IFRS 16 or Topic 842. However, IFRS 16 will change the way former off-balance-sheet leases are presented in the statement of cash flows. Operating cash outflows will decrease and financing cash flows will increase because principal repayments are included with financing activities while interest payments can be included within operating, investing or finance activities. The new Topic 842 standard for finance leases is identical to IRFS 16.[13] In contrast, however, operating lease payments under Topic 842 are included in operating activities.

Notes to Financial Statements

Both IFRS 16 and Topic 842 require additional quantitative lease disclosure compared to past guidance. Among the disclosure items specifically required by both new standards are the following:

- The interest expense on lease liabilities[14]
- Depreciation/amortization charges for right-of-use assets[15]
- Short-term lease expenses
- Variable lease term expenses
- Income from subleasing right-of use assets

- Gains or losses arising from sale and leaseback transactions
- Lease liability maturity analysis

IFRS 16 also requires lessees to disclose total cash outflow for leases, additions to right-of-use assets and the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset. Because Topic 842 uses a dual lessee accounting model, it requires separate disclosure of the weighted-average discount rate for operating leases as well as the beginning and ending balances of operating lease liabilities. Topic 842 also mandates certain qualitative disclosures, including general lease descriptions, restrictions or covenants imposed by leases, and information about significant assumptions and judgments made in applying the new Topic 842 standard.[16]

Market Impact

Both FASB and IASB considered the effects that changes in lease accounting guidance would have on the lease market (e.g., cost of borrowing and debt covenants, noting that a company's financial commitments will be the same regardless of the change in accounting guidance). On balance, FASB and IASB estimate that many companies will benefit from the additional disclosures because analysts and credit rating agencies often overestimate a company's liabilities when they utilize common adjustment and estimation techniques to get a sense of the company's off-balance sheet lease liabilities. Further, both FASB and IASB noted studies from the United States and Europe showing that virtually all credit agreements include "frozen GAAP" or "semifrozen GAAP" clauses that protect companies from changes in accounting standards,[17] and, in any case, banks are unlikely to jeopardize a good customer relationship by calling a loan because of a technical default arising solely from an accounting standards change.

Lessor Lease Accounting

Lessor lease accounting is largely unchanged from that applied under previous GAAP Topic 840 and IAS 17. Thus the operating lease/finance lease distinction is carried forward under IFRS 16, and the operating lease/direct financing lease/sales-type lease distinction continues under Topic 842. Dissimilarities between lessor accounting treatment under Topic 842 and IFRS 16 are largely carried forward from their predecessor standards.[18] Nevertheless, IFRS 16 requires lessors to provide some additional disclosure items compared to prior guidance, including a table of lease income, information about exposure to residual asset risk and information about assets subject to operating leases. Topic 842's changes to lessor accounting primarily incorporate recent updates in revenue recognition guidance and align the lessor accounting framework with specific changes in lessee accounting guidance.

Sale and Leaseback Transactions

In a sale and leaseback transaction, a seller-lessee sells an asset to a buyer-lessor and simultaneously leases it back from the buyer-lessor. Current GAAP and IFRS requirements for sale-leaseback treatment are substantially different regarding whether an asset sale occurs and how to recognize any gain or loss on that sale in a sale-leaseback transaction. Under the new standards, a transfer should be accounted for as a sale-leaseback transaction only if it meets the requirements for "sale" accounting treatment. The result is that some sale and leaseback transactions that would previously have qualified for sale-leaseback accounting will no longer qualify. The new standards differ with respect to how much of the gain or loss on the sale can be recognized: IFRS 16 permits the seller-lessee to recognize only the amount of gain that relates to the rights retained in the underlying asset at the end of the leaseback, while Topic 842 requires the seller-lessee to account for any gain or loss on the asset consistent with the guidance that would apply to any other sale of an asset.

Subleases

Both IFRS and GAAP will require intermediate lessors to account for a head lease and a sublease as two separate contracts, applying both lessee and lessor accounting requirements. This is because an intermediate lessor's head lease obligations are generally not extinguished by the terms and conditions of the sublease. Topic 842 and IFRS 16 differ, however, in their approaches to classifying a sublease as a finance lease or an operating lease by the intermediate lessor. IFRS 16 requires evaluation of the lease by reference to the right-of-use asset arising from the head lease, whereas Topic 842 refers to the underlying asset.

Leveraged Leases

Current GAAP permits a specialized form of accounting, commonly referred to as "leveraged lease accounting," for certain leases financed with substantial non-recourse debt from a third-party financial institution and in which the lessor's net investment declines in the beginning of the term and increases thereafter. Leveraged lease accounting allows for these leases to be accounted for on a net basis (only the lessor's net investment is shown on the balance sheet and the debt is not reflected), and income is booked on the net investment (which results in a front-loaded booking of earnings). FASB decided not to retain the special accounting model for leveraged leases in its Topic 842 update. However, FASB decided to grandfather leveraged lease accounting for existing leveraged leases during the transition period.

Conclusion

Though off-balance sheet accounting treatment will no longer be an option for lessees, the other benefits of leasing (e.g., lower initial capital outlays, the transfer of obsolescence risk and certain tax benefits) are unchanged. In any case, studies reveal that off-balance sheet accounting treatment is not a primary factor for lessees choosing to lease rather than purchase assets. In fact, many lessees will benefit from disclosing formerly off-balance sheet leases because creditors and investors will be able to make decisions based on the lessee's actual lease liabilities rather than relying on crude estimates that often turn out to be overestimates. For these and other reasons, leasing remains a useful asset financing option.

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[1] Early adoption is permitted if IFRS 15, Revenue from Contracts with Customers, has been applied.

[2] ASC 840-10-25-1; IAS 17, ¶¶ 8, 20.

[3] Referred to as a "finance lease" under IAS 17.

[4] ASC 840-20-20; IAS 17, ¶ 8.

[5] IASB, Basis for Conclusions on IFRS 16, ¶ BC3(a) (2016); FASB, Background Information & Basis for Conclusions, Lease (Topic 842) (2013).

[6] ASC 840-20-30-1; IFRS 16, ¶¶ 22, 26.

[7] ASC 840-20-30-5; IFRS 16, ¶ 24(a)–(c). IFRS 16 also includes an estimate of the costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease (unless those costs are incurred to produce inventories) in the cost of the right-of-use asset. IFRS 16, ¶ 24(d).

[8] This distinction is irrelevant for purposes of IFRS 16.

[9] Unless a change in the underlying lease liability requires an updated discount rate. For example, "a change in the lease term or assessment whether the lessee will exercise an option to purchase the underlying asset, a change in the amounts probable of being unwed by the lessee under a residual value guarantee, or a change in the lease payments resulting from the resolutions of a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based." ASC 842-20-35-5.

[10] ASC 842-20-35-3.

[11] Topic 842 further requires lessees to present finance lease right-of-use assets and operating lease right-of-use assets separately from each other and to present finance lease liabilities separately.

[12] Defined as a portfolio with an equal number of leases starting and ending in any one period with identical terms and conditions.

[13] Under GAAP.

[14] GAAP finance leases only.

[15] GAAP finance leases only.

[16] IFRS 16 does not mandate qualitative disclosures but rather sets out objectives and requires companies to determine the information that would satisfy those objectives.

[17] Such clauses state that a change in a lessee's financial ratios resulting solely from changes in accounting guidance either (1) will not constitute a default or (2) will require both parties to negotiate in good faith when a technical default occurs as a result of a change in accounting standards.

[18] For example, IFRS 16 (like IAS 17) does not distinguish between sale-type leases and direct financing leases and thus permits recognition of selling profit on direct financing leases at lease commencement, whereas Topic 842 (like Topic 840) prohibits selling profit recognition at lease commencement on direct financing leases and requires any selling profit at lease commencement to be deferred and recognized as additional interest income over the lease term.

PK AirFinance v. Alpstream: Did the Court of Appeal Hit the Mark on Mortgagees' Duties?

On 21 December 2015, the Court of Appeal delivered its judgment on the appeal by PK AirFinance and GECAS against the decision of the Commercial Court in *Alpstream v. PK AirFinance*,[1] and the judgement provides a welcome clarification of duties owed by mortgagees for financiers and lessors.

The brief facts of the case were set out in our article "Lessons for Financiers and Lessons from *Alpstream v. PK AirFinance:*[2]"

> Alpstream [and Betastream] 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

The Commercial Court originally found in Alphastream's favor-finding that the elements of the tort had been made out:

- PK and GECAS had caused economic loss to Alphastream and had conspired to cause such loss;
- this loss had been caused by PK's wilful misconduct in that it had breached its duty as mortgagee to Alphastream when it failed to arrange for the sale of the Aircraft appropriately; and
- PK and GECAS had met the necessary intention element—they had intended to cause harm.

The Court of Appeal's judgement[3] wholeheartedly rejected this. Taking each element in turn:

No Economic Loss

To date, the Caelus Aircraft continue to be owned in the original structure, operating on lease, and Alphastream's equity interest in the Caelus Aircraft (even if eroded by sale of the Aircraft at an undervalue, as Alphastream alleged) persists—any economic loss is contingent only on the Caelus Aircraft being sold and the proceeds of sale being realised. The Court of Appeal noted that "*such a loss is not actionable prior to the occurrence of the relevant contingency.*"[4] The Commercial Court's calculation of a loss based on the hypothesis of a notional sale of the Caelus Aircraft in May 2010 was incorrect and should not have formed the basis for an award of damages. The Court of Appeal further noted that even if the Commercial Court had been correct, the relevant amount should have been added to the mortgage account, payable through the waterfall, instead of being paid as damages.

No Breach of Duty

In the first-instance decision, the Commercial Court held that PK, as mortgagee, owed a duty to obtain the best price reasonably obtainable in the circumstances for the Aircraft to Alphastream, as the party that held an interest in the residual of the cross-collateralised equity in the Caelus Aircraft. The Commercial Court held that PK and GECAS eroded the value of this interest by agreeing to set a level for the purchase price that PK would bid at the auction of the Aircraft. The Court of Appeal confirmed that this is not correct.

The Court of Appeal ruled that whilst Alphastream might foreseeably suffer a loss if the Aircraft were sold too cheaply, it had no interest in the Aircraft. Alphastream is the creditor of the owner of the Caelus Aircraft, in which it has no interest whatsoever, being an unsecured, subordinated lender and a possible recipient of the residue at the end of the waterfall of any proceeds of any sale of the Caelus Aircraft. Accordingly, PK owed no such duty to Alphastream:

"To extend the duty of PK as mortgagee of the [Aircraft] to Alphastream in its capacity as junior lender or possible recipient of the residue of the [waterfall for the Caelus Aircraft] would involve a departure from established authority which I do not believe to be justified."[5]

It is also of note that the Court of Appeal confirmed that the duties owed as mortgagee are equitable (and that such duties have not been subsumed into the tort of negligence) and that such duties may be modified by agreement.[6] The terms of the transaction documents were such that Alphastream was not to receive any payment under the waterfall until PK had been fully repaid—and "*equity should not recognise a duty in favour of Alphastream […which would…] confound the arrangements as to priority which the parties, including Alphastream, agreed."*[7]

The Commercial Court had held that the manner in which the auction was held was flawed and that PK had not taken reasonable precautions to obtain the best price reasonably obtainable at the time of sale, therefore breaching its duty as mortgagee. Again, the Court of Appeal decided that this was incorrect.

Instead, the Court of Appeal held that "*an auction sale conducted perfectly would not have produced any more from a third party than $146.8m*"[8] (being the price that PK paid for the Aircraft). The decision of the Commercial Court appears to have indicated that the only way that PK could have satisfied its duty as mortgagee was to purchase the Aircraft at the price indicated by an independent valuation, on the basis that GECAS was a "special" or "uncommonly motivated" purchaser—the Court of Appeal confirmed that this was not correct:

"I do not regard PK, which was under no duty to purchase at all, as having been under any duty […] to pay more than it was in fact prepared to pay."[9]

The decision confirms that, on the basis of the evidence, GECAS was not a "special" or "uncommonly motivated" purchaser—the $146.8m figure PK bid was <u>the</u> amount that it was willing to pay for the Aircraft. Additionally, GECAS' dealings with PK, and with JetBlue, indicated that it knew that a third party might outbid PK and that the Aircraft might not be obtained for lease to JetBlue; the Court had already found that "the undisputed evidence was that PK would not have paid any more than it did even though that might mean that others might acquire the [Aircraft]."[10] Accordingly, the Commercial Court's special-purchaser analysis was unsound, and the price PK bid was the best price reasonably obtainable at the time of the sale—no breach of duty as mortgagee could have occurred (even if such a duty had been owed to Alphastream).

No Intention to Cause Harm

Finally, in determining that the intention element had not been met, the Court of Appeal found that *"in circumstances where PK bid or pay more than the aircraft were worth at auction, it seems to me impossible to infer […] (a) that PK knew that its failure to bid or pay more than it did was unlawful, or was reckless as to whether that was so, or (b) that it intended to cause the Borrowers or Alphastream loss or acted deliberately knowing that it would cause them loss."*[11]

Sale to Self

As a cross-appeal, Alpstream argued that the sale of the Aircraft was void on the basis of it being a "sale to self," something both the Commercial Court and the Court of Appeal have rejected—the Court of Appeal held that the sale from Alpstream and Betastream, as owners of the Aircraft (the **Borrowers**), to Wells Fargo (to whom title to the Aircraft had been transferred, as owner trustee, prior to the auction) and then on to PK was not grounds for the transaction to be set aside.

The arrangement did, however, "*give rise to a conflict of interest and duty. That conflict is addressed by the imposition of the reverse burden of proof, which […] was sufficient protection for the claimants. […] there is no good reason to apply or expand the self-dealing rule to the facts of a case such as the present, particularly in light of the common practice in the aircraft industry for a non-recourse secured lender to bid in order to protect the value of his security.*"[12]

PK relied on two further grounds as to why the "sale to self" rule could not apply:

- where there is a sale by a mortgagee which is invalid as a "sale to self," there is authority[13] that a subsequent sale by the mortgagee to a third party is effective; and
- the auction process affirmed the "sale to self," as PK reserved the right to bid in the auction notice and there were no objections.

The Court of Appeal held that the first ground applied in the current case, given the sale from Alpstream and Betastream to Wells Fargo and on to PK; but that the second ground was not applicable, as no such "affirmation" could validate a "sale to self"—a "sale to self" is no sale at all.

Independent Valuation

The Commercial Court placed significant weight on the fact that no independent valuation had been obtained for the Aircraft ahead of the auction, and it awarded damages on the basis of a valuation the judge believed would have resulted had an independent valuation been obtained.[14] The Court of Appeal decided that this valuation was irrelevant for the purposes of the purchase of the Aircraft—"*the only candidate as a purchaser in May 2010 prepared to pay anywhere near [the judge's valuation] i.e., PK would not have been prepared to pay that price for the Aircraft.*"[15] While an independent valuation may act as a guide to a mortgagee of the price that may be obtainable, in this context it was not necessary and should not have formed the basis of the judge's calculation of damages.

Wilful Misconduct

The Commercial Court found that PK had exercised its duties as a mortgagee in a manner that constituted wilful misconduct because of its conduct in the repossession and sale process. Pursuant to the underlying finance documents, PK's liability was limited to situations in which its actions involved gross negligence or wilful misconduct. This limitation of liability extended to its liability not only to the Borrowers but also to Alphastream; the Commercial Court found that the scope of PK's liability to Alphastream could not be wider than the scope of PK's liability to the Borrowers, simply because Alphastream was not a party to such underlying finance documents.

The Court of Appeal found that the judge's analysis was incorrect—whilst PK and GECAS may have engaged in the conduct identified by the Commercial Court, what mattered was whether PK engaged in wilful misconduct in relation to its duty to obtain the best price reasonably obtainable at the time of sale. The failure to obtain such a price was the basis of Alphastream's claim for economic loss, and this was not proved—the Court of Appeal determined that PK paid considerably more than the Aircraft were worth to a third party at a properly conducted auction.

Timing and Conduct of the Auction

The Court of Appeal confirmed that whilst a mortgagee who exercises his power of sale, in connection with enforcement of its mortgage interest, owes the mortgagor a duty to take reasonable care to obtain the best price reasonably obtainable at the date of sale, it is for the mortgagee "*to decide whether and when* *to sell, by reference to [its] own interests, even if the timing is unpropitious [and] that the mortgagee does not owe the mortgagor any duty of care in his choice of time."*[16]

The Court of Appeal also confirmed that, subject to anything to the contrary set out in the relevant mortgage deed, the mortgagee may decide whether a sale should be conducted by auction or private treaty and that the decision between the two involves "*an exercise in informed judgement such that in exercising the power of sale a prudent mortgagee will take advice including, where appropriate, valuation advice.*"[17]

The first-instance judge was quite critical of the manner in which the auction was conducted by PK and opined that this amounted to a breach of PK's duty in the conduct of the auction. The Court of Appeal found that it was open to the judge to find that the duty had been breached in light of some of the conduct but that the judge had erred in stating that the auction was simply *"no more than, a method of obtaining ownership [and that it was, rather,] also a method of obtaining value."*[18] In any event, such conclusions were of no value to Alphastream, as its losses stemmed from the purported failure to obtain an independent valuation of the Aircraft and a purchase of the Aircraft at the value determined pursuant to that independent valuation, something that the Court of Appeal determined that PK, as mortgagee, was under no duty to do.

Tort of Procurement

Alphastream also sought to claim that GECAS had caused PK to breach its duties as mortgagee. The Court of Appeal considered whether the relevant elements of the "tort of procurement" had been made out:

- that there existed a right (here, the right to fulfilment of the duties of mortgagee by PK);
- that such right was breached;
- that there was knowledge of that right and intention to interfere with it;
- that there was direct and unjustifiable interference with that right; and
- that there was resultant damage from the breach of that right.[19]

For the reasons set out above, in relation to the tort of unlawful means conspiracy, the Court of Appeal established that PK owed no duty to Alphastream, that no such duty was breached and that there was no economic loss—the first, second and last elements of the tort of procurement were not established.

The Court of Appeal also found that whilst GECAS knew that PK owed duties to the Borrowers, this does not "*show that it had actual or blind knowledge"*[20] that PK might owe duties to Alphastream or a company in its position. Additionally, the judgement notes that several hours of contentious argument had been held into whether PK owed Alphastream a duty and that it did not seem *"realistic to say that GECAS knew or was recklessly indifferent to whether PK owed such a duty."*[21] Further, even if the judge was correct about the independent valuation, there was no evidence that GECAS knew that "*PK should not have bought at auction at all save in accordance with an independent valuation (plus a bit because they were a special purchaser) and at a price greater than that to be obtained from any third party at any auction."*[22]

Finally, as PK could have been liable to Alphastream (as a matter of primary liability) only if it had engaged in wilful misconduct in accordance with the terms of the mortgage deed, which the Court of Appeal had determined it had not, GECAS could not be secondarily liable, as PK was not primarily liable.[23]

Conclusion

Each of the conclusions in our article on the first-instance case holds true for prudent financiers and should be reviewed by financiers approaching any default scenario.[24]

- Mortgagees owe increased duties to mortgagors when there are connected sales;
- Mortgagees need to be aware of the reversal of the burden of proof in the context of a connected sale to a connected person;

- Auctions must be run in a fashion that achieves the best price reasonably obtainable in the circumstances;
- Limiting claims to "wilful misconduct" in finance documents may serve to limit claims from third parties under the economic torts; and
- Mortgagees may arrange for maintenance work to put an aircraft into the redelivery condition required under the underlying lease documents (even if such work does not "add value") and work that is reasonable in the context of onward leasing of the aircraft.

In addition, four further points are worth outlining as useful confirmations:

- Mortgagees do not owe duties to third parties that have no actual interest in the mortgaged property;
- Mortgagees can choose the timing of the exercise of their power of sale;
- Mortgagees can, subject to any provision to the contrary in the relevant mortgage deed (or any other applicable transaction document), decide whether to exercise their power of sale by way of auction or by way of private treaty, but that decision should be an exercise in informed judgement; and
- Mortgagees must show that they obtained the best price reasonably obtainable at the time of sale, but they are under no obligation to pay more than the market price at that time.

It should be noted that the determinations of the court that no duty as mortgagee was owed to Alphastream and that it had suffered no loss, and that the sale to PK was not a "sale to self," are the primary determinations of the case. The rulings on independent valuations and wilful misconduct, the timing and conduct of the auction and the tort of procurement, as well as other matters not discussed in this article in full, may be viewed as *obiter dicta* that a future court is not bound to follow because the Court of Appeal did not need to give judgement on these matters. That said, the rulings provide a useful guide to mortgagees and may be persuasive in any future case relating to a mortgagee's duties.

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1 *Alpstream AG and others v. PK AirFinance S.à r.l. and another* [2013] EWHC 2370 (Comm)

2 http://www.vedderprice.com/lessons-for-financiers-lessors-alpstream-pk-airfinance/

3 *PK AirFinance S.à r.l. and another v. Alpstream AG and others [2015]* EWCA Civ 1318

4 Para. 160, Ibid.

5 Para. 128, Ibid.

6 Para. 121, Ibid.

7 Para. 129, Ibid.

8 Para. 245, Ibid.

9 Para. 247, Ibid.

10 Para. 206, Ibid.

11 Para. 256, Ibid.

12 Para. 82, Ibid.

13 *Henderson v. Astwood* [1894] AC 165

14 The judgement indicates that the value GECAS' Mr. Beaubron calculated of $171.5m pursuant to GECAS' SAFE system was a SAFE calculation of market price and suggests that GECAS may have conducted something akin to an independent valuation itself, paras. 191 to 194, *PK AirFinance S.à r.l. and another v. Alpstream AG and others* [2015] EWCA Civ 1318

15 Para. 249, Ibid.

16 Para. 198, Ibid. cf. *Silven Properties Ltd. v. RBS* [2004] 1 WLR 997 [14] and *Tse Kwong Lam v. Wong Chit Sen* [1983] 1 WLR 1349, 1355B

17 Para. 199, Ibid. cf. *Michael v. Mille*r [2004] EWCA Civ 282

18 Para. 308, Ibid.

19 Clerk & Lindsell on Torts, 21st Ed. 24-03 – it should be noted that the so-called "tort of procurement" is broken into separate torts, including the tort in *Quinn v. Leathem* and torts involving the breach of a statutory duty owed to another, by some commentators.

20 Para. 318, *PK AirFinance S.à r.l. and another v. Alpstream AG* and others [2015] EWCA Civ 1318

21 Para. 319, Ibid.

22 Para. 335, Ibid.

23 Para. 338, Ibid. cf. *OBG Ltd. v Allan* [2008] AC 1 [8], [44]

24 It should be noted that the Court of Appeal, contrary to our first bullet point, found that only reasonable endeavours were required in the present case.

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