Global Transportation Finance Newsletter

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In This Issue

The Evolving Nature of Private Debt in Aircraft Finance in the United States

Aircraft finance is reliant on both debt and equity markets for the raising of capital. The debt component consists largely of two markets: the public and the private. The public debt markets relate, primarily, to securities issued in the form of enhanced equipment trust certificates (EETCs), which are securities issued by individual airlines to finance the aircraft in their fleets, and to asset-backed securities (ABS) issued by operating lessors to finance their aircraft portfolios with multiple airlines on either a collateralized lease or collateralized debt basis (CLOs and CDOs, respectively). These publicly traded debt obligations are issued as securities, usually with a rating, and are typically acquired by institutional investors (insurance companies, pension funds, etc.). The private debt markets, on the other hand, while also financing airline fleets and lessor portfolios, are typically financed by commercial banks as loans (not securities). This private market also features other investors who acquire aircraft-secured debt on a private placement basis, in transactions that avoid registration under the securities laws. This article will examine the evolution of the private sector of the debt market, looking at the time period this author has been engaged in the aircraft finance markets.

As an initial observation, aircraft finance is a form of asset-based financing, relying on a type of collateral—aircraft—the value of which has historically performed within anticipated ranges. The usefulness of collateral, of course, is dependent on the ability of the financier to access it, and realize upon its value, in a default situation. In light of U.S. bankruptcy laws, primarily Section 1110 of

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Vedder Price Singapore Welcomes Global Transportation Finance Partner Bill Gibson

Bill Gibson

Our team expands in Southeast Asia with the addition of Global Transportation Finance Partner, Bill Gibson, in our Singapore office. Mr. Gibson advises financiers, lessors and airlines in connection with leasing and financing of commercial and corporate aircraft, as well as a broad range of financings involving various asset types and portfolios of equipment.

Vedder Price London Welcomes Global Transportation Finance Partner Dylan Potter

Dylan Potter

Dylan Potter has joined the Firm's London office as a Partner on the Global Transportation Finance team. Mr. Potter advises on a broad range of financing, leasing, capital markets and fund products involving commercial and corporate aviation, shipping, satellites, utilities and industrial equipment.

the U.S. Bankruptcy Code, there has been the well-founded view that the inherent value in aircraft collateral taken with a U.S. airline can be realized upon when that airline debtor cannot repay its aircraft-secured loans. Accordingly, financiers have looked favorably on aircraft finance in the United States as a tempting, relatively safe, market in which to participate.

When I started practicing law in 1983, aircraft finance in the United States was dominated by three pockets of debt providers: U.S. money center banks, Japanese banks and insurance companies. The likes of Citibank, Chase Manhattan, Bankers Trust and Chemical Bank dominated the commercial bank markets. These banks would be in the forefront of extending credit to airline borrowers; it should be noted that in those years the operating lessors were a much smaller part of the market, and were dominated by GECAS and ILFC, neither of which required third-party financing. The Japanese banks of this era likewise took a prominent position in the financing of commercial aircraft in the United States. The likes of Mitsubishi Trust (MTBC), Sumitomo Trust, Yasuda Bank and Sumitomo Bank were very active. These banks were known to lend at low margins and for very long tenors. Finally, the insurance companies taking part in this market were a rather disparate source of financing. They bought aircraft-secured debt as private placement of securities. The primary leaders of this sector included Teachers, Prudential, John Hancock and MetLife, but the sector also included a very large variety of smaller insurance companies with names like The Woodmen.

In the early-mid ‘90s, the landscape changed. U.S. money center banks lost interest in lending, focusing more on fee income. The Japanese banks were largely priced out of this market because their cost of funding sky-rocketed with the turmoil in the Asian markets. This turmoil resulted in what was called the “Japanese premium” – a premium which was the added cost to Japanese banks to fund their deals. As for the insurance companies, they bowed out of this market completely due to newly enacted requirements that their investments needed to be rated by a nationally recognized rating agency. Into this vacuum poured the European banks.

The European banks were a rather diverse lot. There were the German banks, dominated by the “landesbanks” (state-owned banks), which included Schleswig-Holstein, Bayerische, NordLB, Hamburgische, Helaba, WestLB, Sachsen, Bremer, Berliner, Rheinland-Pfalz and Saar. In addition to these landesbanks, German commercial banks also took part, including Deutsche Bank, Commerzbank, Dresdner, DVB, KfW and HVB. In France, market participants included Société Générale, Paribas, Crédit Lyonnais, Crédit Agricole and Natixis. There were Dutch banks participating such as ING, ABN AMRO, NIB, Fortis, Rabobank and MeesPierson. There were also English banks such

Recent Accolades

Dean N. Gerber – 10th year for Equipment Finance Law and Securitization and Structured Finance Law

John E. Bradley – 10th year for Admiralty and Maritime Law

Francis X. Nolan, III – 5th year for Admiralty and Maritime Law

Ronald Scheinberg – 10th year for Equipment Finance Law

Jeffrey T. Veber – 5th year for Equipment Finance Law

Thomas A. Zimmer – 10th year for Corporate Law

Edward K. Gross – 10th year for Equipment Finance Law

Euromoney’s Aviation Expert Guide 2017 has included Attorneys **Mark J. Ditto, Michael E. Draz, Christopher A. Setteducati** and **Clay C. Thomas** in their Rising Stars Guide.

Chambers High Net Worth: Private Aircraft Guide ranks Vedder Price Band 1. Individual Shareholders **Edward K. Gross** (Band 1), **Derek Watson** (Band 1) and **David M. Hernandez** (Band 2) are recognized as leading lawyers for private aircraft and wealth management in key jurisdictions around the world.

as Halifax, Royal Bank of Scotland, Bank of Scotland, NatWest, Barclays and Alliance & Leicester participating in this sector. Finally, there were banks from Italy (Intesa), Switzerland (Credit Suisse) and Austria (Erste).

By reason of this plethora of participants and the resulting competition for business, airlines (and, increasingly, operating lessors) were able to drive margins down from these banks. As well, there was some consolidation of banks during this period, with the following institutions being merger partners: Halifax and Bank of Scotland, Landesbank Schleswig-Holstein and Hamburgische Landesbank (resulting in HSH Nordbank) and Crédit Lyonnais and Crédit Agricole (resulting in CACIB), among others.

The next shake-out of the bank market in the aircraft finance sector took place in the aftermath of the Lehman Brothers-triggered market meltdown of 2007/2008. This development resulted in the loss to the market of a large number of the European banks. No longer were any English or Dutch banks participating in the market, and a number of the French and German banks withdrew from this market as well. Particularly hit hard were the German landesbanks, which were major investors in (housing) mortgage-backed securities – a market that suffered catastrophic losses. Many of these banks were forced to drop out of the aircraft finance market as a quid pro quo to taking state aid for a government bail-out (the German states directed a number of these landesbanks to restrict their activities to local markets). Also, their funding costs skyrocketed and they were priced out of the market (sound familiar?).

In the immediate aftermath of Lehman, then, just a handful of French banks and German banks remained committed to the aircraft finance sector. The French banks included BNP, CACIB and Natixis (and, to a lesser extent, CIC) and the German banks included DVB, NordLB, Heleba, KfW and Deutsche Bank. With fewer bank participants, margins did improve for these banks (although, in many instances, these better margins were necessary to cover increased funding costs). In addition, many of the banks that were compelled to exit the aircraft finance sector post-Lehman were forced to sell their aircraft finance portfolios, while others of the exiting banks simply managed down their portfolios (writing no new business).

The Lehman debacle is now almost a decade behind us. Since the resulting shake-out of the bank market triggered by that event, the number of participants in this market has increased substantially. In addition to the post-Lehman "survivors" named above, Citibank and Wells Fargo Bank, U.S. "money center" banks, are playing an increasing role as well as DekaBank (German), ING (Dutch), CBA (Australian) and Sabadell (Spanish). Also making a significant foray into this market are Japanese

Speaking Engagements

October 8-9

National Business Aviation Association 2017 Tax, Regulatory & Risk Management Conference, Las Vegas

Shareholder David M. Hernandez will co-present in the session, "From Corporate Reorganizations to New Regulations: Managing Change in Your Flight Operation," using real-world client experiences and case studies.

September 19-20

16th Annual Marine Money Week Asia Conference, Singapore

Shareholder Ji Woon Kim moderated the panel, "Alternative Finance - Leasing," in which panelists discussed what deals can be done and what terms are available for lease finance in shipping.

June 27-28

Corporate Jet Investor's UK School of Corporate Jet Finance 2017, Surrey

Partner Derek Watson participated in the session "The Tri-Partite Agreement Followed by Case Study," Shareholder Edward K. Gross presented in the session, "Debt Finance," and David M. Hernandez presented in three different sessions, "Key Legal Aspects of the Sales Process," "Negotiating an LOI," and "Managing Risks: What Can Go Wrong?"

banks (welcome back!) such as DBJ, Norinchukin, MUFG and Tokyo Star. There is also an expectation that other Asian banks, from China, Taiwan and Korea, will soon be increasing their participation in the aircraft finance sector. Finally, we are seeing increasing participation by certain segments of the U.S. insurance company market, such as New York Life and Mass Mutual, which have figured out a way to get a satisfactory rating on privately structured transactions.

The conclusion I would draw from this ever-evolving market for private debt in the U.S. aircraft finance sector is this: aircraft finance has historically been a rather safe investment. This relatively low-risk lending environment naturally draws in investors. The ebb and flow of market participants, then, is not the result of losses in this sector, but rather macroeconomic developments well beyond the aircraft finance market. Stay tuned!

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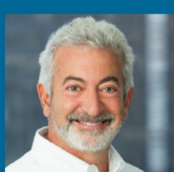

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Necessary Regulation or the UK Government Droning On?

Perhaps as a result of increased publicity in relation to reports of "near miss" events near UK airports, the UK Government opened a public consultation in relation to the safe use of unmanned aircraft systems (known commonly as "drones") in the UK in early 2017. On 22 July 2017, the UK's Department for Transport (the DfT) published their response to the consultation in a paper entitled "Unlocking the UK's High Tech Economy: Consultation on the Safe Use of Drones in the UK."[1]

The paper notes that the multi-billion dollar market is expanding, and will continue to do so; Goldman Sachs believes that spending on drones in construction, agriculture, insurance and infrastructure inspection will total US$20bn in the period 2016 to 2020, with retail and consumer sales of 7.8mn drones globally. PwC predicts that the drone application market will be worth more than US$100bn by 2025.[2] It is clear that the DfT wants the UK to be at the forefront of the drone industry, a world-leading research and development centre – in this context, the UK Government's stated aim is to develop regulatory measures in "a way that they do not raise barriers to the sector's success and the UK realising maximum benefits."[3]

Whilst the overall aim may be to ensure the UK is well placed within the sector, the paper is clear that the UK Government recognises that the misuse of drones (whether unintentional, reckless or malicious) poses challenges to safety, security and privacy.[4]

A study by the DfT, the Military Aviation Authority and the British Airline Pilots' Association, testing and modelling drone impact, showed that very small drones (400g) can pose a critical risk to the windscreens and tail rotors of helicopters. For commercial aircraft, the test results reported by the study were more reassuring to stakeholders—only a much heavier drone of more than 2kg in weight would cause critical damage and, even then, only when aircraft fly at higher speeds; usually outside the range of most drone operations.[5]

Over 650 stakeholders responded, from aircraft pilots to insurance companies and the DfT has concluded that:

- they will require all users of drones of 250g and above to register themselves and their drones and the UK Government will work with stakeholders to embed electronic identification and tracking capability within any registration scheme they establish; and
- they will require mandatory competency testing (i.e. online tests) for all leisure users, with the aim to ensure that all users have a basic knowledge of the law relating to drones and how to fly them safely.[6]

The DfT is also exploring:

- tightening the rules on where certain classes of drones may be flown – the proposal considers that all drones of 7kg or less should be banned above 400ft;[7]
- options to increase certain of the penalties available to the courts where the law in relation to drone operations have been broken – this may include increasing the penalty for operation of a drone within 150m of a large crowd (without a related exemption from the prohibition from the CAA), and the penalty for breaching an airspace exemption, to over £2,500 where the applicable court felt the offence warranted a more severe penalty;[8]
- complete bans for operations of drones where close to an airport; and
- the powers granted to law enforcement agencies in relation to drones—
this may include new powers (i) requiring the production of registration and identification documents, (ii) forcing a drone to land and

Thought Leadership

Getting the Deal Through has published "Aviation Finance & Leasing 2017," which includes "Aircraft operating leases – New York law or English law?", an article co-authored by Shareholders Thomas A. Zimmer and Neil Poland, and a jurisdictional chapter on U.S. law co-authored by Thomas A. Zimmer and Associate, Laura Bond.

Getting the Deal Through has published its annual report, Q&A, Marshall Islands, written by Shareholder Francis X. Nolan, III, providing international analysis in key areas of law and policy including vessel due diligence under Marshall Islands law, repayment, registration of vessels, ship mortgages and other liens over vessels, tax considerations for vessel owners and much more.

Shareholder Edward K. Gross recently co-authored "Leases" in the Fall 2017 edition of *The Business Lawyer*. The survey covers a number of cases in 2016 involving disputes between parties to equipment financing transactions or with third parties regarding the lease financing or related equipment.

California Aviation Professional Speaker Series

Vedder Price hosted the Fall **California Aviation Professionals Speaker Series** on September 12th at the Embarcadero Conference Center in San Francisco. Over 50 guests attended panel discussions on current opportunities and challenges facing boutique aircraft and engine lessors.

(iii) to search for and seize a drone where there is a reasonable belief that a crime is about to be committed or has taken place.[9]

The paper also considered how the implementation of no-fly zones might be best achieved with a focus on providing more information on restrictions and potential technological innovations. Rather than singling out one solution, the paper notes that the UK Government intends to both increase the information available (and notes that new signage has been developed and its use is to be encouraged at national infrastructure sites) as well as working with stakeholders to develop electronic solutions, including in-app geo-fencing.[10]

Additionally, the DfT pledges to work with CAA to support commercial users by:

- updating the Air Navigation Order 2016 to reflect the needs of a growing market;[11]
- supporting the CAA in increasing the efficiency and effectiveness of its permissions processes; and
- setting up a joint CAA/DfT working group to work with the insurance sector and the drone industry to improve the insurance regime surrounding drones.

Looking to the future, the paper states that the UK Government will work to develop an unmanned air traffic management system (i.e. a management system for drones) and will bring forward work to create an authoritative source of airspace data for the UK. It is hoped that this will facilitate geo-fencing for drones and help to build a greater awareness for users of airspace restrictions.

Several commercial respondents to the consultation commented that developing new traffic management systems would aid the emergence of safe and reliable operations that could fly beyond visual line of sight (BVLOS)—an aim of some commercial operators, necessary for viable operations of their businesses.[12]

Conclusion

Both in the consultation and the response, it is clear that the UK Government's focus is on ensuring safety—particularly arising from operational issues in the leisure market; but the response also provides insight into the direction of the UK Government's policy as it affects commercial operators—a determination to develop world-class systems which may, in time, help commercial operators operate in a geo-fenced, BVLOS system.

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1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/631638/unlocking-the-uks-high-tech-economy-consultation-on-the-safe-use-of-drones-in-the-uk-government-response.pdf

2 Para. 2.1.

3 Para. 2.10.

4 Para. 3.11.

5 Para. 3.13.

6 It should be noted that UK commercial users already have standards that must be met.

7 Para. 3.24. It should be noted that heavier drones are already banned over this height.

8 Para. 3.23.

9 Para. 3.24.

10 Para. 3.27. Geo-fencing is the creation of a virtual or digital perimeter for a real-world geographic area.

11 It should be noted that the Order will likely need to be updated to reflect anticipated EU legislation on drones expected next year, in any event.

12 Para 3.44.

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Global Transportation Finance

The Vedder Price Global Transportation Finance team is one of the largest, most experienced and best recognized transportation finance practices in the world. Our professionals serve a broad base of clients across all transportation sectors, including the aviation, aerospace, railroad and marine industries, and are positioned to serve both U.S.-based and international clients who execute deals worldwide.