

The Banking Law Journal

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Aircraft Lender Not Responsible for Customer's Structuring Strategy

*Edward K. Gross and Erich P. Dylus**

In a recent case, a guarantor of an aircraft acquisition loan argued that he should not have to pay the loan balance because, among other reasons, he relied in part upon the lender's expertise and implied advice regarding the tax structure, and it resulted in the aircraft's seizure by the Brazilian government. The authors of this article discuss the decision.

Most business aircraft purchasers, especially high net worth individuals, rely on advice from their various resources when acquiring such expensive assets. Those resources typically include brokers, original equipment manufacturers, lawyers, accountants, pilots and, in some cases, their golfing buddies. Aside from the obvious considerations regarding the suitability of a particular aircraft for the customer's needs, customers often seek advice regarding the related economic considerations including the price, resale value, operational cost, financing terms and pertinent tax implications. Although the tax considerations for U.S. customers could include how to optimize any unique income tax benefits available to aircraft owners, customers often seek advice on how to minimize any related taxes, duties, import or other governmental charges or impositions.

1ST SOURCE BANK v. NETO

In a recent case, *1st Source Bank v. Neto*,¹ a guarantor of an aircraft acquisition loan argued that he should not have to pay the loan balance because, among other reasons, he relied in part upon the lender's expertise and implied advice regarding the tax structure, and it resulted in the aircraft's seizure by the Brazilian government. As discussed below, the lender ultimately prevailed, but the case should serve as an important reminder to lenders, lessors and other financing providers that they should refrain from providing, or even appearing to provide, structural advice to their customers beyond financing.

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¹ *1st Source Bank v. Neto*, No. 3:15-CV-261-JD (N.D. Ind. Jan. 25, 2018).

The guarantor in this case, Joaquim Neto (a Brazilian citizen) used a Non-Citizen Trust (“NCT”) to purchase a Dassault Falcon 2000 aircraft and register it with the U.S. Federal Aviation Administration (“FAA”),² although he planned to primarily hangar and operate the Aircraft in Brazil.³ Neto entered into a grantor trust agreement in 2009 with Wells Fargo, as owner trustee (the “Owner Trustee”), for the purpose of establishing the NCT, and as trustor Neto directed the Owner Trustee to purchase the aircraft and register it with the FAA in that capacity. In 2011, Neto sought financing for the aircraft from 1st Source Bank (the “Bank”), and after counter-signing a letter of intent (“LOI”) from the Bank offering to make a \$6 million loan, he directed the Owner Trustee to enter into a loan and security agreement and other loan documents evidencing the obligation to repay the loan and pledge of the aircraft as collateral to secure that repayment. Neto guaranteed the loan obligations by entering into a guaranty in favor of the Bank.

Unfortunately for Neto, the aircraft was confiscated in 2012 by the Brazilian government while they investigated Neto’s alleged import tax evasion. Neto asserted that he failed to pay any such taxes because he believed that no import taxes would be imposed despite his hangaring and operating the FAA-registered aircraft in Brazil. Neto continued making the loan payments for several months after the confiscation, but stopped paying in September of 2014, and the Bank accelerated the loan balance and sought to enforce its repossession, collection and other remedies under the loan documents.

The Bank was unable to foreclose on the aircraft while in the custody of the Brazilian government so it pursued a casualty claim as loss payee under the insurance policy required under the loan documents, and the insurer remitted the loss proceeds to the Bank. The casualty insurance proceeds received by the Bank were less than the outstanding loan balance. The Bank then sued the Owner Trustee, as borrower, and Neto, as guarantor, to collect the deficiency amount. Neto and Wells Fargo asserted affirmative defenses to the Bank’s demands, alleging that it impaired the collateral and failed to mitigate its damages. The bases for these asserted defenses were that the Bank did not adequately attempt to obtain the aircraft’s release from the Brazilian government, and that it failed to mitigate its damages by accepting less than 100 percent of the loan balance due when settling its casualty policy claim. Of particular interest, Neto also counterclaimed for negligent misrepresentation by

² The use of an NCT ownership structure was necessary for FAA registration of the aircraft because Neto was not a U.S. citizen for the purposes of 14 C.F.R. § 47.2.

³ *Id.* All parties including the Bank were advised as to the aircraft’s primary usage in Brazil. *Id.*

the Bank, alleging that in extending the loan the Bank had impliedly advised Neto that registering the aircraft with the FAA pursuant to the NCT would allow Neto and the Owner Trustee to avoid paying Brazilian import taxes despite hangaring and operating the aircraft in Brazil.

The court granted summary judgment in favor of the Bank for both the recovery of the loan deficiency and other related payment obligations, and against Neto's counterclaim that the Bank had negligently misrepresented the Brazilian import tax implications. The court's holdings regarding Neto's counterclaim and defenses are discussed below.

Customer's Claim that Lender Gave (Bad) Structural Advice

This case is especially noteworthy because the customer asked the court to hold the Bank accountable for damages relating to certain structural aspects of the related transaction. The Bank had to rebut Neto's counterclaim that it negligently misrepresented the tax avoidance benefits of the NCT registration, and he relied on the Bank's advice because it held itself out as an experienced aircraft lender. The sole basis for Neto's misrepresentation claim was the Bank's statement in the LOI which read as follows: "[w]e believe these terms meet your desires as well as fall within our agreed upon credit requirements and applicable U.S. and Brazilian laws."

The court dismissed Neto's negligent misrepresentation counterclaim by holding that despite the Bank's admitted "knowledge of aircraft financing and banking, and that it offers aircraft financing through its Aviation Division of its Specialty Finance Group,"⁴ Neto and the Owner Trustee had already created the aircraft trust prior to seeking the loan and without any consultation with the Bank. Therefore, the Bank's statement in the LOI and related loan terms could not be construed as advice concerning the structure of an already-established NCT, the aircraft's FAA registration, and the related Brazilian tax implications. The court observed that Neto's counsel advised him that the NCT structure for the aircraft's ownership was legally compliant "prior to [the Bank]'s provision of financing services."⁵ The court also noted that the lender was unaware of Neto's intentions regarding the cross-border and non-business operation of the aircraft,⁶ which operation was the Brazilian government's justification for seizing the aircraft⁷ and resulted in the Bank's inability to foreclose on the aircraft.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *See id.*

Customer's Collateral Preservation Defense

The Bank also had to rebut the affirmative defense raised by Neto and the Owner Trustee that the Bank itself impaired the collateral by not adequately attempting to secure the release of the aircraft from Brazilian authorities.⁸ The court rejected Neto's collateral preservation defense by noting that it was the Owner Trustee's responsibility under the terms of the loan documents to "keep the Collateral safe and secure . . . [to] use and operate the Collateral with care and only with qualified personnel in the ordinary course of Customer's business and in conformity with all laws and regulations . . ." and [to] not 'permit [the airplane's] identity to be lost, or otherwise dispose of [the] Collateral or any interest therein . . .'"⁹ The court also noted that the defendants had not alleged that the Bank had taken any action that influenced the seizure of the aircraft, and in any event the aircraft's preservation and reclamation was the Owner Trustee's express responsibility.¹⁰ To the contrary, even though the aircraft's preservation was the Owner Trustee's responsibility, the court noted that the Bank timely notified the Brazilian government of their security interest after the aircraft's seizure, preventing the government from selling the aircraft¹¹ and further impairing its collateral remedies.

Customer's Mitigation of Damages Defense

Neto and Owner Trustee also alleged that the Bank failed to mitigate damages because the Bank settled its insurance claim for less than the full amount of the loan balance.¹² The court interpreted the loan documents to mean that the Bank had no further duty to mitigate damages beyond the insurance settlement, noting "receipt of payment by [the Bank] under the Aircraft Policy did not extinguish the debt that Defendants obligated themselves to pay . . . even if [the Bank] had obtained a full recovery under the [insurance policy]."¹³ Additionally, there was no contractual obligation for the Bank to collect from their insurer before invoking the terms of the guarantee.¹⁴ Neto executed an unconditional guarantee of the loan obligations, prompting the court to reason that under Indiana law, there is "no dispute that the unconditional guarantee that [Neto] entered into made him responsible for

⁸ *See id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *See id.*

¹³ *Id.*

¹⁴ *See id.*

payment in full of the amounts due, regardless of any settlement.” The Bank prevailed, as the court deemed the insurance settlement to be commercially reasonable, and in any event, the settlement had no impact on Neto’s unconditional guarantee to pay the loan obligations.

CONCLUSION

Lenders and other financing providers should avoid conveying the appearance of providing structural advice to their aircraft finance customers. Careful allocation by lenders to borrowers of collateral risks and responsibilities is both equitable and prudent, especially when financing aircraft and other expensive mobile assets. Due diligence before and during the loan term, and prompt and reasonable responses to adverse circumstances, are still essential to maintaining portfolio quality.