

Aircraft lease securitizations

April 13, 2020

2020 | By: **Patrick Dolan, Alexandra Howe, Deborah Stern,** and **Chana Ben-Zacharia,** Norton Rose Fulbright US LLP

This practice note explains the structure of aircraft lease securitizations and certain bankruptcy and rating agency issues that must be considered in structuring these transactions, the benefits of using the debt capital markets for aviation financing, and the issues for the aircraft lease securitization market during 2020.

COVID-19 Concerns

The recent coronavirus outbreak that began in Wuhan, China in December 2019 that causes a respiratory illness called COVID-19 has now been reported on every continent except Antarctica. The aviation sector is directly being impacted by all of the virus containment measures. As a result of governmental travel restrictions and social isolation tactics, the airlines have been compelled to reduce flights, ground aircraft, and temporarily cease operations. It is not unanticipated that many will face bankruptcy. Based on a recent ABS surveillance report, KBRA expects that from a credit standpoint global aircraft lease securitizations will suffer a hard hit. With the lack of air travel, it is no surprise that airlines are requesting rent and maintenance deferrals, which in some cases represent upwards of approximately 80% of lease revenue in some transactions. The degree to which each transaction is impacted will vary depending on the amount of payment deferrals, delinquencies, airline bankruptcies, collateral performance, strength of the servicer, and transaction structure. Without an end in sight for this pandemic, the global economic impact of such a worldwide shutdown is unknown but more severe downgrades are likely to follow.

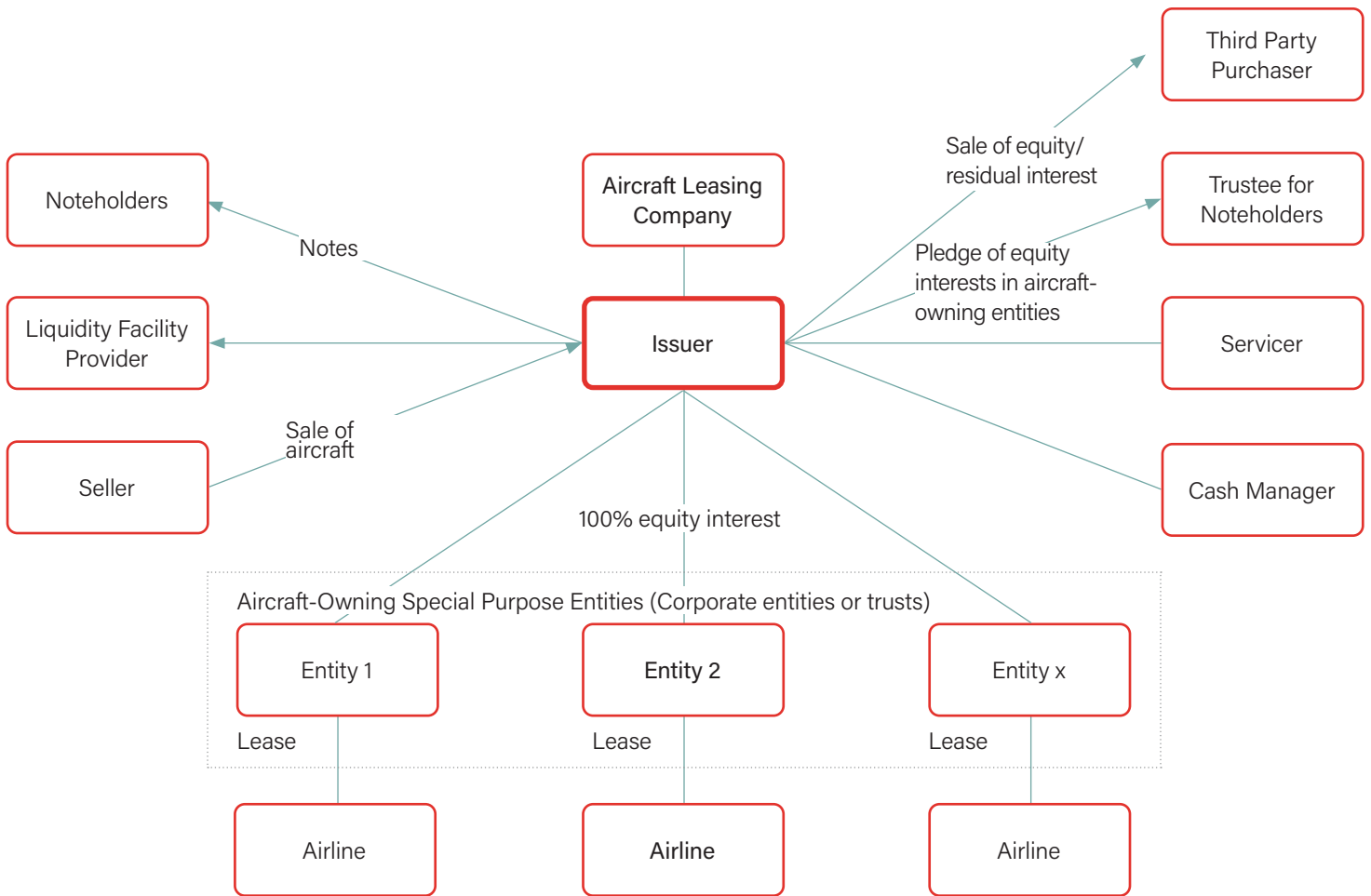
Introduction

Aircraft lease securitizations generally come in two types: aircraft lease portfolio securitizations and enhanced equipment trust certificate (EETC) securitizations.

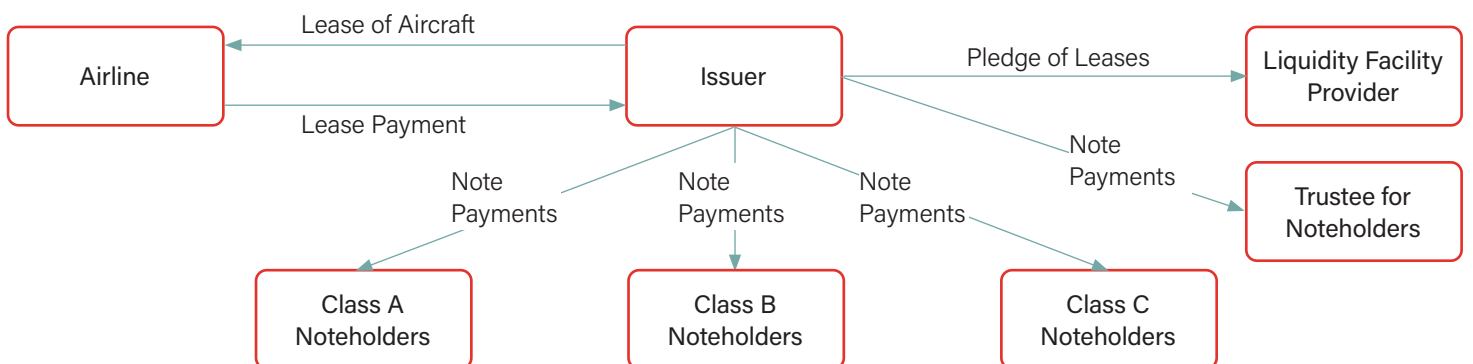
- **Asset-backed aircraft lease securitizations.** In the typical aircraft lease portfolio securitization, the issuing special purpose subsidiary of the sponsor, which is a newly formed bankruptcy-remote entity, owns the equity in various special purpose entities (SPEs) that each owns an aircraft or aircraft engine that is leased to an airline. Normally, the lessees or airlines are located in the United States and around the world. Thus, unlike an EETC aircraft lease securitization (discussed below), the aircraft lease portfolio securitizations rely in part on diversification of credit risk. Similarly, remarketing or releasing of aircraft plays a bigger role in aircraft lease portfolio securitizations so the quality of the servicer is more important.
- **Enhanced Equipment Trust Certificate aircraft lease securitizations.** In the typical EETC aircraft lease securitization, the issuing entity (issuer-lessor), which is a newly-formed bankruptcy-remote SPE and a subsidiary of the sponsor airline, owns a portfolio of aircraft and leases the aircraft to the sponsor airline. As a result, the transaction looks more like a corporate bond offering by the sponsor airline, but the sponsor airline can obtain a better rating on the EETCs than it could on its corporate bonds because of the securitization features.

Transaction Structure

The diagram below shows the structure of a typical aircraft lease portfolio securitization:



The diagram below shows the structure of a typical EETC aircraft lease securitization:



Key Features of the Transaction Structures

In both aircraft lease portfolio securitizations and EETC aircraft lease securitizations, there is a liquidity facility provided by a highly-rated bank to ensure the payment of interest during an aircraft remarketing period (up to 18 months) following a default by an airline lessee. In EETC aircraft lease securitizations involving U.S. airlines, the lessor would typically rely on [Section 1110 of the U.S. Bankruptcy Code](#) to repossess an aircraft from a bankrupt lessee. Section 1110 permits a lessor to repossess an aircraft if the bankrupt lessee does not elect to assume the lease and cure all defaults within 60 days of the bankruptcy filing.

In both types of securitizations, the lessor will typically grant possessory and security rights to a security or indenture trustee, which will represent and act on behalf of the noteholders. Following a default, the trustee will have the ability to enforce legal and contractual remedies against such rights in accordance with the relevant law and the terms and conditions of the trust indenture and the security trust agreement. The types of rights pledged to the trustee often include:

- Lessor rights under the lease, to receive rental payments directly and perform other acts reserved for the lessor, including without limitation, if there is an event of default, then the trustee shall be entitled to exercise all rights, remedies, powers and privileges of Lessor, as lessor
- Ownership rights in the aircraft, to enforce a deregistration power of attorney to take possession of and remarket or re-lease the aircraft
- Rights to any proceeds from the lessee's insurance policy relating to the aircraft, to collect such proceeds and distribute to the noteholders in an event of loss –and–
- Membership rights in the lessor itself, to take control of the lessor and act in its stead

This trustee arrangement allows for trustee companies experienced in aircraft lease securitizations to centralize the decision-making process for several noteholders and to protect the rights and interests of those noteholders without requiring them to develop industry expertise.

In an EETC aircraft lease securitization or an aircraft lease portfolio securitization involving the bankruptcy of a foreign airline, [Section 1110 of the U.S. Bankruptcy Code](#) would not be available. Instead, the lessor would have to rely on the 2001 Cape Town Convention and its Aircraft Equipment Protocol (collectively, the Cape Town Convention) discussed below in [Insolvency Issues](#). Finally, prior to the 2008 credit crisis, monoline insurance companies often provided bond insurance for bonds issued in aircraft lease securitizations. Since the credit crisis, however, aircraft lease securitizations no longer have this feature but rather rely on, among other things, over-collateralization.

The sponsor or an affiliate of the sponsor is normally the servicer in an aircraft lease securitization. In an aircraft lease portfolio securitization, it is not unusual to have two issuers of the bonds, a Delaware issuer and a Cayman Island issuer, and local law mortgages are not taken over the aircraft. Aircraft lease securitizations also often have many of the following features:

- A maintenance reserve account that is funded at closing and replenished during the course of the transaction
- Performance triggers such as aircraft utilization rate, loan-to-value ratio and debt service coverage ratio (a default of either could result in a cash sweep and/or a cash trap)
- A feature that permits the sponsor to sell a limited percentage (e.g., 10%) of the portfolio at purchase prices below the allocable debt amount for such sold aircraft
- Concentration limits on, among other things, aircraft model, engine model and jurisdiction of lessees
- A provision allowing for substitution of aircraft subject to certain conditions, for example
 - No event of default or rapid amortization event has occurred
 - The substitution occurs prior to specified anniversary of the closing date (e.g., the seventh anniversary)
 - The substitution will not result in a concentration limit being exceeded
 - The substitute aircraft has a value at least equal to the disposed aircraft and is of the same, or a newer, model –and–
 - The value of all additional aircraft does not exceed a specified percentage of the initial value of the portfolio at closing

- A provision requiring each lease to meet certain criteria (e.g., minimum term, lessees' credit rating, etc.)
- A provision requiring the issuer to enter into an interest-rate protecting hedging agreement shortly after the funds are drawn
- A provision allowing the issuer to use a portion of the lease security deposits for working capital subject to certain conditions

While in theory it is possible to have an EETC aircraft lease securitization involving a non-U.S. airline as the sponsor, these transactions are not common.

Another feature found in recent aircraft lease portfolio securitizations is the sale of the residual or equity interest (E-notes) in the transaction to third-party investors, with some E-note investors seeking a role in decision-making in areas that are typically otherwise managed independently by the servicer (e.g. timing of enforcement action and setting lease rates). Previously, this interest was retained by the sponsor.

Insolvency Issues

As noted above, in an aircraft lease portfolio securitization many of the lessees may be airlines located outside the United States and [Section 1110 of the U.S. Bankruptcy Code](#) is not available to the issuer in the securitization in this situation. The Cape Town Convention permits countries to select one of two options for dealing with airlines in bankruptcy:

- **Alternative A.** Alternative A provides that upon the occurrence of an insolvency-related event, the bankrupt debtor must give possession of an aircraft to the related creditor no later than the earlier of (1) the end of the "waiting period" and (2) the date on which the creditor would be entitled to possession of the aircraft if the Cape Town Convention did not apply. The waiting period is defined in the Cape Town Convention as the period specified in a declaration of the ratifying state/jurisdiction, which is the primary insolvency jurisdiction. States interested in achieving efficient pricing for financings and securitizations of aircraft have typically adopted a waiting period of 60 days (some states, like Brazil, have adopted a shorter period of 30 days).
- **Alternative B.** Alternative B has no outside time limit for the bankrupt airline to decide whether to assume or reject an aircraft or aircraft engine lease.

In non-Cape Town Convention countries, investors must determine what protections there are for creditors in an airline bankruptcy in the jurisdiction of the lessee.

Rating Agency Considerations

Some of the factors that a rating agency will consider in rating an aircraft lease securitization include:

- Lessee credit quality
- Country risk
- Lessee concentration
- Country concentration
- The age of the aircraft and the mix of narrow-body planes versus wide-body planes in the portfolio (wide-body planes are generally more difficult to remarket)
- The initial leases' remaining lease terms
- Whether the transaction has performance triggers (e.g., aircraft utilization rate, debt service coverage ratio) and a liquidity facility to cover interest payments during the remarketing/re-leasing of planes

The rating agencies will typically require satisfactory appraisals of the aircraft prior to closing and may also require a maintenance appraisal showing projected maintenance expenses for the aircraft portfolio being securitized.

The rating agencies will also consider the following factors:

- The loan to value ratio of the rated classes of bonds
- Whether the models of aircraft or aircraft engines in the transaction are still in production
- The servicer's experience and capabilities for servicing the aircraft (i.e., aircraft sales, re-leasing/remarketing of aircraft, etc.)
- Whether the lessees are domiciled in highly-rated countries
- Whether the maintenance reserve has a forward-looking feature
- Whether any aircraft in the portfolio is owned by an existing entity as opposed to a newly-formed bankruptcy remote special purpose entity (the concern being whether there are any existing liabilities)

In an aircraft lease securitization where the aircraft and/or aircraft engines are owned by pre-existing SPEs, as opposed to newly formed entities, the rating agencies require a recycling memorandum from the issuer's counsel. A recycling memorandum provides an overview of the recycled entities and the benefits of structuring the transaction using recycled entities, instead of newly-formed entities. Recycling memorandums detail the history of each SPE, specifically regarding past ownership, formation, age of the SPEs, previous involvement with aircraft ownership, and liabilities of the SPEs. The recycling memorandum must characterize the benefits of using recycled entities, which includes but is not limited to, mitigating the risk of triggering any transfer taxes by not transferring title to an engine or aircraft, eliminating some of the expense associated with obtaining transfer tax advice related to transferring title to the assets, minimizing the need to undertake the time consuming and expensive negotiations with lessees, and reducing the risk of deal-changing commercial negotiations and attendant strain on relationships with lessees for other elaborate local law imposed arrangements, which are key to the success of the contemplated transaction.

Lessee Considerations

In an asset-backed aircraft lease securitization, the lessees of the portfolio aircraft are likely to be based in a diverse range of countries. Though transaction structures have been simplified (e.g. to avoid the need for local security or to comply with local perfection requirements), there will inevitably be a degree of work for the sponsor in securing the cooperation of the lessees. Lessees will typically be asked to:

- Acknowledge the assignment of the lease to the security trustee in the securitization, and agree that if the security trustee notifies the lessee that the securitization financing has defaulted, the lessee will recognize the security trustee, rather than the owner, as lessor of the aircraft
- Provide updated insurance certifications, with the interests of the securitization transaction parties noted and often the designation of the security trustee as the sole loss payee of the receipt of insurance proceeds
- If the leasing is by way of a two-tier structure involving a headlease and a sublease (often driven by a lessee's tax concerns, for example, to ensure tax efficiencies that would not be available with a direct lease between the relevant SPE and the lessee) agree to a novation or assignment of the sublease, if necessary, to preserve the existing lease structure by novating or assigning both the headlease and sublease to an intermediary lessor who is either an existing grantor, or new grantor pursuant to the security trust agreement

- Provide corporate documentation and various local law documents in respect to the aircraft, such as an air operator's license, to satisfy the requirements of local counsel to issue a legal opinion in the lessee's jurisdiction in a form satisfactory to the rating agencies and the initial note purchasers

Many sponsors will, for economic reasons, be keen to complete the transfer of the portfolio aircraft into the securitization as soon as possible after it has launched. Persuading lessees to engage in a timely fashion, particularly where there may be no incentive for them to treat the matter as urgent, can be challenging. As such, a sponsor's relationship with the lessees will be key.

Lessees will often, and particularly where their lease provides that the cost will be picked up by the lessor, appoint counsel to represent them. Sophisticated lessees will be familiar with the sort of requests that are made of them. For other lessees, it will be necessary to explain the nature of the securitization transaction and the roles of the different parties, and address lessee concerns (e.g. in relation to quiet enjoyment or adding of additional insureds to the insurance certification) before the lessee will agree to cooperate.

Benefits of Using the Debt Capital Markets in Aviation Finance

There are several benefits to sponsors in accessing the U.S. debt capital markets by means of an EETC aircraft lease securitization or aircraft portfolio lease securitization. First, the capital markets may provide cheaper financing than the bank financing market, the ability to accommodate larger transactions and provide a solution to permanent financing for mid-life aircraft which can be challenging to finance. By using securitization structures, non-investment grade airlines or aircraft lessors can issue investment grade debt. Also, by accessing the capital markets, the sponsor airlines or aircraft lessors can gain exposure to new lenders and investors. Finally, the negative covenants in an aircraft securitization are generally less restrictive than those in a typical bank financing. This is in part because in a Rule 144A offering, which is how most aircraft securitizations access the U.S. capital markets, investors normally hold their securities in uncertificated form through DTC and this makes it difficult to obtain an amendment or waiver of the transaction documents after closing so the covenants must be drafted to allow for flexibility.

Risk Retention Rule

The Risk Retention Rule requires that the sponsor of any securitization transaction must retain an economic interest in the credit risk of the securitized assets. The sponsor is the person that initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. A securitization transaction is a transaction involving the offer and sale of asset-backed securities (defined below in Defined Terms) by an issuing entity. The sponsor of a securitization transaction must retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof as follows:

1. If the sponsor retains only an eligible vertical interest, the sponsor must retain an eligible vertical interest of not less than 5%.
2. If the sponsor retains only an eligible horizontal residual interest, the amount of the interest must equal at least 5% of the fair value of all ABS interests (defined below in Defined Terms) in the issuing entity issued as part of the securitization transaction, determined using a fair value measurement framework under U.S. GAAP.
3. If the sponsor retains both an eligible vertical interest and an eligible horizontal residual interest as its required risk retention, the fair value of the eligible horizontal residual interest and the eligible vertical interest must be at least 5%.

The percentage of the eligible vertical interest, the eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction. In lieu of retaining all or any part of an eligible horizontal residual interest, the sponsor may, at closing of the securitization transaction, cause to be established and funded in cash, an eligible horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof, subject to certain specified conditions. The Risk Retention Rule contains specific provisions for alternative modes of risk retention for certain asset types (e.g., commercial mortgage-backed securitizations, credit card securitizations, asset-backed commercial paper, etc.).

Defined Terms

“Asset-backed security” is defined by incorporation of the definition of asset-backed security in the U.S. Securities and Exchange Act of 1934 (Exchange Act) and reads in relevant part as follows:

a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset... [emphasis added]

“ABS interest” is defined in the Risk Retention Rule, in relevant part, as:

[a]ny type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest...payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity...

Risk Retention White Papers

A recent development in the risk retention area is the circulation of white papers by law firms that argue that particular asset types should not be subject to the Risk Retention Rule. For example, a white paper circulated in December 2016 relating to securitizations of aircraft lease portfolios suggested that the initial leases in the portfolio being securitized do not produce enough cash flow to pay off the related asset-backed bonds, so the underlying planes need to be released and, in some cases, sold in order to pay off the related asset-backed bonds. Consequently, the bonds should not be deemed asset-backed securities for purposes of the Risk Retention Rule because the initial aircraft leases are not “self-liquidating,” and the bondholders are not repaid “primarily” from payments on those initial leases.

In practice, in aircraft and aircraft engine lease portfolio securitizations, the sponsors do not comply with the Risk Retention Rule.

Conclusion

Some issues that have come up in recent transactions include the following:

- Does it make sense for aircraft leasing companies (as opposed to airlines) to enter into EETC lease securitizations?
- In connection with the sale of equity/residual interests to third parties, are the interests of the seller/servicer aligned with those of the equity purchasers, how involved should the equity purchasers be in decision-making and how are the equity interests made more liquid?
- What are the advantages and disadvantages of Rule 144A offerings of bonds versus term loan transactions?
- Is the E.U. risk retention rule applicable to aircraft lease securitizations?
- In connection with aircraft lease securitizations that contain C-tranches, how far down the capital stack should C-tranches go and are C-tranches mitigated by their short weighted average life?
- How should collections be allocated between bonds and equity and specifically what is the impact of the concept of “excess proceeds,” which provides that revenue that is not typical basic rent or maintenance reserves, and which could result in the reduction of the value of the aircraft (e.g., end of lease payments, payments in lieu of maintenance, green-time lease rentals, finance lease rentals, etc.), get split between bonds and equity pro rata based on the then loan-to-value ratio?
- What is the impact on aircraft lease securitization deal structures of the addition of turbo prop planes, older planes and engines?
- What is the impact of the recent bankruptcies of Avianca Brasil, Primera Air, Air Berlin, Alitalia, VIM and Monarch Airlines, among others, on transaction structures?
- Regarding the Cape Town Convention, how do investors value the Cape Town Convention and how much help does the Cape Town Convention provide in the repossession of aircraft (a question which has been put into the spotlight by recent court proceedings connected with aircraft repossessions from Avianca Brasil)?
- What is the impact of having an issuer who is also a Recycled Entity?
- What is the impact of COVID-19 on transaction structures?

The aircraft lease securitization market is an evolving one and the transaction structure issues continue to be interesting.

Contacts

Patrick Dolan

Partner

+1 212 318 3399

patrick.dolan@nortonrosefulbright.com

Alexandra Howe

Counsel

+44 20 7444 2539

alexandra.howe@nortonrosefulbright.com

Deborah A. Stern

Associate

+1 212 318 3359

deborah.stern@nortonrosefulbright.com

Chana Ben-Zacharia

Associate

+1 212 318 3220

chana.ben-zacharia@nortonrosefulbright.com



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