



Aviation Insider

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In this issue:

Johnny Says – still in crisis...but some light at the end of the tunnel	01
Aviation finance – are you ready to get back to work?	05
BEPS 2.0 (Pillar 2) – impact on aircraft leasing	12
Nei Bao Wai Dai security registration – recent challenges in an already challenging environment for cross-border aircraft finance	16
Wells Fargo case – update on appeal	19

Johnny Says – still in crisis... but some light at the end of the tunnel



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How China recovers fast

I was grateful to have made the trip to Mainland China in the middle of August. After a 14-day quarantine in Shanghai, I spent two months travelling to 10 cities in China and was pleasantly surprised at new activity I was able to assist with. It was amazing that the first outbreak was only less than eight months prior, before which the aviation market – which was among the most seriously affected – was exuding with optimism and new prospects.

While in China, I conducted an informal poll of industry practitioners which helps illustrate just how positive the outlook is on the mainland, which we cover in detail below. But first I would like to share some observations from the trip for your consideration in your future commercial planning and investment:

Rise of low-cost carriers

Until recently, Chinese airlines did not believe in low-cost. They believed most costs are fixed and even mandatory. However, a few successes during the pandemic such as Spring Airlines, 9-Air and China Express have already proven this concept wrong. The post-COVID-19 market is strengthening the idea and showing Low Cost Carriers (LCCs) have the strongest resilience against the bottom of cycle. They achieved profitability, even in the worst period of 1H 2020, while full service carriers can only survive by selling very low-priced tickets and hence could barely sustain their liquidity. These results would inevitably increase the confidence of investors in setting up low-cost model airlines in the future.

Cargo market is hot, hot, hot

I once heard a comment that air cargo was a small sector in aviation and was not worth too much attention. However, the dynamics of the market have changed.

(US\$ billion)	2019 (actual)	2020 (estimated)	2021 (forecast)
Global passenger revenue	612	191	287
Global cargo revenue	102	117	140
% Cargo in total global revenue	12.2%	35.7%	30.5%

Source: IATA (November 2020)

In this environment more investment is obviously flowing into the air freight market, globally and in China, including:



More non-traditional buyers of freighter aircraft.

Users are no longer restricted to airlines but cargo forwarders and agents which have made good money in the latest round of surging business. Leasing companies and financiers are more enthusiastic about entering into sale and leasebacks and financing of cargo planes. Lessors are entering the market as an alternative to trying to remarket passenger aircraft.



Passenger-to-freighter (P2F) conversion market active.

Maintenance, Repair, Overhaul shops (MROs) are gearing up capabilities and production lines. Investors are coming in to set up new shops or work together with capable engineering companies for new (joint) ventures.



Conversion feedstock aircraft values well supported.

Values of used passenger aircraft which are suitable for conversion are receiving support amid a market collapse due to the mass global grounding of the fleet. 737NGs, A320ceos, A330s, and 777-300ERs have not witnessed landslide de-valuations despite ageing or obsolete technology because of their potential freighter after-life.



Production freighters hard to find.

Naked cargo planes, particularly long-haul ones such as 747-400Fs, 747-8Fs, and 777Fs, are almost unavailable in the market.

Localisation of aviation resources

Due to the inability to travel, many aviation businesses have found it difficult or impossible for their staff to fly to e.g. monitor aircraft delivery and maintenance as well as perform inspections and undergo training. Therefore, there is a call for sourcing domestic suppliers of products and services. Interest has arisen among investors to look for opportunities in additional spare parts storage, MROs and flight academies. Some even are looking for production lines, manufacturing supply companies, and licensees in overseas markets, speculating on the success of bringing them onshore into the country in future. Of course, part of the rationale is to support the emerging domestic aircraft manufacturing industry, for example, in respect of the development of COMAC aircraft.

Government support and investments

Local government bodies in China have been active in the aviation industry for a few years via their commercial arms in aviation, transport, and municipal/provincial investment companies. Besides this, the success of the Tianjin free trade zone in aircraft leasing has attracted tremendous interest in aircraft leasing by other free trade zones, tax-free zones and bonded areas. There is a scoring system in China for these zones and local government bodies are keen to invest in aviation as it would help them to climb up the ranking ladder.





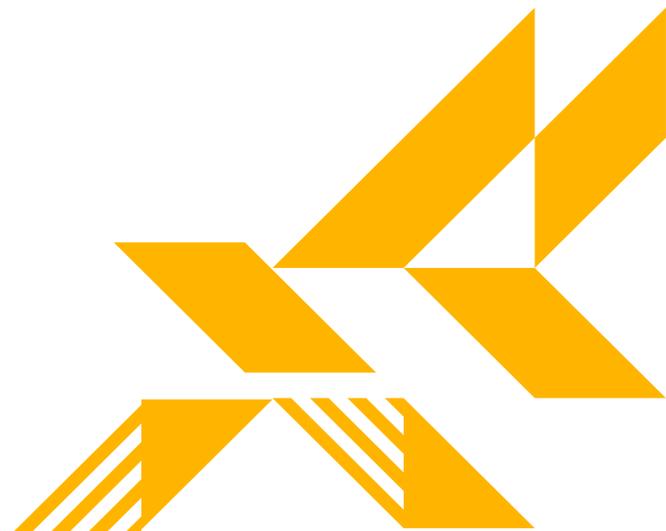
As a result, more cities are now putting resources in encouraging local companies to make aviation investments by setting up MROs, industry parks around airports (with spare parts storage and small equipment production lines) as well as centres of aircraft leasing companies. These resources can be in the form of tax incentives or direct subsidies. In order to further boost the volume of passenger and cargo traffic at the airports in these cities and provinces (which can also help the scores), some governments have dashed to buy those weaker private airlines which had run into liquidity crises even before COVID-19. Airports have also directly benefitted as projects are encouraged via funding from government entities, including new terminals, additional runways, aero-economic zone expansions and even outbound investment.

Local lessors focus on domestic market

Due to restrictions by regulators and more conservative investment perspectives towards international markets (either by management or credit committees or both), Chinese aircraft lessors are fighting each other to win business locally, driving the yield of deals down to pre-COVID-19 levels if not worse. Still, some lessors claim they consider themselves lucky not to have any or over-exposure in international deals which might be in default or have aircraft on ground.

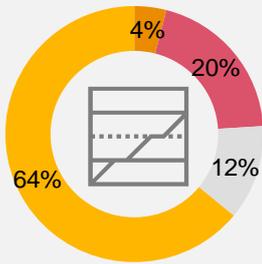
Survey on market recovery and business growth trends of Chinese practitioners

A sample of 25 Chinese representatives, one each from a domestic or an international aircraft leasing company, were asked to answer five questions which reflected their confidence and attitude in the middle of COVID-19 pandemic during September and October 2020. They were randomly selected from middle and senior management of these companies. (see next page)





Question 1: Market Recovery – When will the global aviation market return to end-2019 level?



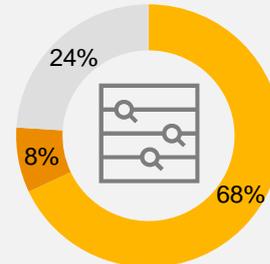
■ Within 2021 ■ Mid-2022 ■ End-2022 ■ 2023 or beyond

PwC comment

Most respondents hold a very pessimistic view but in line with the forecasts of major industry organisations.



Question 2: Business Growth – How will your total asset portfolio change in the next 12 months?



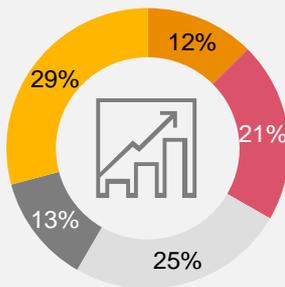
■ Increase ■ Decrease ■ No Change

PwC comment

Most companies are still actively seeking growth, but nearly one-third appear more cautious than peers.



Question 3: Business Growth – How do you expect your aircraft trading activities will change?



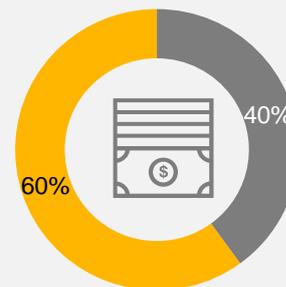
■ purchase only ■ purchase > sales
 ■ sales > purchase ■ sales = purchase
 ■ no purchase nor sale

PwC comment

Trading activities are predicted to remain strong as participants are expecting bargain buy-side opportunities in the market downturn. However, market pricing to date does not reflect this. And more than one quarter are prepared to sit on the sidelines.



Question 4: Financing Requirements – Do you need money?



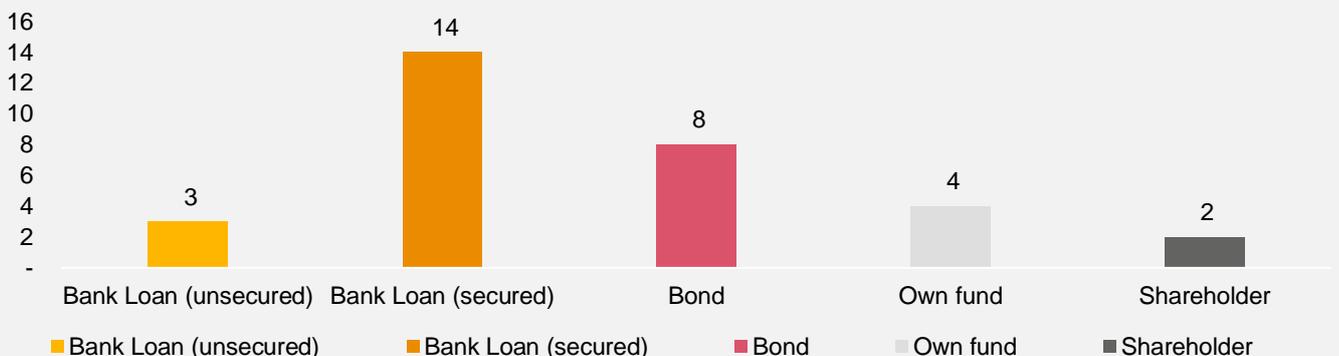
■ Yes ■ No

PwC comment

It would seem the domestic market still has access to plenty of liquidity.



Question 5: Financing Methods – What are your financing sources? (can select more than 1)



■ Bank Loan (unsecured) ■ Bank Loan (secured) ■ Bond ■ Own fund ■ Shareholder

PwC comment

Chinese banks are still quite active lending into deals won by Chinese lessors but mainly in relation to Chinese lessees.



Aviation finance — are you ready to get back to work?



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The COVID-19 crisis is having an unprecedented impact on the global air transport industry. Health considerations and government-imposed restrictions on travel to and from quarantine zones are creating huge challenges.

Even prior to COVID-19, some lessors started to recognise that their input assumptions and pricing sensitivities might eventually be challenged, even in a good market. Enter the worst crisis to ever hit aviation, and we now have a level of distress for which even ratings agencies could not account.

While we are currently in a challenging situation, aircraft financing will still be required. Historically, global air traffic has doubled every 15 years, led by countries including China and India. Post-9/11, the proportion of aircraft that has been leased versus owned increased significantly.

After the current crisis subsides, some airlines will be paying down debt and looking to lease aircraft. Fleet planning will continue to evolve with customer demand and as various countries open up. There will be opportunities for investors to enter this asset class for attractive returns. It will be key to have an “objective” model beyond half-life base values to see where the value drivers are.

As deal margins became thinner over the past few years, there was more focus on internal pricing models. Further, as the industry continues to grapple with the effects of this pandemic, the extension of credit, deferral of rentals and forbearance of payments along with the under-utilisation of capitalised assets will create an unprecedented level of analysis in order to fully understand the financial implications of this crisis. The intricacies required to support some exit and leasing strategies during COVID and while recovering are riddled with assumptions that must support highly refined structures. The structure of the model must be resilient to manage the economics and risks. The ability to quickly sensitise the assumptions will help manage the value of the portfolio and drive key decisions. Those who have been relying on substandard models will soon start to see the error of their ways.

Central assumptions to focus on include credit and asset risk grading, valuation assumptions, lease terms, debt parameters, trading opportunities, and cyclical sensitivities overlaid with a broad view on overall model integrity and structure.

What are the key assumptions?

Asset

There are currently more than 60 different types and over 100 sub-variants of western-built aircraft in the global commercial fleet. There are 50 different large-engine types with an exponential quantum of different model designators. Subtle variant delineations in any major asset category can be the difference between net gain or loss, and careless assumptions can drive erroneous decision-making. For example, engine type could make a key difference in residual value and residual recovery options. Effective models need to incorporate such granularity and account for market nuances.

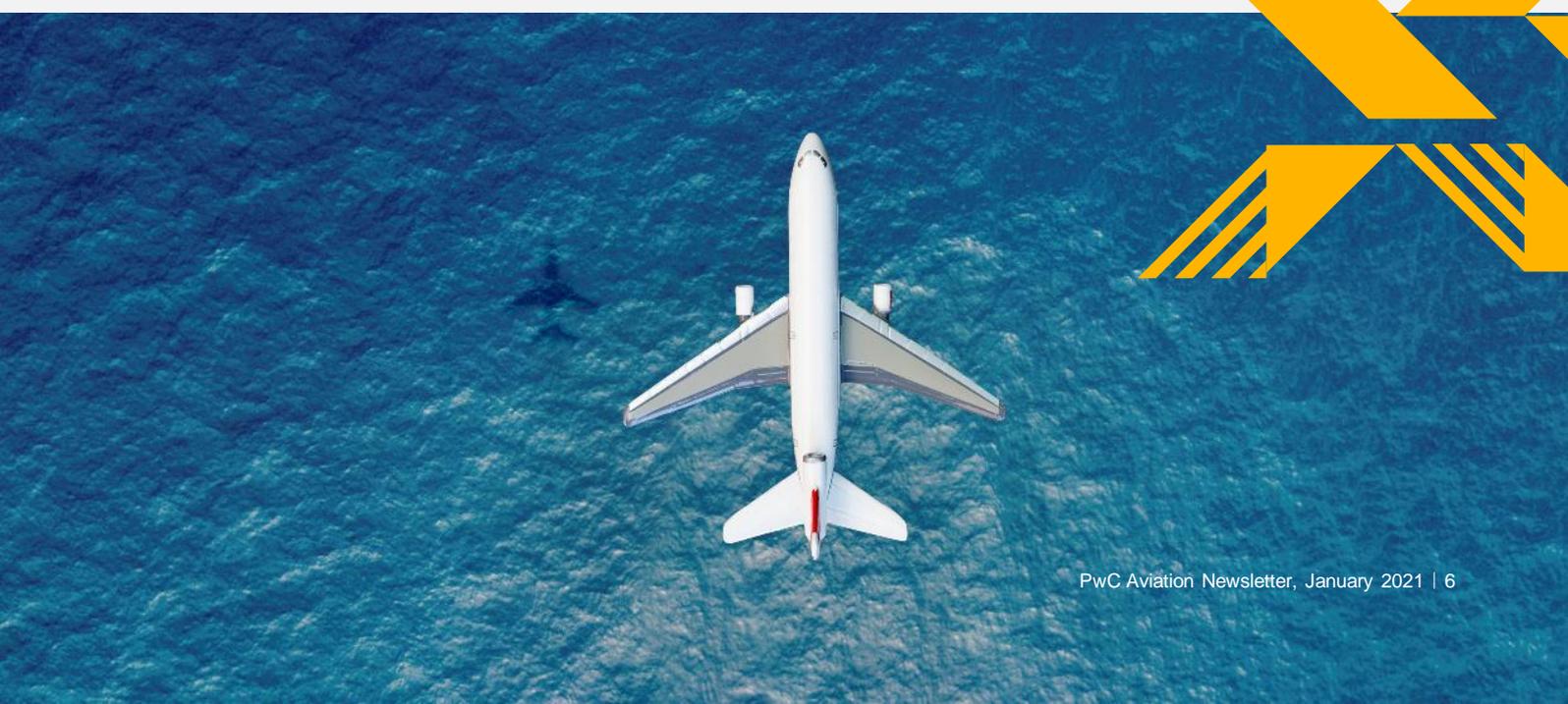
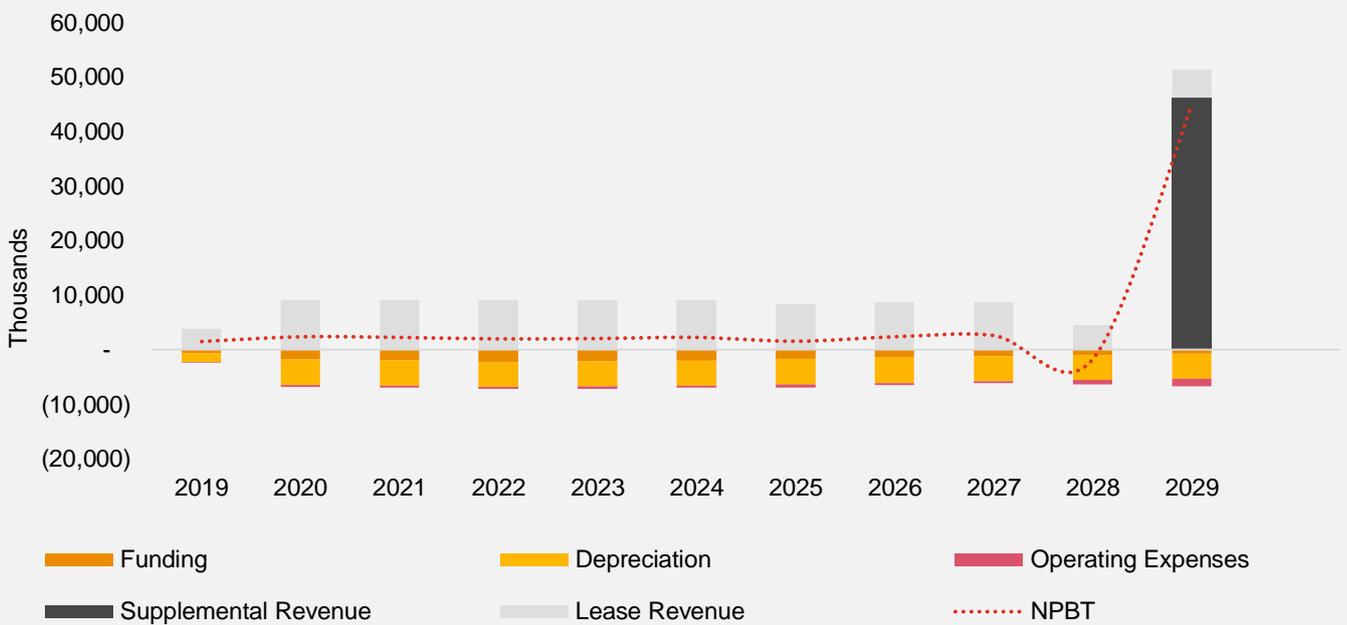


Cash flow

Determining the leasing strategy would be key for cash flow assumptions and having a model that enables you to quickly flex those assumptions could lead to additional insights and more timely decision-making. What does the cash flow look like given the pandemic and struggling airlines? Would the intent be to re-lease aircraft at the end of lease? What would the lease rate be? Are you capturing the right timing and expenses? Would the aircraft be converted to a freighter, sold/traded or parted out? What value would each of these options create, and what are the risks and scenarios?

Forecasting maintenance events, reserve balances and lease-end return compensation would be additional features of the model that would provide a more robust view of monthly and end-of-lease economics.

Total NPBT Forecast





Discount rate considerations

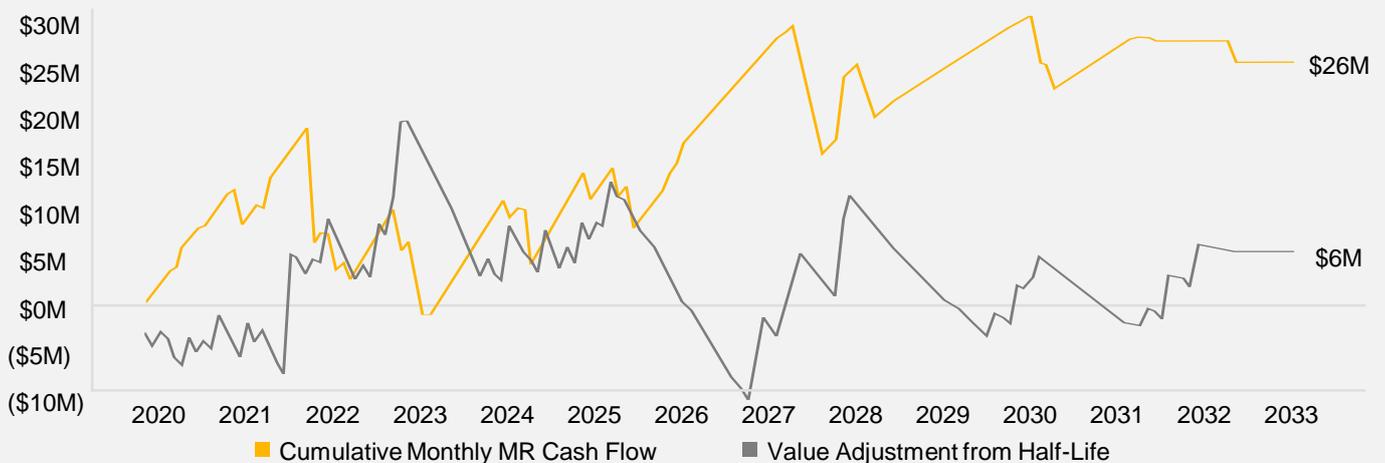
To address the reasonable risk of a lease-encumbered aircraft portfolio, it will likely require careful consideration of the specific cash flow risks. This would depend on key inputs, such as lessee credit rating and risk, geographical risk, asset/residual risk, cost of debt and cash flow assumptions, among others. Using a broad discount rate for the entire portfolio could be quick, but it might not capture each aircraft or lease and their unique attributes and potential volatility to the portfolio. Should the model include levered cash flows and a discount rate, further considerations would need to be assessed. Having a link from your credit monitoring system to a discount rate model calculation will provide the most up-to-date view of the portfolio.

Maintenance forecasting

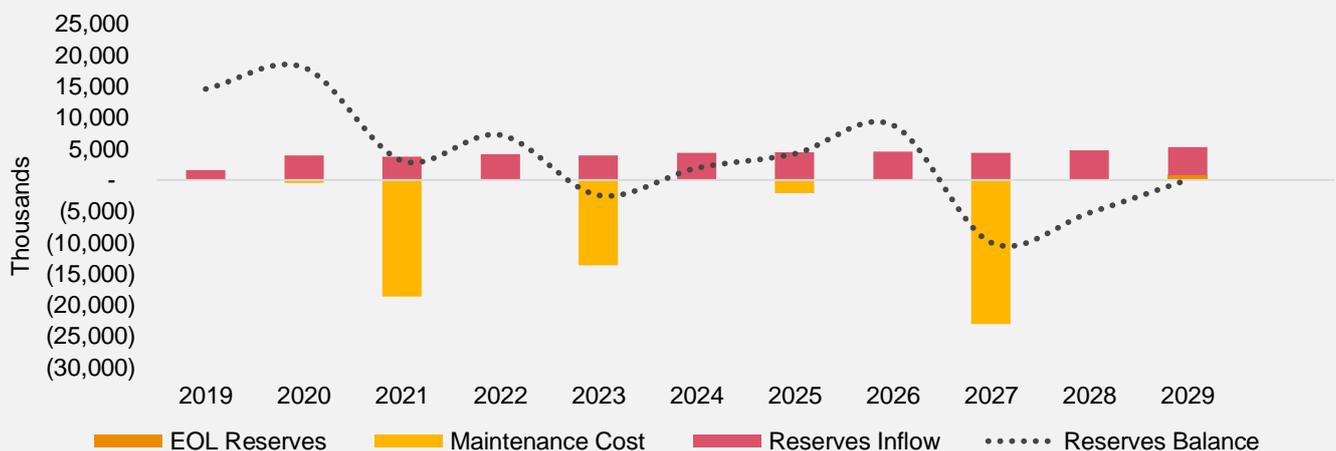
Aircraft and engines are now more complicated than ever, and their intrinsic value — especially as these assets age — will increasingly be pegged to their maintenance status. Keeping a plane airworthy is becoming more expensive. Failure to follow a regular maintenance schedule risks compromising the value of the plane and the return on assets, and more importantly, poses dangers to both passengers and aircraft. Maintenance Planning Documents (MPD), which come in all shapes and sizes, are the backbone of aircraft maintenance. However, not all operators follow the same MPD requirements.

With reduced use and the possible extension of calendar-based maintenance events, the forecasting of maintenance and the accompanying ancillary revenues will become more challenging as aircraft remain stored and lessors still need to account for check intervals that might expire even when parked.

Overall Fleet monthly maintenance reserve (MR) cash flow and half-life value adjustment



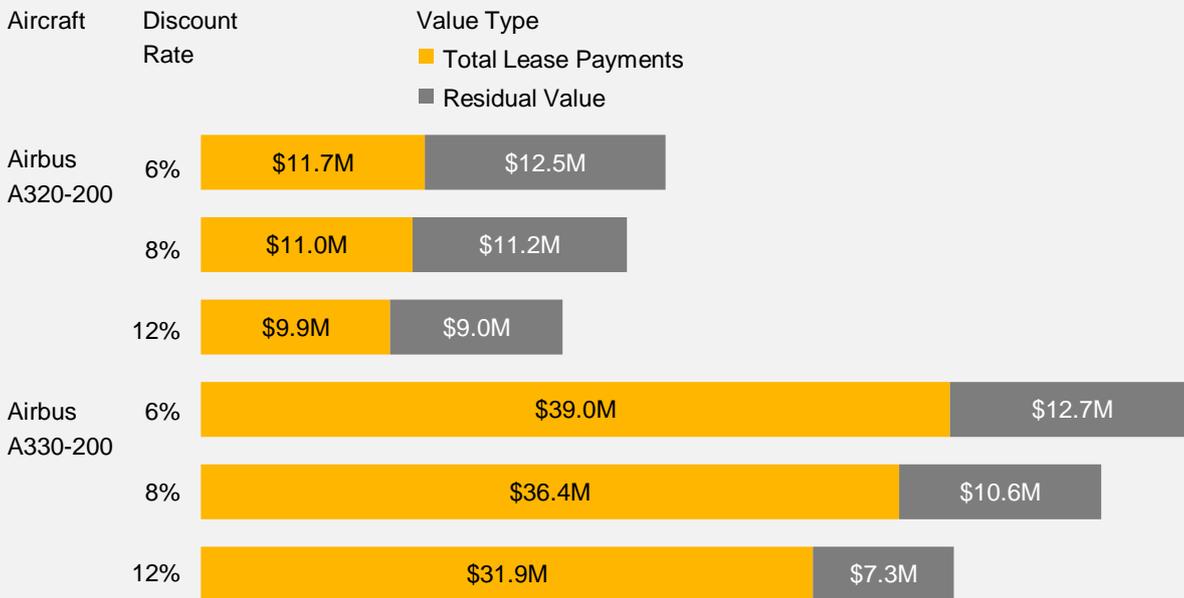
Total Maintenance Reserves Balances



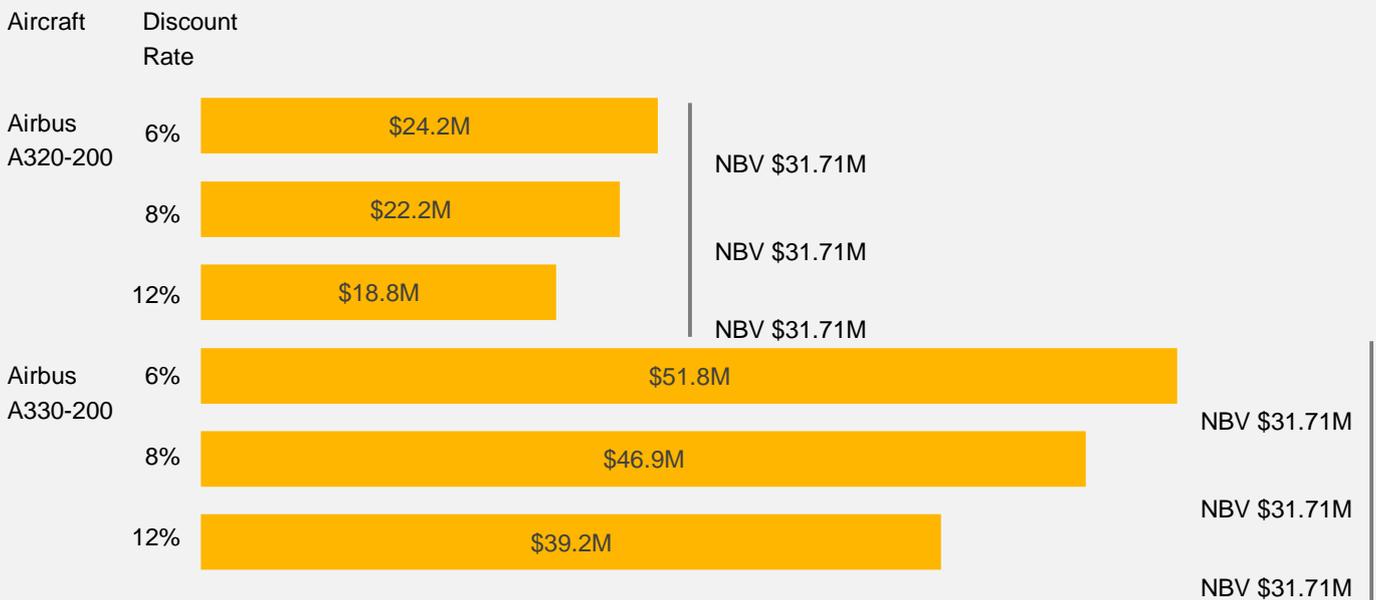


Additionally, lessors will need to coordinate with portfolio managers and internal accounting groups to get proper guidance on maintenance expense and income to sufficiently analyse aircraft values and cash flow.

VIU breakdown vs NPV



NPV vs NBV





Residual value

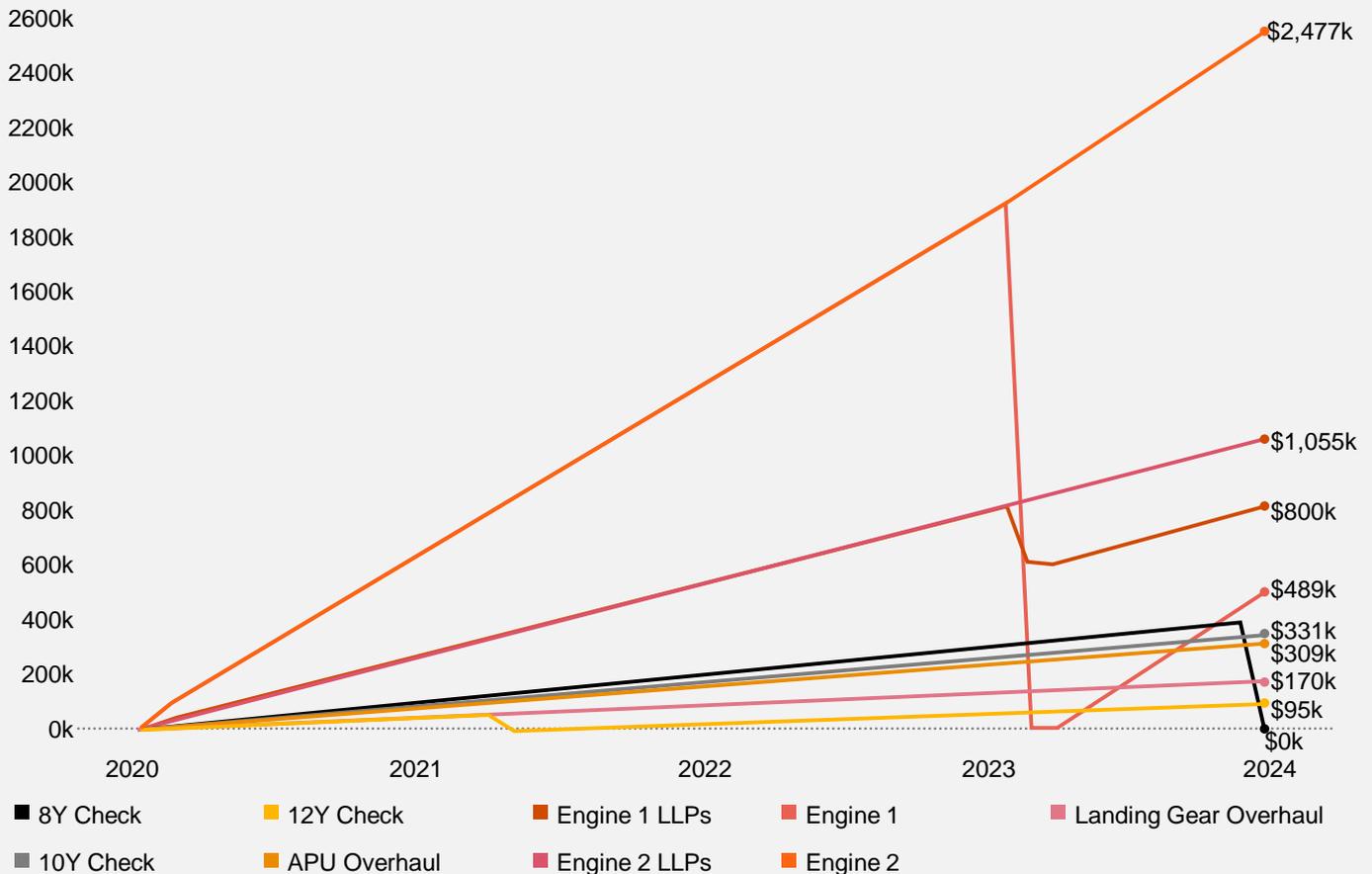
Residual value should not be a “placeholder”, but rather a distinct number supported by practical and thorough analysis. While the residual value by itself represents a future value in time, it does not necessarily represent a future market (weak or strong) value, and a simple half-life value does not always accurately reflect the anticipated maintenance status at a specific moment. The residual value should be just as important as the starting value, with assumptions rooted firmly in a forecast technical status and accurate cost expectation, along with any applicable return conditions or end-of-lease compensation analyses. It should also be stress tested for potential market inflections and multiple technical scenarios.

A properly calculated residual value is a key pillar in any Net Present Value (NPV), and just like using the appropriate discount rate, these clearly defined assumptions are vital parts of any model structure and should be reviewed annually for accuracy and currency.

Lease analysis

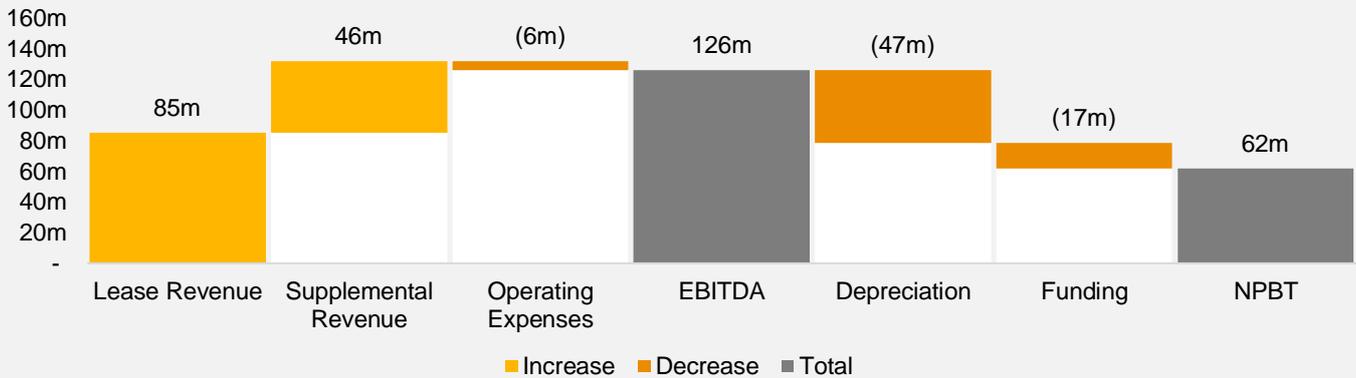
Granular lease analysis goes beyond lease rate and tenor, and while a simple NPV calculation might help start the conversation, the intrinsic value of a lease lies within the lease terms (rate, tenor, maintenance return conditions, escalation, cost of maintenance events, maintenance reserves, end-of-lease compensation, upsy/downsy calculations, technical thresholds). In addition, modeling analytical tools should be able to provide an in-depth snapshot of the economics of the lease with enough built-in flexibility to stress assumptions and identify vulnerabilities.

Cumulative maintenance reserve by aircraft component (4 year lease from January 2020)





Total NPBT Waterfall



The four key actions you can take now:

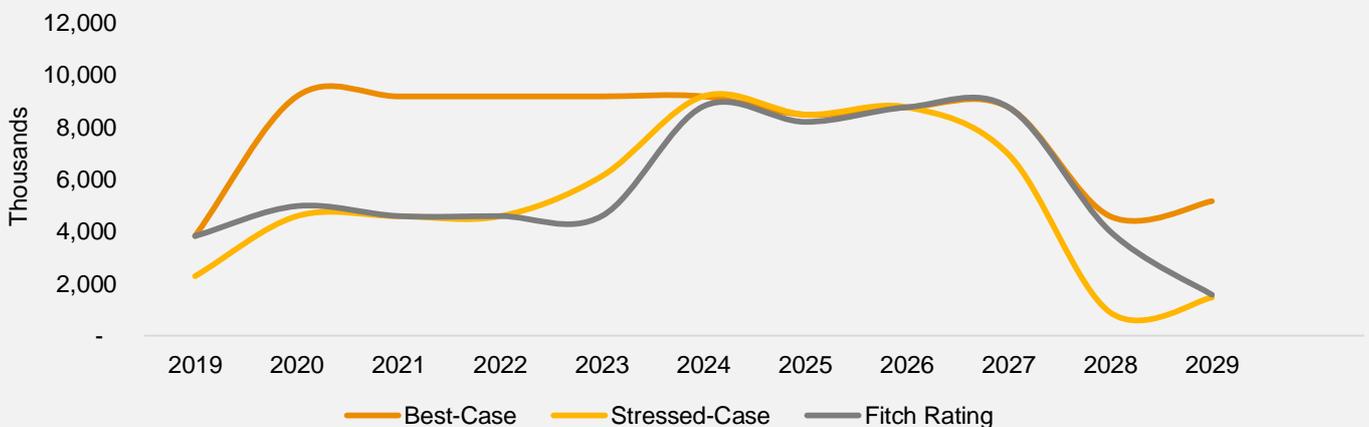
Self-review

Questions should be asked whether your model is delivering what you need. Does it help or hinder your evaluation? Is it a useful tool, or is it an obstacle? Is your model up to date and current with the right assumptions? Most importantly, can your team trust and rely on the output? Model maintenance is tough and time-consuming — and given its importance, it should be routinely updated and reviewed. Take time to thoroughly review your model with a critical eye and ask yourself these questions:

Challenge and stress

If you think your model does what it should, now is the time to challenge it. Test the accuracy of its output against a live transaction and sensitise assumptions. Is the output realistic? Does it challenge or support your business plan? Do you agree with what it is telling you? Do you either green-light or halt the opportunity? In addition to being a decision tool, does your model show you vulnerabilities that you can alleviate to proactively protect yourself?

Scenario Analysis – Total Lease Revenue





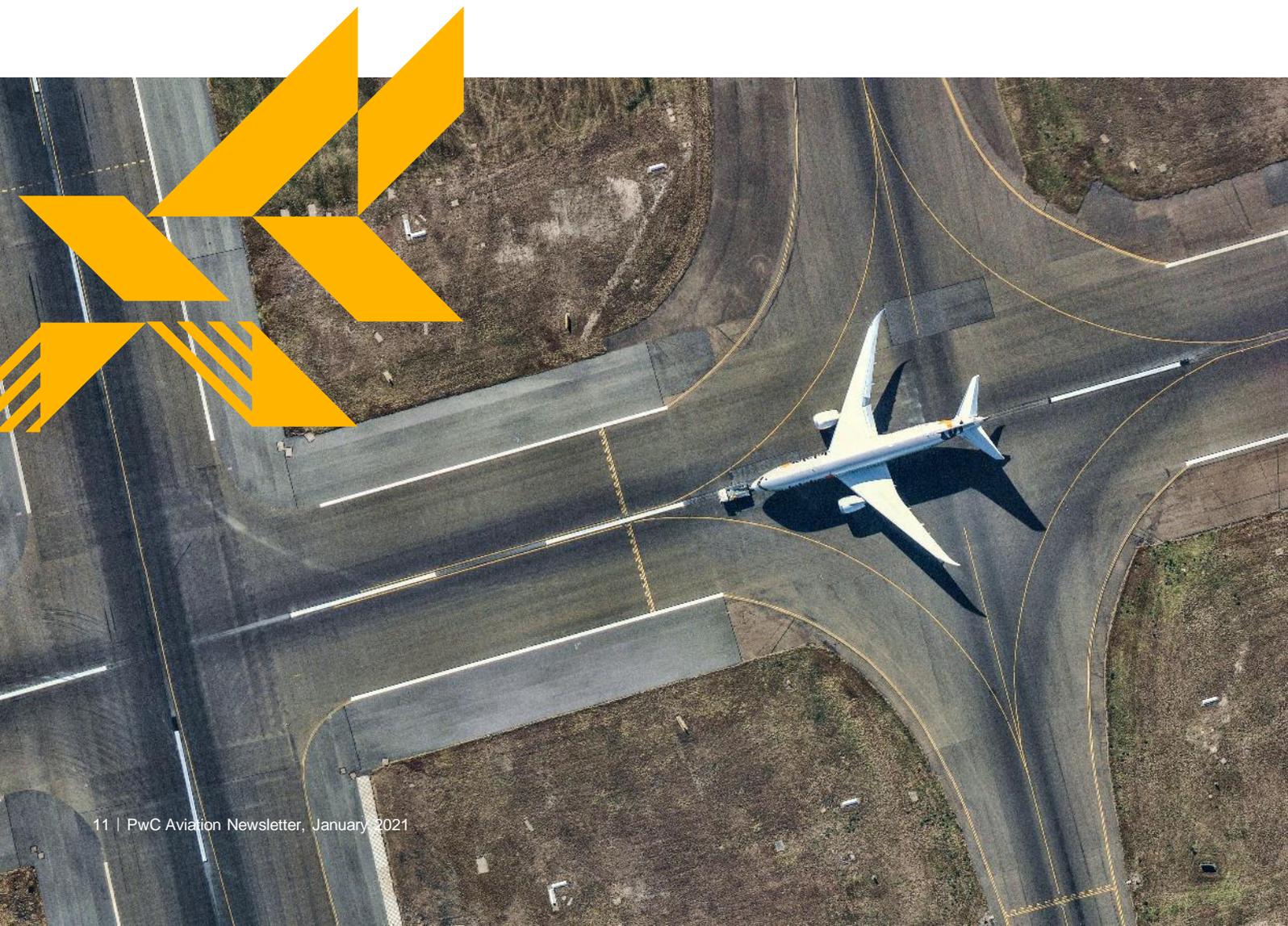
External review

Your model is only as good as its formulas and coding. You can have the best assumptions and stress guidance, but if it is not properly calculating or pulling from the correct dataset — or has become corrupted due to improper use — it might be time for a thorough review by professionals to ensure your model is working efficiently and effectively. Be sure assumptions are correct and relevant, and incorporate international standards that ensure error checks and lock down sensitive information.

Incorporate

Once your model is ready to go, it should be properly on-boarded to your team to ensure proper use and implementation of protocols. The model should be part of a thorough internal evaluation process that can be reviewed when needed and can be “learned” from, so previous mistakes are not repeated, and new understandings are incorporated. Best-in-class models contain accompanying instructions and user guides to promote transparency and knowledge transferability throughout the team.

Thoroughly reviewing and challenging previously held assumptions that have been built over time which are embedded in a proprietary transaction model is a multi-pronged process that requires an expert review, usually from the outside looking in. As this crisis has tested our entire industry, now is the time to take stock of habitually incorporated norms and rebuild with confidence internal outputs that will help you understand and manage your aircraft economics better in any future transactions. The key to this is having a model that’s error-free, correctly incorporates commercial assumptions and sensitivities; and is foolproof, with visualisations to match.



BEPS 2.0 (Pillar 2) – impact on aircraft leasing



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How will the anticipated overhaul of international tax rules impact on aircraft leasing?

On 12 October 2020, the OECD released a set of “work-in-progress” proposals aimed at reforming the international tax system to address taxation challenges arising from the digitalisation of the economy and perceived remaining Base Erosion and Profit Shifting (BEPS) concerns. The proposals are grouped into two sets, Pillar One and Pillar Two. While the proposals under Pillar One are targeted at highly digitalised and consumer-facing businesses, the proposals under Pillar Two focus on the development of a global minimum Effective Tax Rate (ETR) which will affect all businesses with cross-border activities (subject to certain thresholds and carve-outs).

Pillar Two aims to introduce such a global minimum corporate income tax rate (the Global Anti-Base Erosion (GloBE) Minimum ETR) through two sets of inter-related rules: (1) the Subject to Tax Rule (STTR) and (2) the GloBE rules.

The GloBE Rules consist of three separate but interconnected rules: (a) the income inclusion rule, (b) the switch-over rule and (c) the undertaxed payments rule. Collectively, the three rules are designed to ensure that in-scope Multi-National Enterprise (MNE) groups are subject to tax at a minimum rate in each jurisdiction they operate in (where jurisdictional blending is adopted).

The GloBE Rules propose the introduction of a worldwide minimum effective tax rate – likely set in the 10-15% range

While thresholds and carve-outs are proposed, from a review of a recent top 50 listing of aircraft lessors based on portfolio market value it would appear that approximately 60% of aircraft lessors fall within the scope of the proposed rules. The application of the rules has the potential to materially impact on those lessors’ cash tax liability position and ETRs to varying degrees. Broadly, the rules may provide tax authorities in the Ultimate Parent Entity (UPE) jurisdiction of a MNE group, or even subsidiary or sister company jurisdictions, with a right to apply a top-up tax to bring the ETR of a group entity in another jurisdiction up to the GloBE minimum.

Potential GloBE Rules impact Ireland

As the trading tax rate in Ireland at 12.5% is squarely in the middle of the expected minimum rate range, for lessors with an Irish platform the key concern is likely how timing differences between local tax depreciation and accounting depreciation are dealt with for GloBE purposes. If a favourable option is not adopted, the impact could be drastic – ETR could be regarded as zero in the Irish platform with ongoing top-up taxes equating to the full GloBE Minimum ETR applied effectively eliminating cash tax deferral benefits and potentially increasing ETRs. However, it appears likely that such timing differences will be appropriately accounted for in the GloBE Minimum ETR calculation which may limit the concern for Irish leasing platforms as to whether the GloBE Minimum ETR is set marginally above 12.5% and to any additional compliance requirements which will undoubtedly flow from the new rules if introduced.



Hong Kong and Singapore

For lessors with Singaporean and/or Hong Kong-based platforms, the rate established for the GloBE Minimum ETR will be key (Singapore must also consider the timing differences issue referenced above).

In both jurisdictions, the ETRs are likely to be below the expected GloBE Minimum ETR. For in-scope MNE groups, considering their leasing platforms in those jurisdictions in isolation, there is a heightened risk that the group's ETR could significantly increase in some instances.

However, if jurisdictional blending is adopted, the impact could be lessened or offset to an extent by the higher general tax rates applying in those locations (17% in Singapore and 16.5% in Hong Kong) where the group has other activity in those locations taxed at the higher rates. Such group consideration could result in the overall ETR for the relevant jurisdiction exceeding the GloBE Minimum ETR, and thus no top-up taxes would apply to the relevant leasing platforms despite tax rates therein which dip below that minimum.

Additionally, the Hong Kong and Singaporean tax authorities have taken early steps to evaluate measures to keep their tax regimes competitive which hopefully will ultimately be to the benefit of lessors based there.

Offshore low or no tax jurisdictions

For MNE groups with operations in low or no tax jurisdictions such as the Cayman Islands, Bermuda, BVI, etc., if the rules come through as proposed, any tax benefit derived from locating activities in such locations could disappear overnight for in-scope groups, with the GloBE Minimum ETR applied to profits realised in such locations and annual cash tax liabilities arising on those profits in other group jurisdictions.

Other key higher tax jurisdictions – U.S., Mainland China, Japan, etc

While we expect timing differences to be dealt with in a favourable manner, if they are not, common parent and generally higher tax jurisdictions may not be immune to the application of additional top-up taxes. It appears more likely that the primary concern for parent companies in such jurisdictions will be administrative – new compliance requirements will emerge from these rules which will necessitate the development of new processes and systems to monitor and adhere to a whole new set of filing and tax liability compliance requirements.



The subject to tax rule (STTR) is intended to apply or increase withholding tax on certain cross-border payments between related parties where the recipient is subject to tax below a minimum nominal rate (the STTR Minimum Rate)

Unlike the GloBE Rules, no minimum revenue threshold has been referenced for the application of the STTR – a revenue threshold below EUR750 million may be set, or none may be set at all. The STTR therefore requires consideration by a much larger cohort of the aircraft leasing community. However, given its intended application to specified related-party payments only, it is likely relevant to a more limited number of structures – in particular, certain Lease-In Lease-Out (LILO) structures and intra-group financing structures reliant on double-tax treaty benefits.

Conclusions

The GloBE Rules, and to a lesser extent the STTR, could reduce the tax benefits on offer in certain key leasing locations through increases in ETRs and/or a reduction or loss of cash tax deferral benefits. However, there are a myriad of other factors, some still tax-related (double-tax treaty networks, for one), which mean that the core global leasing platform locations are likely to remain as they are. The impact will be dependent on exactly what minimum rate is set, on other aspects of how the rules are introduced, and most importantly, on whether consensus can ultimately be reached on the introduction of the rules in the current format.

If leasing jurisdictions such as Ireland, Hong Kong and Singapore adopt local minimum top-up tax rates, in order to maintain their attractiveness to the widest range of groups, it will, in my view, be critically important that they introduce a local top-up tax system in a manner that applies only where the GloBE Rules would otherwise have applied. In addition, for regimes such as the one in Hong Kong, if a rate change (amongst other changes) is ultimately necessary to maintain attractiveness for in-scope MNE groups, it will be important for the Hong Kong tax authorities to make such rate change an option available to those affected.

As with the original BEPS Action Plan, a prolonged period of uncertainty with regards to MNE tax affairs is ahead of us. Certainty is something entities seek when estimating tax costs, but something which is unfortunately increasingly difficult to achieve. The BEPS 2.0 proposals will ensure this uncertainty continues for several years to come.





What can lessors do now?

While it is still very difficult to accurately assess the impact, the potential outcomes should be factored into strategic platform decisions where possible and, more granularly, contemplated when evaluating pricing on leasing transactions.

The key actions lessors can take now include:



Conduct an assessment of your structure to determine whether your business is in scope of the proposed GloBE Rules;



If so, leveraging Country by Country Reporting (CbCR) procedures and information to do high level modelling focusing on the ETR impact; and



Separately assessing the possible impact of the STTR.



Nei Bao Wai Dai security registration –recent challenges in an already challenging environment for cross-border aircraft finance



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Brief introduction to Nei Bao Wai Dai security arrangement

In a cross-border aircraft finance transaction involving a foreign lender (as lender), an offshore owner (as borrower and head lessor), onshore (PRC) lessor (as sub-lessor), and/or an onshore lessee (as sub-lessee), a typical security arrangement is the pledge of equity of the onshore lessor (often a SPV incorporated in one of the Chinese FTZs) by its shareholder. This will give the foreign lender control of the onshore SPV following the occurrence of an event of default under the financing transaction, and to step in the shoes of the sub-lessor to deal with the lessee or dispose of the aircraft.

Under PRC foreign exchange regulations such an equity pledge falls into the category of foreign security for a “Nei Bao Wai Dai” (onshore security for the purpose of obtaining offshore debt financing) transaction. The pledgor (the security provider) is required to register the equity pledge (together with other security such as the aircraft mortgage) with the local SAFE (where the lessor is domiciled) within 15 working days of its execution. Between 2014 (when the rules governing Nei Bao Wai Dai were issued and foreign exchange control relaxed) and 2017 the registration process has been straightforward and painless.

Beginning in 2017, however, the arbitrage and capital outflow caused by excessive use of the Nei Bao Wai Dai security arrangement was brought to SAFE’s attention. It was also reported that SAFE investigated the abuse of this scheme by Chinese enterprises and subsequently started taking a harder look at all Nei Bao Wai Dai applications. Since then SAFE has been keeping a close eye on the four aspects of Nei Bao Wai Dai security arrangement:



genuineness of the
financing transaction



commercial justification of
the security arrangement



compliance with laws
and regulations; and



default risk and likelihood of
performance of the security.

As a result, SAFE issued a number of guidelines to implement the Foreign Exchange Operation Guidelines for Cross-Border Security (《跨境担保外汇管理操作指引》) which gave the agency power to request written explanations from security providers if it has any doubt regarding the four aspects of the security arrangement. SAFE may reject a Nei Bao Wai Dai security registration if it believes that, based on reasonable commercial standards and rules and regulations, the explanation of the security provider cannot obviously stand.

As such Nei Bao Wai Dai has become a sensitive registration item and SAFE has been subjecting Nei Bao Wai Dai registration applications to very strict examination. It is said that there have been few successful cases of Chinese enterprises completing Nei Bao Wai Dai security registrations.



As an illustration of such tightening of Nei Bao Wai Dai security registration, we have come across a live case where the registration of the equity pledge in favour of a foreign lender has become a substantive review exercise and lasted for almost a year (and is still ongoing). This has really alarmed us, and we thought the concern should be voiced to raise the awareness of the aircraft finance/leasing community.

As this is a very sensitive topic in a live case, we will not disclose the specifics of the matter in this article.

The case in question

The transaction in question can be summarised as follows:

- An offshore owner head leases the aircraft to an onshore SPV/headlessee incorporated in one of the Chinese FTZs;
- Onshore SPV then sub-leases the aircraft to one of the major Chinese airlines;
- A foreign bank grants a loan facility to the offshore owner/sub lessor; and
- The shareholder of the onshore SPV pledges its equity in favour of the foreign lender.

SAFE registration requirements

Normally, when applying for Nei Bao Wai Dai security registration of an equity pledge in favour of a foreign lender, only the following original executed and dated agreements are required by SAFE:

- The facility agreement;
- The loan supplement;
- The equity pledge agreement; and
- Identity documents of pledgor and pledgee (lender or security trustee).

After closing of the financing transaction, the registration application together with the above documents were submitted to local SAFE for review. All parties thought that this was just a customary document review process by SAFE and the registration should be completed within 20 working days upon submission. This proved to be too idealistic/optimistic: almost a year has gone by and after rounds of discussions, SAFE is still not satisfied with the application.

Some of the issues raised by SAFE include:

- After much discussions, SAFE remains very confused about the deal structure (which we thought was quite straightforward: a LILO lease structure with offshore bank financing and onshore security package bolted on);
- SAFE is also concerned about the ability of the borrower (the offshore owner/head lessor) to repay the loan under the current economic environment;
- SAFE has additionally required extensive evidence to be provided before they would be prepared to proceed with the registration, including very specific information about the parties including their identity, the identity and financial standing of the equity investors, copies of the transaction documents and other matters in exhaustive detail and in many instances, to be accompanied by translations in Chinese.
- SAFE's current forms do not reflect the revised requirements and they will need to update its application forms and will ask for more chops or signatures when all the above are ready.

Given the concern about arbitrage that has brought about SAFE's heightened oversight, SAFE's concerns about seeking evidence of the commercial justifications and genuineness of the financing transaction may appear at first glance to be reasonable. However, in the context of an asset finance transaction where the debt is serviced through a leasing structure with the rent payments are from a major Chinese state owned airline, it is quite surprising that SAFE seems to be expressing doubt about the borrower's ability to service the loan and by extension, this Chinese airline's credit worthiness.



Formality requirement against the backdrop of COVID-19

Another challenge arising from Nei Bao Wai Dai security registration is pandemic inflicted. For the equity pledge registration, SAFE requires notarised and legalised incorporation certificate of the pledgor/pledgee if they are offshore entities, which in our experience needs to be notarised by local notary public first and then legalised by Chinese Embassy/Consulate.

This has now proven to be extremely difficult (if not impossible) given the lockdown in parts of the world and shutdown (or limited services) of government authorities. As it is a mandatory requirement that the SAFE registration of Nei Bao Wai Dai should be submitted to SAFE within 15 working days after the execution of the security document, meeting this deadline seems to be mission impossible these days. As a compromise, what security providers can do is to submit whatever documents it has (even though they may not be the original, notarised or legalised) to SAFE within the 15 working days window. If SAFE has any requirements on the formalities, the security provider can always explain that it intends to use its best efforts to satisfy the formalities. However, due to the pandemic, it will take much longer than usual to obtain such documents. In doing so, we believe SAFE will, at least, not challenge the registration on the ground of the submission being belated.

Conclusion

It can be seen from the above that, given the uncertainty of the world economy and the concern about capital outflow using Nei Bao Wai Dai security arrangements, SAFE is taking a very cautious approach towards Nei Bao Wai Dai registration. Any complex deal embedded with Nei Bao Wai Dai security arrangements will likely take longer for SAFE to digest and analyse (especially for those local SAFE with limited cross-border aviation finance experience).

Onshore security providers should start early and be well prepared when submitting applications to SAFE. Offshore lenders should also be prepared for such prolonged registration process and require the onshore security provider to cooperate with SAFE to ensure good communications.

Finally, SAFE should also pool the industry expertise and prior experiences (for example, artificial intelligence (AI) powered registration system) to establish a nationwide standardised system for Nei Bao Wai Dai registration.

Rui Bai has extensive experience in assisting to meet the SAFE verification requirements (including the specific formalities and evidence the relevant local SAFE is looking for) and would be happy to discuss these requirements should any clients require assistance in such transactions.



Wells Fargo case – update on appeal



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In our September 2020 Aviation Insider update, we provided an alert on the Wells Fargo Trust Company, National Association (trustee) v VB Leaseco Pty Ltd (administrators appointed) case. It is one of the first cases considering the meaning and content of the requirement under Alternative A of the Cape Town Convention and Aircraft Protocol (the “CTC”) to “give possession” of the aircraft object to the creditor. For more background, you can read our previous update [here](#).



As reported in our previous article, the court at first instance had held that the meaning of “give possession” necessarily required, on proper construction of the relevant provisions of the treaty, for the lessee to return the aircraft object in accordance with the redelivery requirements of the lease.

The court ordered the administrator to return possession of the engines leased to VB Leaseco by Wells Fargo (as owner trustee) under the lease in the contractually agreed redelivery location (in Florida) together with certain technical documents which were required to be provided under the lease.

The administrators appealed the decision and while the Court of Appeal of the Federal Court of Australia agreed with the court of first instance’s approach to interpreting and construing the relevant provisions of the CTC, the Court of Appeal did not agree with the conclusions and over-turned the judgment in a number of key aspects.

In particular, the Court of Appeal held that the requirement to “give possession” did not necessarily require the lessee to “give possession” of the aircraft object in accordance with the lease agreement. Rather, the obligation of the lessee was to give possession of the aircraft object to the extent necessary to pass to the creditor the form of possession that the creditor could have taken in the exercise of its self-help right to take possession.





In coming to this view, the full Federal Court reasoned that:

- the CTC itself does not expressly state the lessee was required to “give possession” under Alternative A in accordance with the lease agreement;
- where requirements under security agreements had to be complied with, the CTC expressly says so in several other places, which further indicates that where the CTC has a requirement to comply with underlying security agreements, it would explicitly say so;
- the concept of possession in common law and civil law countries extends beyond purely physical possession and can be achieved in ways other than physical delivery (in other words, possession can be deemed, or “constructive” if sufficient control can be established), and therefore the requirement to “give possession” under applicable law does not strictly require physical redelivery;
- while the CTC prevails over local law, it does so only to the extent of any inconsistency, therefore to the extent that local law would prevent the debtor from giving possession (or the creditor from taking possession), then the CTC would prevail, but only to that extent;
- the reading in by implication of the words “in accordance with the lease agreement” would go beyond overriding any inconsistency, and this is especially the case since this would require funds to be taken directly out of the insolvency estate in order to meet these obligations. This would be a redistribution of the estate in favour of lessors (as unsecured creditors) in preference to all other unsecured creditors. Because the repossession costs would usually be paid out of the secured assets and to the extent of any shortfall, lessors and secured parties would usually only be able to claim *pari passu* with all other unsecured creditors;
- the court also agreed that until the lessor was given an opportunity to take possession, the lessee must remain liable to maintain the aircraft.

Our views on the case

Prior to the ratification of the CTC in Australia, a lessee would be entitled to issue a notice stating that it did not intend to use an asset and leave an asset “as is, where” is for recovery by the lessor. The administrators would (in theory) not be required to take any affirmative actions, so long as they did not act inconsistently with the notice (e.g., by continuing to use the asset or actively obstructing repossession actions) and did not have to take any positive steps to return an asset to the lessor.

Post ratification, it seems that administrators would have a stronger obligation, as “give possession” requires the administrators to take affirmative actions. However, the extent of the affirmative actions is to:

- maintain and preserve the aircraft as required under the CTC until the obligation to “give possession” is performed; and
- to take such affirmative steps as is required to allow a lessor to exercise its self-help rights to take possession, and to the extent that the administration of the lessee presents an impediment to the ability of the lessor to exercise its self-help rights, the administrators must do what is needed to overcome any barrier to taking possession that is a consequence of the insolvent administration.

While it seems to be clear that the administrators are not allowed to passively disclaim, it is not entirely clear to what extent the obligation to “give possession” requires positive acts from the administrators, and the court itself expressly referred this back to the judge at first instance for redetermination.

While lessors may be disappointed with the outcome of the appeal, industry participants have also made the point on a number of occasions that when a lessee is in default, what is actually happening on repossession is that the lessee’s right to lease the asset – in other words, the lessee’s right to possess the asset as lessee – is terminated. On such termination, the lessee would not necessarily know who actually has the real or superior right to possession (for example, if the lessor financed the asset, it may be that the lessor is itself in default, and the mortgagee would have a superior right), and therefore the lessee can only make the asset available for repossession by the person who is claiming to have the best right to possession.

We will continue to monitor and provide updates of any further developments on this case.

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