Aviation Insider

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In this issue:

Johnny Says

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Prelude

Many friends of mine working in aircraft leasing companies were complaining the market is no longer attractive. Most aviation bankers I speak with regularly also shared the same opinion, and were considering to charge higher risk premiums on transactions they were contemplating. However, I do not find the facts reflect these feelings or approach. Instead, we witness continually low lease rental factors, high aircraft costs and low interest rate margins. It has become more difficult to find attractive deals even with new, lower return expectations as compared to previous times. Yet there are still new leasing companies emerging, and more investors coming into aviation assets from unfamiliar sectors.

What's going on seem to be contradictory.

However, it becomes easier to understand this contradiction if we look out into the overall global economy. There are fewer and fewer opportunities to invest. It is difficult to identify asset classes which provide reliable returns without the concomitant risk of losing all one's capital. Regional risks are also increasing. Owing to negative changes in economic and political environments on almost every continent, investors have become very cautious about increasing their investments in traditional sectors. Aircraft leasing assets become an alternate "safe haven" for capital with a relatively stable and reliably positive - albeit single-digit - return.

This new funding infiltrates the aircraft leasing industry either through active involvement, such as setting up independent leasing vehicles or investing in funds organised by financial institutions, or simply by purchasing aircraft asset-based securities (ABS) in public markets.

The high liquidity makes the lives of practitioners in traditional aircraft leasing companies excited, but also nervous. Over-promised investors may exit easily, leading to a collapse of the funding chain if the market performs weakly or a systematic global event occurs. However, these new investors provide a healthy avenue for offloading over-concentrated positions and higher-risk assets amidst many juicy profit opportunities.

However, if the trend continues and a newer-entrant player collapses, the much anticipated downturn or even a market plunge would inevitably happen. We just do not know when.

Current Storm

The COVID-19 outbreak seems destined to become long and drawn out with significant impact on the aviation market. There may be some positive impacts, but mostly negative effects are expected. Companies which have been financially disciplined and building war chests should be winners in the current environment, as cash is always king in times of great disruption. Many others will face serious damage as they experience difficulties to attract capital to fill ever-widening balance sheet holes. A few exceptions - such as dedicated freighter operators - are benefitting now due to the unusual upsurge in business opportunities.

I remember working at a bank during the SARS outbreak of 2003, all airline credit lines were frozen and the bank required weekly reports on classifications for most aviation companies. The bank still managed to approve a lease transaction investment with one of the most-affected - albeit a very strong - airlines in the region (sorry, readers will have to guess which). The investment amount wasn't much, but a very good return. On the other hand, a mid-life aircraft owned by the bank leased to a Chinese airline avoided a redelivery by discounting the rental by 55%, but was sold two years after the lease extension for a seven-figure profit.

This lesson was valuable as it makes me believe we will find opportunities even during dark days. Airlines will survive, with some consolidation likely, and aircraft lessors with liquidity will stay strong (and become stronger).

The financial market will be smart enough to understand, with risk-reward in perspective, that the aviation industry is fragile but resilient in the face of global black swan events.

Closing remarks

Perhaps a silver lining in the current environment may be a long-awaited correction in the aviation market, which has been expected for some time now, and hopefully a soft landing. Smart investors with good teams will definitely get something out of it. We shall see.

COVID-19: Rental holidays or business as usual?

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Air travel has been greatly reduced during these challenging times, with many organisations stopping all non-critical business travel in the region.

In this article, we look at some specific issues relating to the aviation sector.

Rent payments

In the aviation sector, it is expected that counterparties to various types of contracts (especially PRC airlines) would be looking for short term relief. For example, we have heard of industry requests that some airlines have sought rent holidays and related concessions in view of the disruptions around the COVID-19 outbreak.

The legal position

Aircraft leases – It is market standard that aircraft leases contain "hell or high water" clauses. These provisions state that a lessee's rent payment obligations are absolute, unconditional and continue despite any intervening events or circumstances.

The intended effect of such clauses is that a lessee must continue to pay rent regardless of any intervening circumstance. Indeed, even if a lessee has a claim against its lessor (for example, contribution to maintenance), they must continue to pay rent as a separate obligation while making a separate claim against the lessor, as leases usually do not allow lessees to "set off" such claims against their rent payment obligations.

The lessee's jurisdiction may also play a part in an enforcement scenario. English courts have generally upheld the validity of such "hell or high water" clauses, confirming the absolute and unconditional nature of the lessee's rental and other payment obligations despite a number of arguments that lessees have put up over the years (for example, unfair contract terms, loss of use of asset or frustration). It would be very unlikely for lessees to avoid paying rent given the strength of these provisions.

Having said that, lessees and lessors should carefully review their leases and be clear on their contractual rights and obligations based on the contractual terms of their leases and whether there would be any scope for relief.

Practical outcomes

From a lessor's perspective, how the airline wishes to manage its own fleet capacity is entirely the responsibility of the airline. The risk of general market downturns or over-capacity are the type of risks that the lessee has agreed to assume under industry standard “hell or high water” clauses which are typically included in aircraft lease agreements. Lessors also have to manage their own cash flow and financing arrangements, or they could be in default under their financing arrangements.

Our assessment of recent leases, as described above, is that leases will generally have very strong “hell or high water” clauses. We expect lessees’ mitigation strategies should not primarily be focused on legal arguments (assuming a well drafted lease) and parties will need to agree on outcomes that are commercially acceptable to all parties (for example, how lessees can look to sweeten the deal for lessors).

Some possible scenarios include:

1. Restructuring leases and financings to include lease extensions. While the lessee may have short term relief as part of the deal, the lessors / financiers also get a more valuable asset taking into account the extended lease.
2. Converting cash deposits into LCs to allow that liquidity to be used towards paying lessors and financiers.
3. Sub-leasing or wet-leasing so excess capacity can be utilised for some degree of revenue generation.

- **Other contracts**

Aside from leases, we expect all servicing, insurance and purchase agreements will need to be examined on a case by case basis. In particular, care will need to be taken to review any force majeure provisions and / or consider if other legal principles such as the common law doctrine of frustration may come into play.

- **Tax**

Care should be taken on the tax implications if the lease or the financing is required to be restructured between the lessors, the lessees and the financiers.

- **Quick guide for staying in business during COVID-19**

Tiang & Partners together with PwC have published a circular relating to other matters relevant to staying in business during the coronavirus outbreak. These relate to issues which are relevant to all businesses (including the aviation industry). This guide can be accessed with the QR code.

CAAC's pro-active consultation in respect of the evolving interpretation of the Cape Town Convention

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Introduction

You may be aware that the PRC version of the Cape Town Convention (CTC), which has been in force in mainland China since 2009, contains the declaration under Article 50(1) of the Convention to opt out of the application of the Convention for "internal transactions".

If funding is required to acquire aircraft assets to lease to PRC airlines, a number of structures can be used including on-shore funding structures from domestic banks or offshore US dollar funding from international banks. Where offshore funding structures are used, it is common for assets to be owned offshore and leased into the PRC.

One commonly adopted structure involving offshore funding, for tax and other reasons, is the "lease in, lease out" (LILO) transaction. These transactions involve leasing an aircraft from an offshore lessor into a PRC free trade zone sub-lessor, who then sub-leases the aircraft to the PRC airline.

This article provides the latest developments on the Civil Aviation Administration of China's (CAAC) practice and interpretation on the "internal transaction" declaration and its implications for offshore funding structures.

Current situation

Under the CTC, the internal transaction declaration has the effect of turning agreements that would otherwise constitute international interests (which have the full protection of the CTC) into "national interests". The prevailing view is that any lease between two PRC entities constitutes an internal transaction and is a separate transaction from any superior head lease from an offshore lessor or any offshore financing.

A consequence of the prevailing view is that the sub-lease between the two onshore parties make up a separate internal transaction. Consistent with this approach, although AEP Codes (which must be issued by the CAAC in order for international interest registrations for CAAC registered aircraft to be effective) can be provided and international interest registrations can be made on the “offshore” part of LILO transactions (the mortgage and head lease from the owner to the sub-lessor) the CAAC will not issue AEP Codes for the sub-lease part of any LILO transaction where the sub-lessor and sub-lessee are PRC parties.

This is despite the fact that the owner is an offshore entity and the benefit of the aircraft is provided through the owner having obtained funding from offshore lenders. Another consequence is that the CAAC will not accept any IDERA for recording in respect of such LILO transaction, as the IDERA is an instrument that must be granted by the airline (as the registration holder under CAAC rules), and the IDERA remedy is not available for national interests.

Permitting IDERAs to be recorded in LILO structures

There have been two recent updates that are worth reporting.

First, the CAAC consulted with industry stakeholders including with the co-author of this article, Mr Liu Yi of Rui Bai Law Firm, at the end of 2019, as to whether the prevailing view should be revisited. The CAAC requested industry views on whether it should allow IDERAs to be recorded in LILO structures. The CAAC invited representatives from major airlines, PRC lessors, financiers and representatives from the Tianjin Free Trade Zone to present their views so as to obtain feedback and opinion from a wide range of industry stakeholders.

Rui Bai (a PwC network member law firm) was one of an exclusive number of PRC law firms invited to provide our views on aviation expertise to the CAAC. We can report that most stakeholders (including airlines, lessors and law firms) were in favour of a departure from the current approach and to recognise LILO transactions as forming one larger transaction with international elements, so that IDERAs should be granted and recorded in LILO transactions.

Technical arguments in favour of this position were put forward at the meeting by the law firms involved, while industry participants proposed a number of commercial and policy arguments in favour of recognising IDERAs (at least in the context of LILO transactions). These arguments form the basis of legal and policy reasons for the CAAC to reconsider the prevailing view.

After the meeting, the CAAC has said they will consider the industry participants’ views and adopt a principles based approach, including to give effect to the China’s treaty obligations.

In our view, the CAAC’s willingness to consult with market participants could be seen as a positive step as it indicates the CAAC and industry participant’s willingness to continue analysing the PRC’s adoption and implementation of the Cape Town Convention using a principles based approach.

As registration on the CTC and the ability to de-register aircraft using an IDERA usually form an important part of lender's credit assessment (where available), many industry participants (including the Aviation Working Group) have for many years lobbied for a reconsideration of the prevailing view with reference to legal and policy principles behind the adoption of the Cape Town Convention.

Specific considerations in respect of Hong Kong and Taiwan lessors

The CAAC has suspended issuing AEP Codes for "offshore" transactions involving Hong Kong and Taiwan based lessors leasing into PRC in another recent development. For Hong Kong, this is further complicated by the fact that the PRC has declared that the CTC does not apply to Hong Kong.

It is well understood where an aircraft is being leased from a non-CTC jurisdiction to a CTC jurisdiction, the CTC would still apply as the creation of an international interest is determined by the debtor's location or the aircraft's state of registration. This analysis also applies for aircraft leased in from Hong Kong or Taiwan. However, the CAAC is now reconsidering this given the heightened political sensitivity around categorising Hong Kong and Taiwan as separate states, although noting that the CTC position permits divergent application between separate territorial units within one state.

While this may be a temporary suspension on issuing AEP codes, the CAAC has not indicated when they will re-commence issuing AEP Codes. The CAAC has also to date not provided any indication of when they will reach a final view on whether they will recommence issuing AEP Codes for Hong Kong and Taiwan IR registrations. We continue to monitor the CAAC's position.

Please contact the authors for further thoughts on how best to approach the credit analysis around common funding and leasing structures based on current state of affairs, including best practices to protect our clients' position, and the circumstances and the extent to which international interest or national interest registrations are appropriate or possible.

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Navigating GATS

All eyes and ears in the aviation finance and leasing circles are on the Global Aircraft Trading System (GATS) electronic platform with hopes that it will be the ultimate solution to the pain of transfers of leased aircraft ownership - lease novations and tripartite transfers. While GATS has the potential to greatly simplify trading and (possibly) financing of aircraft, it has also created nuances and complexities which need to be considered.

What is GATS?

Aircraft equipment under GATS will be held through bare trusts. The legal title will being held by a professional trustee and the economic risks and benefits retained by the beneficial owner. GATS also prescribe a set of standard documents to establish GATS trusts and the transfer of beneficial and security interests, which will be executed using e-signatures through the GATS platform and recorded on an e-ledger. These features are designed to allow beneficial interest in the aircraft to be transferred while leaving the underlying lease untouched. This will reduce the lessee's involvement and limit the parties' ability to seek to re-negotiate the terms of the lease.

Recognition of trusts

The foundation of GATS, being the holding of the legal title of aircraft equipment in trusts and effecting transfers of ownership by only changing the named beneficiaries, is not an unfamiliar concept in aviation finance. However, the suitability of GATS trust structures in each jurisdiction will need to be assessed individually.

The basis of GATS' solution relies on whether the relevant jurisdictions involved in a transaction recognise trusts. In addition to jurisdictions which inherently recognise trusts, GATS falls back on the Cape Town Convention which requires signatories (even if the jurisdiction does not otherwise recognise the concept of a trust) to give effect to validly created foreign trusts[1]. It is argued that in theory most (if not all) common law jurisdictions and Cape Town countries will recognise GATS as an effective way of recognising ownership interests and transfers of such. Despite its broad subscription, the Cape Town framework is not without uncertainties, and the level of accession and compliance varies substantially among contracting states.

This concern is somewhat addressed in the legal opinions[2] obtained by the Aviation Working Group (AWG) on the validity and enforceability of the GATS standard documents in their governing jurisdictions (for example, on an insolvency of a GATS Trustee, the governing jurisdiction would recognise that while the aircraft and related assets are legally owned by the Trustee, the property is held for the benefit of the beneficiaries and not available to the Trustee's general creditors).

Industry players should note that these legal opinions will only be addressed to the AWG for information purposes only, and it is equally important to consider the positions in the jurisdictions of the GATS Beneficiaries and the lessees.

In theory, GATS Beneficiaries can be located in any jurisdiction which recognises the concept of trusts, but related considerations, such as tax and insolvency treatment, may make certain jurisdictions more desirable or undesirable than others. Local laws in the jurisdiction where the aircraft is registered or situated would also impact on an owner's ability to repossess the aircraft in an event of default.

Although these issues are not likely to obstruct the working of the system at this stage, industry players should get comfortable on the enforceability of the GATS Trust Instruments in the relevant jurisdictions at the outset. It would also be helpful for potential GATS Participants to understand the risks associated with appointing professional GATS Trustees and seek proper advice on how to deal with residual legal and tax risks in the GATS Trust.

[1] Article VI of the Aircraft Protocol requires participating countries to recognise a validly created foreign trust of purposes of the creation and enforcement of rights in relation to the Cape Town Convention.

[2] The legal opinions relate to the jurisdictions of the initial GATS Trust Branches (Ireland, Singapore and United States (New York, Delaware and Utah)).

Formalities requirements

Issues such as execution via e-signatures and creation of a valid deed differs across jurisdictions and may require deeper analysis. The issue of whether electronic execution and delivery within the GATS Platform is sufficient for creation of deeds is expressly carved out in some of the aforementioned legal opinions addressed to AWG. This issue may also be relevant as local formality requirements, for example, in situations where there is a lack of valuable consideration on the face of the transaction.

In addition, even if the documents do not need to be executed as deeds, the ability of parties to execute documents by e-signatures, and the recognition of such, would need to be considered in each relevant jurisdiction to ensure that the GATS documents are duly executed. In the absence of such comfort, parties may wish to execute documents electronically on the GATS platform while also requiring a physically signed "wet-ink" version as a back-up should there be any uncertainty.

Dispute resolution and conflicts of laws

Complications may arise from the conflicts of the various governing laws of the documents constituting the GATS structure (for example, there may be difficulties in consolidating the litigation proceedings to a single tribunal if the law governing the constitution of the trust is different from that of the finance documents). This has led some commentators to worry that increasing the number of jurisdictions and governing laws may lead to more complicated conflict of laws and choice of forum issues.

As GATS develops and expands, would it overlap with the functions of the International Registry? As with the International Registry practice of purchasers making International Registry filings even when not strictly speaking required (and where they would have no legal effect) for informational purposes, the GATS e-ledger could be used in the same way. It would then also stand as another register parties would be expected to search. The effect of such actual or imputed notice may also have an impact as an evidentiary matter or legally under the applicable local laws.

Tax implications

The AWG has advocated for the GATS trust to be treated as a transparent entity for tax purposes. In-depth analysis on a case-by-case basis, especially where jurisdictions which do not recognise trust structures are involved, would be required. The AWG recognised this and has formed a GATS platform tax advisory board at which PwC will be represented. The advisory board is due to take effect in March 2020.

The way forward

The real benefit of GATS is to reduce friction in completing transfers by eliminating the need for novations and simplifying the transfer process.

This is especially so where the terms of the underlying lease attached to the aircraft are non-negotiable (although the system still requires lessees to connect and confirm that all conditions are met).

With the major lessors and members of AWG driving adoption, there is no doubt many participants will at some stage be documenting (or be requested to document) their aircraft acquisition and leasing transactions via the GATS system.

GATS supporters have also pointed to potential added benefits if GATS could also serve as a central secure system for storing and tracking all documents relating to an aircraft.

Indeed, once there is a critical mass in the uptake, future innovations could include the ability to put aircraft onto a public or private blockchain, or pave the way for fractional ownership or new technology-led investment opportunities.

For all of these reasons, all industry players should keep a close eye on its continuing development.

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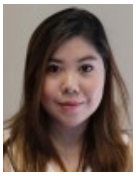

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