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CURRENT ISSUES IN AIRCRAFT FINANCE

MICHAEL DOWNEY RICE*

THE AIRLINE BUSINESS is capital-intensive. The price list at Boeing or McDonnell-Douglas starts at about $25 million for a twin-engine, narrow-body aircraft, and goes up to approximately $130 million for a wide-body aircraft capable of transcontinental travel. At that, the order books are full, and commercial transport sales of United States manufacturers are expected to exceed $30 billion in 1991. The trend continues upward.¹

Under these circumstances, the airline capital budgeting process, particularly the aircraft financing process, deserves a careful analysis. A difference of a few basic points in financing costs has enormous significance in a hundred million dollar transaction. Achieving the optimum financing arrangements is a complex and not entirely quantitative exercise. The needs and desires of the financing parties—banks, insurance companies, pension plans, and other institutional investors—deserve as much analysis as net present values and internal rates of return.

The current legal environment is the setting for interaction between industry and investor, borrower and lender, lessee and lessor—an interaction that is as much a romance as a negotiation, as much a marriage as a contract. Certain legal aspects of financing packages are attractive, while others seem repulsive. Event-risk

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¹ McKenna, Airline Industry Forecasts for ’91 See the Strong Gaining and the Weak Losing, AV. WEEK & SPACE TECH., March 18, 1991, at 87.
covenants may be enticing indeed, while an absence of section 1110 protection in the event of the lessee’s bankruptcy will force most of the eligible financers off the dance floor.²

A decent respect on the part of all parties for the concerns of the other parties to financing transactions will produce the most satisfactory results: the lowest cost of financing for the airline and the greatest degree of investment integrity for the financers. This impels us to examine some of the current legal aspects of aircraft financing that concern airlines and financers.

**Forms of Aircraft Finance**

A few well-heeled airlines are able to finance aircraft out of earnings or through the issuance of unsecured debt, such as medium-term notes. Most airlines, however, find the lowest cost of funds in a combination of lease financing and debt secured by particular aircraft. Airlines usually employ lease financing when they see some benefit in having the transaction off the balance sheet or when they can no longer take advantage of the tax benefits of accelerated cost recovery deductions associated with equipment ownership.

**Debt Financing**

The adoption of article 9 of the Uniform Commercial Code³ in every state made possible the replacement of the old, somewhat contrived forms of secured financing for personal property, such as chattel mortgages, with the more rational notion of a security interest. Under the new approach, the debtor owns the property, and the creditor has a “security interest” which permits him, as the “se-
secured party," to recover and sell the property upon default on the debt. Old habits die hard, however, and aircraft financers still use the old forms, particularly in the public markets.

The most familiar form of financing is the mortgage, which is ostensibly a conveyance of the aircraft in trust to a trustee acting for the lenders. When the debt is fully discharged, the conveyance is regarded as void. A traditional aircraft mortgage has a granting clause, a habendum ("to have and to hold ...") clause, and a defeasance clause, as did real estate mortgages in medieval England, and railroad mortgages in the last century. Mortgages have been written to cover a changing pool of collateral, so that airlines can finance aircraft, engines, and spare parts without impairing their ability to acquire and release such equipment in the ordinary course of business.\(^4\) Regardless of the label, courts treat aircraft mortgages in the United States as security agreements governed by UCC article 9. No harm is done by using this old form.

Another legacy from railroading, the equipment trust, should be explained here as well. The equipment trust is a legal structure used for both railroad equipment and aircraft financing which was invented in the early part of the nineteenth century for financing canal boats. In the beginning of the industrial era in the United States, there was no legal device available to establish an interest in personal property as security for a debt. Mortgages on real property were common but an interest in personal property apart from possession was regarded as fraudulent; one was presumed to own what one possessed.\(^5\) Commerce demanded progress, however, so Philadelphia lawyers invented the bailment-lease to finance canal boats. Under the bailment-lease, an investor or group of

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investors would purchase a canal boat and lease it to a boatman for a period of years. The rents were sufficient to recover the investment with interest. The boatman was responsible for running the boat, feeding the mules, and taking care of maintenance. Upon completion of the schedule of payments, the boatman would become the owner of the boat.\(^6\)

In the early part of the nineteenth century, Pennsylvania courts validated the superiority of the investors' nominal ownership over the claims of third parties.\(^7\) Railroads adopted the bailment-lease for equipment financing when they began to compete with the canal companies. The Philadelphia plan equipment trust, as it became known, was based on a lease of the equipment from an investor group to the railroad. A trustee held ownership in trust for the investors, and issued certificates to the investors as evidence of their participation. The trustee purchased the equipment out of the proceeds of the issue of certificates and a substantial advance "rent" payment, perhaps twenty percent of the equipment cost, received from the railroad. He distributed subsequent rents paid by the railroad to the investors as recovery of principal and as "dividends." At the end of the trust term, usually fifteen years, the trustee conveyed the equipment to the railroad for no additional consideration. It became customary for the railroad to endorse the trust certificates with its guaranty.

Railroads throughout the country adopted the trust form as the preferred means of financing equipment acquisition.\(^8\) This form has survived almost without change while other types of personal property security devices have undergone a century and a half of legal evolution. Railroad companies still routinely issue Philadelphia plan certificates.

\(^{6}\) Id. at 87.

\(^{7}\) Id. at 87 n.6 (citing Lehigh Coal & Navigation Co. v. Field, 8 Watts & Serg. 232 (Pa. 1844)). See generally Montgomery, The Pennsylvania Bailment Lease, 79 U. Pa. L. Rev. 920 (1931).

\(^{8}\) K. Duncan, Equipment Obligations (1924).
equipment trust certificates by public offering, and these certificates have a ready acceptance in the financial markets.\(^9\)

When the airlines came to Wall Street in the 1950s to raise funds to purchase aircraft, the railroad equipment trust was adapted for aircraft financing, complete with the bailment-lease, the trustee, the certificates, and the guaranty.\(^10\) The major difference was a change in terminology for the return on equipment trust certificates from “dividends” to the more accurate designation of “interest”.

To a significant extent, the equipment trust format has been recognized in statutes: securities laws,\(^11\) the Bankruptcy Code,\(^12\) and legal investment laws.\(^13\) UCC article 9, the fundamental law regarding personal property security, however, treats the bailment-lease embodied in the equipment trust as a legal fiction. Under article 9, the nominal lessee is really the owner, and the nominal owner is merely a secured party. Thus, the bailment-lease in an equipment trust is not a lease at all, but a security agreement.

Perhaps there is no harm in the continuation of this legal hocus-pocus. The equipment trust is not what it purports to be, but it works; the holders of equipment trust certificates have a claim on the equipment. Calling a security interest a lease for the sake of tradition, however, can be a source of confusion in transaction documents and disclosure statements, which are often unclear even under the best circumstances. The so-called lease can be particularly troublesome in a business environment populated by financing transactions that involve genuine leases.

\(^9\) See M. Rice, Railroad Equipment Obligations 111 (1978); D. Street, Railroad Equipment Financing 69 (1959); Rice, supra note 5, at 88.


\(^13\) See Rice, supra note 5, at 105 n.103.
LEASE FINANCING

Lease financing of aircraft is often viewed as the alternative to "straight" debt financing. In some forms it is an alternative, but in others there is very little difference between the two; the range of secured debt and lease financing devices represents an almost continuous spectrum, and the line between one and the other is indistinct.

Leasing in the aircraft industry began with short-term arrangements, a method of exchanging equipment among airlines to accommodate seasonal variations in traffic. Longer-term leases emerged as financing devices for equipment acquisition in the 1960s, with the advent of tax incentives for equipment investment in the Kennedy-Johnson era. Tax incentives were of no use to airlines whose tax liability had been fully offset by other deductions and credits, but other corporate taxpayers were willing to purchase aircraft and lease them to the airlines at rates reduced to reflect the availability of those tax incentives: the investment credit and accelerated depreciation.

The use of leverage moved leasing into the front rank of financing devices. An owner-lessee could borrow up to 80% of the cost of an aircraft from the same institutions that would provide debt financing directly to the airline, because the lease, non-cancelable for the term of the debt, would be assigned to the debt participants. Willing to look only to the stream of lease rents for payment, the debt participants excused the owner-lessee from liability on the debt. Thus, the debt participants had a self-liqui-

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15 See generally Johnston, supra note 14, at 303-06 (discusses tax consequences of leasing); Lambert, supra note 14, at 661 (discusses tax consequences to lessor).

16 Leverage is "the ability to finance an investment with a small amount of one's own funds, . . . with the balance consisting of borrowed funds." BLACK'S LAW DICTIONARY 906 (6th ed. 1990).
dating investment with good collateral, the equity participant (the owner-lessee) obtained a handsome return, and the airline lessee achieved financing, off the balance sheet, at a cost below that of equivalent debt.17 It was a splendid business "ménage à trois."

In those early days of leasing, neither the airline lessees nor the lessors regarded the value of the aircraft at the end of the lease term as a significant factor in the economic analysis of a leasing transaction. This was a time of rapid technological evolution; the industry went from piston-engine aircraft to turbo-props to turbojets and there was substantial growth in the size and range of commercial aircraft. It was customary for lessors to give airlines an option to purchase an aircraft at the end of its lease term at fair market value.

Times have changed, however. Aircraft financed in fifteen-year leveraged lease transactions have reached the end of the lease term with values approximating their original cost. Such values are largely a result of inflation, but inflation is a recurring problem which has caused airlines to be sensitive to the need for some sort of protection against indeterminable increases in residual value. A current leveraged lease transaction typically involves a very long term, perhaps in excess of twenty years, and includes options for the airline lessee to purchase the aircraft at a fixed price at the end of the lease term or at some time before the expiration of the lease. The fixed-price purchase and early buyout options are set at figures estimated at the beginning of the transaction to be no less than the fair market value of the aircraft at the anticipated time of exercise of the option.

The use of fixed-price purchase options and long lease terms was once thought to be aggressive from a tax standpoint, because the transactions began to take on many characteristics of secured loans. Nevertheless, such features have become standard in aircraft finance leases. Ex-

17 Lambert, supra note 14, at 657-62.
experienced lessors have become quite comfortable with the notion that the tax benefits of equipment ownership are available to them, and they price the transactions accordingly.\textsuperscript{18}

**CROSS-BORDER LEASING**

Not all nations subscribe to the same theories regarding the difference between a lease and a secured loan. As a result, a form of arbitrage is possible, leasing an asset from one country to another in a transaction that is regarded as a lease in the lessor’s country and a secured loan in the lessee’s country.\textsuperscript{19} In such a case, the lessor and the lessee would each be treated as the owner of the leased asset in its respective home country, and each would be entitled to the tax benefits of ownership—a “double dip” of tax benefits.\textsuperscript{20}

Some countries give substantial credence to the form of a transaction, so that a transaction styled as a lease would be treated as a lease,\textsuperscript{21} while other countries look to the economic substance of the transaction to determine whether a true lease exists.\textsuperscript{22} Even countries that use tests of economic substance may not agree on the standards to be applied.\textsuperscript{23}

Leasing brokers have been busily matching country pairs in their search for lucrative transactions. They must always be on the alert for new opportunities, because the tax authorities in many jurisdictions look upon “double-dip” leases with something less than benevolence and have changed the rules accordingly.\textsuperscript{24} As the authorities change the tax laws, the lease brokers, like Nathan Detroit

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\textsuperscript{18} See id. at 640-44.
\textsuperscript{19} See Koffey & Umbrecht, Japanese Cross-border Leasing into the United States, 43 \textit{TAX LAW.} 149 (1989).
\textsuperscript{20} \textit{Id.} at 159 n.6.
\textsuperscript{22} \textit{Id.}
\textsuperscript{23} \textit{Id.}
\textsuperscript{24} \textit{Id.} at 1269.
and his floating crap game, move to a new location and continue their activities.

The first cross-border, double-dip transactions of significant size were aircraft leases from the United Kingdom to the United States. The United Kingdom once had very high tax rates, and had an available write-off of 100% of the cost of a capital asset in the first year of ownership. At the same time, the United States offered the investment tax credit and accelerated methods of depreciation. The United Kingdom double-dip transactions were leases from an entity in the United Kingdom, the nominal owner-lessee, to a lessee in the United States. These leases were designed with purchase options that caused each transaction to be regarded as a secured loan under United States tax laws without defeating its treatment as a lease by the United Kingdom revenue authorities. If the user of the aircraft in the United States could not take full advantage of the tax benefits of ownership, another entity would serve as the nominal lessee and sublease the aircraft to the ultimate user. The sublease would have the essential characteristics of a “true” lease so that the lessee-sublessor would be treated as the owner under United States law.

The United Kingdom authorities soon put a stop to such double-dip transactions by establishing special rules for leases in which the ultimate user was outside of the United Kingdom. Eventually the economic incentive behind these transactions declined as the United Kingdom reduced its tax rates and eliminated the 100% first-year write off.

The Kingdom of Sweden has been the most durable host country for cross-border leases. Leases from Sweden into the United States offer attractive tax benefits in both jurisdictions, possibly because of a somewhat lower threshold of permissible fixed-price purchase options in

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26 Taylor, supra note 21, at 1262.
27 Id. at 1262, 1269.
Sweden. Although the high Swedish income tax rates have made investment in lease transactions an attractive tax shelter in Sweden, there is a limit to the appetite of Swedish investors, so the practice has not gotten out of hand. Swedish tax authorities have traditionally tolerated double-dip leases only where national interests, such as export of goods manufactured in Sweden, are at stake.

Japanese cross-border leases have received the greatest notoriety in recent years, particularly in the area of aircraft finance. These leases involve special challenges because of withholding taxes and the currency risk.

In the typical Japanese lease of aircraft, the Japanese corporate investors, seeking shelter from Japanese income taxes, formed a special entity called a tokumei-kumiai, which permitted the tax incidents of a transaction to flow through to the investors. The tokumei-kumiai borrowed a significant portion of the purchase price of the aircraft from a bank, usually the Japanese branch of a global bank, and then leased the aircraft to an American airline. If the airline could not use the tax benefits, a financing party leased the aircraft and then subleased it to the airline.

The lease from the Japanese entity to the American entity was designed to qualify as a lease with the Japanese National Tax Agency (JNTA), permitting the Japanese investors to receive the tax benefits of ownership, but to fail as a lease under the United States tax rules. Giving the lessee an option to purchase at between thirty and forty-five percent of the original cost when the lease term expires is a common way of accomplishing these goals. If the lessee does not exercise the option, it must pay the option price; the lessor must then sell the aircraft and reimburse the lessee from the proceeds of the sale.

Lease payments from the United States into Japan are subject to withholding tax, and any payment denominated

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28 See Koffey & Umbrecht, supra note 19, at 149.
29 Id. at 156.
30 Id.
31 Id. at 156-57.
in yen bears a risk of currency shifts.\textsuperscript{32} To avoid these problems, Japanese lease transactions have been "defeased" by the lessees. To accomplish this "defeasance," the lessee paid an amount equal to the present value of the full rent obligation and the purchase option to a bank in a jurisdiction that has no withholding tax for payments to Japan; that bank then agreed to make the future payments under the lease in the appropriate currency. The present value of the rent and purchase option payments would be less than the cost of the aircraft; this difference, usually about five percent of the cost of the aircraft, justified all the effort that went into constructing these deals.

The defeasance payment was usually financed through unsecured borrowing, but on a few occasions complete domestic leveraged lease transactions have been based on a sale and leaseback of the airline's leasehold interest in the aircraft. In theory, the defeasance has effectively eliminated the interest of the Japanese financing parties in the aircraft. The domestic financing parties have sometimes been able to obtain a full subordination of their rights in the aircraft from the Japanese financiers.

Japanese lessors have leased aircraft into other countries as well, and the global impact on aircraft financing has been considerable.\textsuperscript{33} The Japanese tax authorities have viewed this development with increasing alarm.\textsuperscript{34} In mid-1989, the JNTA advised Japanese tax advisors of its disapproval of two-tiered transactions in which the Japanese lessor leases to an American financing party, which in turn subleases to the ultimate user.\textsuperscript{35} In 1990, the JNTA declared the defeasance structure taboo; the only Japanese cross-border lease transactions now permitted require that the Japanese financing parties remain at risk

\textsuperscript{32} Id. at 157.
\textsuperscript{33} Japan's New High Fliers, AIRFINANCE J. 12 (Supp. 1990). It was estimated that in early 1990 that Japanese lease transactions had grown to 20\%-30\% of aviation finance. \textit{Id.}
\textsuperscript{34} Koffey & Umbrecht, supra note 19, at 157.
\textsuperscript{35} \textit{Id.}
for the lease payments. Since the obligors in these transactions must contend with the problems of withholding tax and currency risks, the entire concept is considerably less attractive than in its heyday in early 1989.

Europe may be the most favorable venue for continued tax-oriented cross-border leasing into the United States. Many European nations, either in reliance on civil law respect for form or in traditional tolerance of fixed-price purchase options, treat as lease transactions that which American tax authorities consider to be secured transactions, creating tax owners in two jurisdictions. Treaties currently in force with these countries eliminate withholding tax on cross-border payments, and currency risks can be eliminated by denominating the obligation in dollars. Thus, European-American leases need not be defeased; they can remain in place as true financing. To achieve the desired tax consequences, it is essential that the transaction is officially viewed as a form of export subsidy or other perceived benefit to national interests.

Tax-oriented lease transactions from the United States to other countries require more ingenuity than leases into the United States. American tax authorities take what is perhaps the strictest view on the globe of what constitutes a lease, so definitional arbitrage in the outbound direction is not practical. Furthermore, use of equipment predominantly outside of the United States disqualifies that equipment for the most favorable accelerated cost recovery deductions. Fortunately, Congress has provided the Foreign Sales Corporation (FSC), an export-assisting de-

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56 See id.
57 These problems are not insurmountable. Withholding tax for payments to Japan can be avoided by arranging for the transaction to fit within the exemption for portfolio interest. The currency risk can be ameliorated by denominating the debt portion of the payments in dollars and hedging the yen risk for the remaining portion. Some airlines have yen receipts that can be matched to the yen obligations.
59 See generally Taylor, supra note 21, at 1243 (discussing the effect of treaties on cross-border leasing).
60 I.R.C. § 168(g) (1988).
vice which enterprising brokers have adapted for lease financing.\textsuperscript{41}

FSCs were designed to replace domestic international sales corporations (DISCs), as a form of export assistance for American manufacturers because several European countries criticized DISCs as contrary to the General Agreement on Tariff and Trade.\textsuperscript{42} FSCs provide partial exemption from United States income taxes on export profits.\textsuperscript{43} In order to obtain the exemption, an American corporation organizes the FSC in a permissible foreign country or a United States possession. A percentage of profits, which would otherwise be taxed to the parent corporation, is allocated to the FSC, and a portion of those profits is exempt from tax.\textsuperscript{44} The income can then be paid to the parent corporation without additional tax under the dividend-received deduction.

FSCs have been adapted for use in leasing American aircraft to foreign users.\textsuperscript{45} The simplest technique, called the "commission FSC," involves leasing an American-manufactured item owned by the parent of the FSC for use outside the United States. In form, the FSC arranges the transaction and receives a commission out of the leasing income from the parent. Part of that commission is exempt from tax, sheltering the parent's income tax to that extent.\textsuperscript{46}

A more complex scheme involves actual ownership of the leased item by the FSC. The complexity results from efforts to leverage the transaction with debt funds, while

\textsuperscript{41} See id. §§ 921-27; Staff of the Joint Comm. on Taxation, 100th Cong., 1st Sess., Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation 178 (1987) [hereinafter Technical Corrections].


\textsuperscript{44} I.R.C. § 922 (1988).

\textsuperscript{45} P. Geoghegan, The Use of FSCs in Connection with Aircraft Leases (paper presented in address to The Tax Club, Apr. 18, 1990).

\textsuperscript{46} Id.
ensuring that an interest deduction does not reduce the amount of income attributable to the FSC. This effect can be accomplished by inserting a third corporation between the parent and the FSC; that middle corporation borrows the funds and injects them into the FSC for acquisition of the item to be leased. Thus, the full rent income is attributable to the FSC and subject to the exclusion without deduction for interest on debt, while the interest is attributable to the middle corporation. This corporation and the parent file consolidated tax returns, making the interest deduction available to set off against other income.\textsuperscript{47} The nature of the security for the debt leads to interesting negotiations; instead of a security interest in the aircraft, the lending institution receives a pledge of the stock of the foreign corporation. Fortunately, the rules require that some part of the negotiations take place outside of the United States, and a suitable tropical venue is usually selected.

\textbf{REGISTRATION AND RECORDATION}

The facilitating feature of flight equipment financing transactions is the federal system of recordation of interests in aircraft.\textsuperscript{48} The Federal Aviation Administration (FAA) maintains an aircraft registry in Oklahoma City as a national depository of interests in aircraft, aircraft engines, propellers, and spare parts. This system takes the place of filings under the Uniform Commercial Code in various states. The registry actually serves two distinct functions: aircraft registration\textsuperscript{49} and recordation of financing documents.\textsuperscript{50} The two functions must not be con-

\textsuperscript{47} Id.
\textsuperscript{49} Id. § 1401(a) (1988). Registration is a requirement for all flights within U.S. airspace. \textit{Id.} There is a limited exemption for foreign aircraft. \textit{Id.} § 1508(b) (1988).
\textsuperscript{50} Id. § 1403(a)(1)-(3) (1988). "An interest in aircraft or aircraft engines is not valid until such conveyance or other instrument is filed for recordation in the Office of the Secretary of Transportation." Aircraft Trading & Serv. v. Braniff, Inc., 819 F.2d 1227, 1230 (2d Cir.), \textit{cert. denied sub nom.}, 484 U.S. 856 (1987).
fused. Registration is both a requirement for flight within the United States and a prerequisite for recordation.\textsuperscript{51} Recordation of interests in aircraft with the registry protects those interests throughout the United States and, through an international convention, in many foreign countries. Since recordation with the FAA is the exclusive means of perfecting such interests, a search of the aircraft registry will disclose both the identity of the owner of an aircraft and the existence of any liens against it.

\textit{Registration}

Section 501(b) of the Federal Aviation Act sets forth the eligibility requirements for aircraft registration.\textsuperscript{52} The eligibility determination turns on ownership and citizenship. If a corporation fails the citizenship test, an aircraft can still be registered if it is "based and primarily used in the United States."

\textit{Ownership}

The concept of ownership plays a significant role in lease transactions. Ordinarily, an aircraft would be registered in the name of the owner-lessee, but the FAA is willing to examine the terms of a lease to determine whether

\begin{footnotes}
\textsuperscript{52} 49 U.S.C. § 1401(b) (1988). The Code states:
An Aircraft shall be eligible for registration if, but only if —
(1) (A) It is—
(i) owned by a citizen of the United States or by an individual citizen of a foreign country who has lawfully been admitted for permanent residence in the United States; or
(ii) owned by a corporation (other than a corporation which is a citizen of the United States) lawfully organized and doing business under the laws of the United States or any State thereof so long as such aircraft is based and primarily used in the United States; and
(B) is not registered under the laws of any foreign country; or
(2) it is an aircraft of the Federal Government, or of a State, territory, or possession of the United States or the District of Columbia or a political subdivision thereof.
\textit{Id.} For the purposes of this subsection, the Secretary of Transportation shall, by regulation, define "based and primarily used in the United States."
\end{footnotes}
it is in fact a lease or is really a secured loan. This question is particularly important in the case of cross-border leases in which the lessor and nominal owner is a foreign entity; such lease transactions are unavailable to American aircraft users unless the FAA accepts the proposition that the nominal lessee is the actual owner and registers the aircraft in the name of that nominal lessee.

The FAA has been willing to permit such transactions in certain circumstances. Until recently only a series of opinions rendered by the FAA's Assistant Chief Counsel at the Aeronautical Center in Oklahoma City have articulated the FAA position on ownership for registration purposes. There has been no rule-making on the issue; the Federal Register published the only public statement on the issue some years ago. On October 3, 1990, however, the FAA Chief Counsel in Washington, Gregory S. Walden, published an opinion which set forth new guidelines for future determinations of ownership for registration purposes. Walden's opinion acknowledges that it is necessary to look beyond the form of a transaction to its economic substance. His analysis begins with the new definition of "security interest" in the revision to section 1-201(37) of the Uniform Commercial Code, which will be enacted with the new article 2A on personal property leasing. This comprehensive definition narrows the range of uncertainty in this area, while leaving room for a determination based on the facts in each case. After discussing the circumstances under which the FAA has been asked to determine ownership for aircraft registration purposes, Walden concludes with this statement:


54 The FAA will examine lease transactions to determine whether they are "true" leases or leases for security. In the latter case, the FAA considers the lessee to be the actual owner and permits registration in the name of the lessee. In this way, the FAA disregards the citizenship of the nominal lessor. Id.


56 Treatment of Leases With an Option to Purchase, supra note 53, at 40,502.

57 Id. at 40,503; see U.C.C. art. 2A (1987).
Accordingly, we are of the opinion that the Registry should recognize as the owner for aircraft registration purposes the lessee under a lease with an option to purchase when:

(1) The purchase option is 10 percent or less of the value of the aircraft determined at the time the lease is executed; or

(2) The purchase option price is above the 10 percent bright line, but contains a requirement that if the option is not exercised, the lessee nevertheless is obligated to pay a residual value or termination sum equal to or exceeding the purchase option price; or

(3) The purchase option is higher than 10 percent and there is no mandatory full payout if the option is not exercised, but the option price is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised.

In all cases where a lease in form is to be considered a lease intended for security, the usual lease factors must also be present:

(a) The lessee has the obligations of maintenance, insurance, taxes, operations and risk of loss; and

(b) The lease must not permit the unilateral right to terminate the lease without economic penalty.58

Thus, the FAA position on the distinction between a true lease and a lease for security, and the consequent location of ownership in the lessee or the lessor, follows current thought in making the same determination for tax purposes. Despite the greater certainty provided for aircraft financing by this statement, however, any aggressive or innovative transaction should be presented to the FAA for a determination early in the documentation process.

**Citizenship**

Owners of United States registered aircraft must be American citizens.59 A corporate applicant for registra-

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58 Treatment of Leases With an Option to Purchase, supra note 53, at 40,504.
59 See McMeen & Sarchio, Administrative Flexibility and the FAA: The Background and Development of United States Registration of Foreign-Owned Aircraft, 46 J. AIR L. & COM.
tion need only certify that it has United States citizenship.\(^6\) If a domestic corporation cannot truthfully make such a certification, registration is available under section 501(b)(1)(A)(ii) of the Federal Aviation Act if the aircraft is to be "based and primarily used" in the United States.\(^6\)

To meet this test, FAA regulations require that the flight hours of the aircraft in the United States, or between points in the United States, amount to at least sixty percent of the total flight hours of the aircraft in a six-month period.\(^6\) This requirement can be a point of stress in a lease transaction involving an air carrier, because no carrier wants to restrict its flight operations because its lessor fails to meet the test of United States citizenship. Thus, in arranging lease transactions, air carriers ordinarily specify that the lessor (and any future transferee of the lessor) must be an entity eligible for aircraft registration in its name without limitations on location or use of the aircraft.

1 (1980); Stewart, United States Citizenship Requirements of the Federal Aviation Act: A Misty Moor of Legalisms or the Rampart of Protectionism?, 55 J. AIR L. & COM. 685 (1990). The Federal Aviation Act defines a "citizen of the United States" as:

(a) an individual who is a citizen of the United States or one of its possessions, or

(b) a partnership of which each member is such an individual, or

(c) a corporation or association created or organized under the laws of the United States or of any State, Territory, or possession of the United States, of which the president and two-thirds or more of the board of individuals and in which at least 75 percent of the voting interest is owned or controlled by persons who are citizens of the United States or of one of its possessions. 49 U.S.C. app. § 1301(16) (1988).

\(^6\) 14 C.F.R. § 47.7 (1990).
\(^a\) Id. § 47.9(a)(3).
\(^b\) Id. § 47.9(b). The regulation states:

(b) For the purposes of registration, an aircraft is based and primarily used in the United States if the flight hours accumulated within the United States amount to at least 60 percent of the total flight hours of the aircraft during—

(1) For aircraft registered on or before January 1, 1980, the 6-calendar month period beginning on January 1, 1980, and each 6-calendar month period thereafter; and

(2) For aircraft registered after January 1, 1980, the period consisting of the remainder of the registration month and the succeeding 6-calendar months and each 6-calendar month period thereafter.

Id.
Because of acquisition by foreign interests, many financial institutions in the United States that invest in aircraft for lease can no longer certify United States citizenship. To qualify in these situations, a trustee or a subsidiary corporation with its stock held in a voting trust may own the aircraft.\textsuperscript{63} In either case, the trust agreement must conform to certain regulatory requirements to ensure that control remains in the hands of United States citizens.\textsuperscript{64}

\textit{Registration Procedures}

Aircraft registration procedures, once expeditious, are currently changing to conform to the requirements of the Federal Aviation Administration Drug Enforcement Assistance Act of 1988.\textsuperscript{65} General aviation aircraft are important vehicles for drug smuggling. Abuses of and deficiencies in the aircraft registration system have hampered law enforcement efforts by making it difficult or impossible to trace the ownership of aircraft from the "tail" numbers.\textsuperscript{66} Pursuant to Congressional mandate, the FAA has initiated a proceeding to address these abuses and deficiencies by revising registration procedures.\textsuperscript{67} Some of these changes will have an impact on financing transactions. Under the current rules, a copy of the application, retained by the applicant, constitutes temporary authority to operate the aircraft.\textsuperscript{68} Under the proposed system, the FAA would issue temporary authority to operate only after receipt of the application, and this temporary authority

\textsuperscript{63} See \textit{Id.} \textsuperscript{§}§ 47.7(c), 47.8.
\textsuperscript{64} \textit{Id.} \textsuperscript{§}§ 47.7, 47.8.
\textsuperscript{67} 49 U.S.C. app. \textsuperscript{§} 1401 (1988); \textit{see also} Drug Enforcement Assistance; Notice of Proposed Rulemaking, \textit{supra} note 66, at 9270.
\textsuperscript{68} The FAA has instituted a rule limiting operation under this temporary authority to flights within the United States. Revision of General Operating and Flight Rules, 54 Fed. Reg. 34,284 (1989) (to be codified at 14 C.F.R. \textsuperscript{§} 91.203(a)(2)); \textit{see also} Drug Enforcement Assistance; Notice of Proposed Rulemaking, \textit{supra} note 66, at 9271.
would be limited to operations in the United States. The proposal also includes an expedited procedure which would allow the issuance of a temporary certificate of registration for use of the aircraft outside of the United States.

Under the existing regulations, registration is effective when the FAA Aircraft Registry receives the application and necessary accompanying papers. If the aircraft was last registered in a foreign country, however, registration is not effective until the application has been examined and the certificate issued. The proposed regulations would delay effectiveness of the registration in all cases until the Aircraft Registry determines that the registration requirements have been met. Under section 503 of the Federal Aviation Act conveyances, security interests, and the like can only be recorded if the aircraft is registered under current regulations. Unless these new regulations are reconciled, financing documents cannot be recorded until after the FAA has reviewed the application for registration. An expedited procedure will be necessary to eliminate this time gap in order to provide adequate protection for financing parties.

Application for registration under the new rules will involve strict procedures to verify the identity of the applicant. For instance, the corporate officer signing a corporate application must establish his own identity and verify the corporate existence as well. These procedures are not particularly onerous in the context of a complex

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69 Drug Enforcement Assistance; Notice of Proposed Rulemaking, supra note 66 at 9271.
71 Id. at 9272.
73 Drug Enforcement Assistance; Notice of Proposed Rulemaking, supra note 66, at 9272.
76 Drug Enforcement Assistance; Notice of Proposed Rulemaking, supra note 66, at 9271.
financing transaction, but parties must anticipate them to avoid delays in registration. The new rules will require renewal of registration every three years, and the renewal application will involve supporting materials similar to those furnished with an original application.\textsuperscript{77}

\textbf{Recordation}

For the financing parties, the heart of the federal aircraft registration system is section 503 of the Federal Aviation Act, which establishes a system for central recordation of interests in aircraft and related parts.\textsuperscript{78} Clause (1), which refers to aircraft, is derived from section 503 of the original Civil Aeronautics Act, passed in 1938.\textsuperscript{79} Clauses (2) and (3), which deal with engines and other parts of aircraft, came along in the 1948 amendments.\textsuperscript{80} The drafters added the reference to propellers

\textsuperscript{77} Id. at 9293.
\textsuperscript{78} 49 U.S.C. app. § 1403(a) (1988). The statute provides for the recording of:

\begin{enumerate}
\item Any conveyance which affects the title to, or any interest in, any civil aircraft of the United States;
\item Any lease, and any mortgage, equipment trust, contract of conditional sale, or other instrument executed for security purposes, which lease or other instrument affects the title to, or any interest in, any specifically identified aircraft engine or engines of seven hundred and fifty or more rated takeoff horsepower for each such engine or the equivalent of such horsepower, or any specifically identified aircraft propeller capable of absorbing seven hundred and fifty or more rated takeoff shaft horsepower, and also any assignment or amendment thereof or supplement thereto;
\item Any lease, and any mortgage, equipment trust, contract of conditional sale, or other instrument executed for security purposes, which lease or other instrument affects the title to, or any interest in, any aircraft engines, propellers, or appliances maintained by or on behalf of an air carrier certificated under section 1424(b) of this Appendix for installation or use in aircraft, aircraft engines, or propellers, or any spare parts maintained by or on behalf of such an air carrier, which instrument need only describe generally by types the engines, propellers, appliances, and spare parts covered thereby and designate the location or locations thereof; and also any assignment or amendment thereof or supplement thereto.
\end{enumerate}

in 1959.\textsuperscript{81} There are subtle but important differences between the original language of clause (1) and the language of the later clauses.

Clause (1) speaks of conveyances. The term "conveyance" has a broad meaning under the Federal Aviation Act and includes "a bill of sale, contract of conditional sale, mortgage, assignment of mortgage, or other instrument affecting title to, or interest in, property."\textsuperscript{82} Thus while clause (1) covers many of the items listed in clauses (2) and (3), the latter clauses do not cover conveyances or bills of sale. This variation has resulted in very different administration of those provisions by the FAA. Documents covering aircraft, which the FAA accepts for recording pursuant to clause (1), relate to both ownership and encumbrances.\textsuperscript{83} Documents accepted under clauses (2) and (3), which cover engines, propellers, and spare parts, relate only to encumbrances.\textsuperscript{84} Thus, the aircraft registry provides a means of tracing ownership of aircraft, but not of engines, propellers, or spare parts.\textsuperscript{85}

The FAA has established a special bill of sale form for recording transfers of aircraft ownership, AC Form 8050-2. This form also serves as evidence of ownership for purposes of registration.\textsuperscript{86} The FAA monitors transfers of ownership closely,\textsuperscript{87} because the ownership records are essential in identifying the party entitled to register an air-

\textsuperscript{83} Aircraft Ownership and Encumbrances Against Aircraft, 14 C.F.R. §§ 49.31-49.37 (1990).
\textsuperscript{84} Encumbrances Against Specifically Identified Aircraft Engines and Propellers, 14 C.F.R. §§ 49.41-49.43; Encumbrances Against Air Carrier Aircraft Engines, Propellers, Appliances, and Spare Parts, Id. §§ 49.51-49.55.
\textsuperscript{85} Section 502 of the Federal Aviation Act permits the Secretary of Transportation to "establish reasonable rules and regulations for registration and identification of aircraft engines, propellers, and appliances . . . ." 49 U.S.C. app. § 1402 (1988). The only regulations thus far promulgated under this section relate to identification marks; there is no administrative procedure for registration. 14 C.F.R. § 45 (1990).
\textsuperscript{86} 14 C.F.R. § 47.31 (1990).
\textsuperscript{87} Id. § 49.17.
The aircraft registry can determine the owner of any aircraft with a given registration number, or "tail number." Contrariwise, aircraft engines and propellers, can be sold and resold without recording a bill of sale with the FAA. Thus, there is no "chain of title." A search of the records will disclose security interests and encumbrances against the engines and propellers, and clues to ownership, perhaps, but not complete evidence. The aircraft registry will be unable to determine who is the current owner of a given engine or propeller.90

In *Aircraft Trading & Services, Inc. v. Braniff, Inc.*, a security interest in an engine followed the engine through several transfers of ownership of the aircraft to which it was attached. The secured party prevailed over the third transferee, even though the security interest was not recorded with the FAA until after the second transfer. Although this result has been criticized,92 the case demonstrates that the federal aircraft registry is not proof against defects in title to aircraft engines, even those installed on aircraft.

**Assignments of Leases**

The clauses of section 503 that cover engines, propellers, and spare parts are broader than the original clause covering aircraft in that they mention leases and assignments. The United States District Court for the Eastern District of Pennsylvania has held that the absence of references to leases and assignments in clause (1) means that assignments of aircraft leases can only be perfected under state law.93 The District Court for the Southern District of New York has held otherwise, however, positing that sec-

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88 Id. § 47.11.
89 Id. § 47.15.
91 819 F.2d 1227 (2d Cir. 1987).
tion 503 of the Federal Aviation Act represents the exclusive method of perfecting security interests in aircraft leases. This split of authority suggests that debt participants in leveraged leases and other financiers that rely on assignments of aircraft leases should perfect their interests in those leases both under article 9 of the Uniform Commercial Code, by possession of the lease or by filing an appropriate financing statement, and under the federal statute, by recording the assignment with the FAA.

**Avionics**

Perfection under both state and federal law would be prudent for financing parties in other circumstances as well. In *Ahlum v. Craig (In re Craig)*, a bankruptcy court determined that when the operator was not an air carrier, federal recordation of aircraft did not perfect a security interest in avionic equipment. Thus, financiers of general aviation aircraft should use the appropriate state filing for avionic equipment and describe that equipment with specificity.

**Spare Parts**

Financing of spare parts requires a close reading of the statute and the related regulations. Recording under section 503(a)(3) of the Federal Aviation Act represents the exclusive method of perfecting security interests in the spare parts inventories of air carriers of the type that this section specifies; perfection under state law would be ineffective. This section is limited to coverage of parts

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96 Id. at 64.


maintained by or on behalf of an "air carrier certificated under section 604(b) of this [Act]."\(^9\) Determining what sort of air carriers it covers requires reference to both section 604(b) of the Federal Aviation Act\(^{100}\) and the definitions in section 101 of that act.\(^{101}\) An essential characteristic is common carriage of persons or property, or carriage of mail. Contract carriers and intrastate carriers are not covered, even if they are certificated under section 604(b). A section 604(b) certificate is a safety-related certificate, such as the FAA issues under part 121 or part 135 of the Federal Aviation Regulations,\(^{102}\) rather than the certificate of convenience and necessity issued under section 410 or 418 of the Federal Aviation Act.\(^{103}\)

**THE EFFECT OF RECORDATION**

Subsection 503(d) of the Federal Aviation Act states that "[e]ach conveyance or other instrument . . . shall from the time of its filing for recordation be valid as to all persons without further or other recordation. . . ."\(^{104}\) The statute does not expand on this statement of effect; section 506 specifically defers to the law of the state in which the instrument was delivered for matters of validity.\(^{105}\) The federal statute does not cover priorities, remedies, or the other matters of secured transaction law that the laws of the various states cover in their versions of article 9 of the Uniform Commercial Code.\(^{106}\)

Whether it is more desirable to fill in the gaps in the federal law with state law or to fashion a wholly federal solution to problems such as priorities and remedies is a question that has long troubled courts and commenta-

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\(^{100}\) 49 U.S.C. app. § 1424(b) (1988).
\(^{101}\) Id. § 1301.
\(^{104}\) Id. § 1403(d).
\(^{105}\) Id. § 1406.
\(^{106}\) See U.C.C. art. 9 (1987).
The drafters of the Uniform Commercial Code envisioned a mechanism that would work in harmony with the federal statute, using the federal recordation system to file for perfection. Section 9-302 of the Uniform Commercial Code, the section that establishes the filing requirements for perfection of security interests, addresses the question of federal filing in subsection (3); subsection (4) attempts a rational interface with federal recordation laws.

The drafters added much of the current language in the 1972 revisions in an effort to resolve inconsistent reconciliations of federal and state statutes in the courts. The authors of a state statute, however, can only do so much; the doctrine of federal pre-emption threatens any state effort to influence interpretation of federal statutes.

The federal-state interface was defined officially, albeit somewhat differently from the intention of the drafters of article 9, in Philko Aviation, Inc. v. Shacket. This case established both the pre-emptive nature of federal law and

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(3) The filing of a financing statement otherwise required by this Article is not necessary or effective to perfect a security interest in property subject to
(a) a statute or treaty of the United States which provides for a national or international registration or a national or international certificate of title or which specifies a place of filing different from that specified in this Article for filing of the security interest.
110 Id. § 9-302(4).
(4) Compliance with a statute or treaty described in subsection (3) is equivalent to the filing of a financing statement under this Article, and a security interest in property subject to the statute or treaty can be perfected only by compliance therewith except as provided in Section 9-103 on multiple state transactions. Duration and renewal of perfection of a security interest perfected by compliance with the statute or treaty are governed by the provisions of the statute or treaty; in other respects the security interest is subject to this Article.
111 Id. § 9-302(2) (Official Explanation of 1972 Amendment).
the gap-filling role of state law. The Supreme Court held that rights obtained by recording under the federal statute prevail over rights obtained under state law, but that priority disputes between parties who have recorded under the federal statute would be resolved by reference to the applicable state law.\textsuperscript{113} The important difference between this holding and the federal-state interface which the drafters of the Uniform Commercial Code contemplated is that article 9 gives a priority to certain parties who have not filed financing statements, such as buyers in the ordinary course of business and holders of certain mechanics' liens, over parties who have filed;\textsuperscript{114} under \textit{Philko}, failure to file is fatal.\textsuperscript{115} Once proper recordation under the Federal Aviation Act is made, however, a party preferred by the Uniform Commercial Code obtains whatever priority is available under article 9 over others who have recorded under the Act.\textsuperscript{116}

\textbf{INTERNATIONAL EFFECTS}

Most aircraft financing transactions for air carriers involve some international aspects. Even a carrier with only domestic routes would be unwilling to enter into a lease or security agreement that restricted use of the aircraft outside the United States. International route opportunities may arise in the future, charter flights may cross borders, and sublessors may wish to use the aircraft abroad. Furthermore, transactions with foreign carriers force the parties to face the effect of foreign law. An analysis of the international aspects of aircraft financing transactions involves consideration of two situations. The first is the

\begin{itemize}
  \item \textsuperscript{113} \textit{Id.} at 412.
  \item \textsuperscript{116} \textit{Philko}, 462 U.S. at 413; see also Aircraft Trading & Serv., Inc. v. Braniff, Inc., 819 F.2d 1227 (2d Cir.), \textit{cert. denied sub nom.}, 484 U.S. 856 (1987).
\end{itemize}
case of an aircraft registered in the United States and occasionally (or regularly) flown to other countries, and the second is the case of an aircraft registered in another country. The second circumstance may seem remote for parties financing only domestic airlines, but many airlines, in offering transactions to the financial community, specify sublease rights that permit registration of the aircraft in another country and deregistration in the United States (to the great discomfort of lending institutions). \(^{117}\)

**The Convention**

The United States and fifty other countries \(^{118}\) have adopted the Convention on International Recognition of Rights in Aircraft. \(^{119}\) Ten other countries have signed the

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\(^{118}\) The countries adopting the convention are: Algeria, Argentina, Brazil, Cameroon, Central African Republic, Chad, Chile, Congo, Cuba, Denmark, Ecuador, Egypt, El Salvador, Ethiopia, France, Gabon, Germany, Greece, Grenada, Guinea, Haiti, Iceland, Iraq, Italy, Ivory Coast, Kuwait, Laos, Lebanon, Libya, Luxembourg, Madagascar, Mali, Mauritania, Mexico, Netherlands, Niger, Norway, Pakistan, Paraguay, Philippines, Portugal, Rwanda, Seychelles, Sweden, Switzerland, Thailand, Togo, Tunisia, Uruguay, and Zimbabwe. The United States and the Netherlands do not accept a reservation made by Mexico and do not regard the convention as being in force between the two countries. *Treaty Affairs Staff, Office of Legal Advice, Dept. of State, Treaties in Force: A List of Treaties and Other International Agreements of the U.S. in Force on January 1, 1988*, 273 (1988).


(a) rights of property in aircraft;

(b) rights to acquire aircraft by purchase coupled with possession of the aircraft;

(c) rights to possession of aircraft under leases of six months or more;

(d) mortgages, hypotheces and similar rights in aircraft which are contractually created as security for payment of an indebtedness; provided that such rights:

(i) have been constituted in accordance with the law of the Contracting State in which the aircraft was registered as to nationality at the time of their constitution and

(ii) are regularly recorded in a public record of the Contracting State in which the aircraft is registered as to nationality.

*Id.* Rights in Aircraft, *supra* note 119, article I, at 1833, 310 U.N.T.S. at 153-54.
Convention but not ratified it; the Convention does not apply to those countries. Among those adopting the convention, Latin America and Western Europe are well represented. Some countries of Africa and Asia have adopted it as well. The United Kingdom, the other countries of the British Commonwealth, and the countries of Eastern Europe, however, have not adopted the Convention. Coverage of the Convention on the world map clearly has many gaps.

In those countries that have not adopted the convention, financing institutions can take some comfort in an analogy to maritime law, which is often applied in air law cases. Under maritime traditions, reference to the law of the nation of registry, the *lex registri*, usually determines the validity of interests in vessels. This is the same rule that the Convention established. But the maritime analogy brings with it the system of maritime liens, which favors local suppliers and claimants over the holder of a mortgage.

The Convention itself embodies certain traditions of the priority of maritime liens. The property and security rights that the convention recognizes are subject to salvage claims, expenses indispensable for the preservation of the aircraft, and, in the absence of suitable insurance, claims for injuries or damages. The Convention even adopts the maritime rule that gives priority

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120 Those countries are: Australia, Belgium, China, Columbia, Dominican Republic, Iran, Ireland, Peru, the United Kingdom, and Venezuela. Rights in Aircraft, supra note 119, at 1831, 310 U.N.T.S. at 176-77.


122 See generally M. RICE, supra note 38, at 335-36 for a review of maritime liens; see also Varian, *Rank and Priority of Maritime Liens*, 47 Tul. L. Rev. 751 (1973) for a more thorough analysis.

123 Rights in Aircraft, supra note 119, art. IV(1)(a), at 1835, 310 U.N.T.S. at 154.

124 Id.

125 Id., Article VII(5), at 1836, 310 U.N.T.S. at 156.
to those claims in the inverse order of attachment.\textsuperscript{126} Although the Convention does not address the matter of local claims for fuel, mechanical services, or landing fees, any party repossessing an aircraft in a foreign jurisdiction must, as a practical matter, expect to deal with such claims. In a nation not subscribing to the Convention, maritime legal principles would give these local claims priority over a foreign owner or secured party.\textsuperscript{127}

Registration of a financed aircraft in another jurisdiction exacerbates these problems. Although most nations, like the United States, require local registration as a condition of local flight operations and limit registration to their own citizens, the registration laws of many countries permit registration in the name of a lessee as well as an owner.\textsuperscript{128} Thus, it is possible to engage in cross-border lease financing into those countries. Cross-border secured debt financing is also possible, although some countries do not have central mortgage registries, and some make the established registries available only to citizens.\textsuperscript{129}

When a financed aircraft is registered to a lessee or debtor in a foreign jurisdiction, the matter of deregistration must be faced in any repossession. Most countries, including the United States, do not permit registration of an aircraft while it is registered in another jurisdiction. Thus, there is no reason to recover an aircraft without being able to terminate its local registration. A prudent financing party holds powers of attorney and similar instruments against the day when deregistration may be necessary, but since deregulation is ultimately an official act, the financing party will be at the mercy of the government agency charged with these matters.

Despite some dissatisfaction with the handling of mat-

\textsuperscript{126} Id., Article IV(2), at 1835, 310 U.N.T.S. at 156.
\textsuperscript{127} See M. Rice, supra note 38, at 342.
\textsuperscript{128} See McBain, supra note 121, for a summary of the registration laws around the world.
\textsuperscript{129} Id.
ters by local authorities, financers have thus far been able to recover aircraft from defaulting obligors in their home countries, although there have often been delays and local claims to be satisfied before the aircraft have been released.\textsuperscript{130} Experienced financers find it most effective to seize an aircraft while it is outside of the defaulting operator’s home jurisdiction.\textsuperscript{131}

Political risk insurance is available to cover the risk of repossession. Policies generally cover confiscation, expropriation, nationalization, refusal of a host country to permit repossession, and inability to deregister an aircraft.\textsuperscript{132} Additionally, export financing agencies, such as the Export-Import Bank of the United States, offer credit support to cover political risks.\textsuperscript{133}

Generalizations are dangerous when dealing with a global variety of laws and local interests, but it is probably safe to say that the interests of an owner-lessee are more likely to be enforced than the interests of a mortgagee or other security interest holder. Leasing across national borders is a universal, extensive, and successful endeavor; fledgling airlines throughout the world are able to obtain aircraft on lease from experienced lessors, in circumstances where loans, even secured loans, are unavailable.

Cross-border lease financing received some international support in 1988, when the International Institute for the Unification of Private Law (UNIDROIT) adopted the Convention on International Lease Financing.\textsuperscript{134} This convention is not binding on a country unless adopted, but the drafters felt that the absence of personal property leasing law in many nations, particularly the less-devel-

\textsuperscript{130} See, e.g., Duffy, Repossession and the Collapse of Hispania, AIRFINANCE J., Sept. 1989, at 6.

\textsuperscript{131} Id.

\textsuperscript{132} See Margolis, Political Risks for All, AVIATION INS., Aug. 1990, at 5 (a supplement to AIRFINANCE J.).

\textsuperscript{133} See M. Rice, supra note 38, at 563.

\textsuperscript{134} UNIDROIT Convention on International Financial Leasing, reprinted in EQUIPMENT LEASING-LEVERAGED LEASING, supra note 21, app. D-3 at 1837; see also Taylor, supra note 21, at 1223.
oped countries, would encourage courts in those countries to look to the Convention for guidance.\textsuperscript{135} Thus, the Convention promulgates rules for determining validity, enforcement, and the measure of damages in the comprehensive fashion of articles 2A and 9 of the Uniform Commercial Code in the United States. An interesting aspect of the leasing convention is that it avoids the problem, so troublesome in American law, of distinguishing between a lease and a security interest. The international convention applies to a transaction styled as a lease even if it has nominal purchase or renewal options,\textsuperscript{136} features fatal to true leases in the United States.\textsuperscript{137}

**Bankruptcy**

Section 1110 is perhaps the only section of the Bankruptcy Code\textsuperscript{138} that institutional investors, business people, and lawyers alike can identify by number. This section provides special protection for aircraft financers in carrier bankruptcy by overriding other provisions of bankruptcy law that would suspend payment on obligations or prevent repossession. Financers consider the availability of section 1110 protection to be crucial to the market success of airline equipment obligations.

Before attempting to parse section 1110, we should consider the background of bankruptcy law and the treatment of leases and secured loans thereunder without section 1110 protection.

**Secured Transactions in Bankruptcy**

Financial transactions must be arranged against a background of bankruptcy law. Most payment defaults are


\textsuperscript{136} \textit{UNIDROIT} Convention on International Financial Leasing, \textit{supra} note 134, at 1820; \textit{see id.} art. I., para. 3 at 1820.

\textsuperscript{137} U.C.C. § 1-201(37) (1981).

caused by the sort of financial distress that ultimately results in bankruptcy. Even when an obligor has defaulted but is not actually under the protection of the bankruptcy courts, any work-out negotiations will be influenced by the effect of bankruptcy laws on the rights and remedies of the parties.

Financing parties should keep in mind that a business entity need not be insolvent to seek the protection of the bankruptcy laws. While involuntary bankruptcy requires a showing that the debtor is generally not paying its debts when due,\textsuperscript{139} voluntary bankruptcy does not.\textsuperscript{140} Otherwise solvent businesses have filed petitions in bankruptcy to ameliorate the effects of massive tort claims or to resist court judgments or to abrogate burdensome contracts.\textsuperscript{141} Any highly leveraged enterprise that has difficulty paying its obligations is a prospect for the relief of the bankruptcy system.

The bankruptcy process involves judicial suspension of the ordinary rights and remedies of creditors, while either the property of the bankrupt entity is liquidated to pay claims in an orderly manner, or a reorganization is effected to give the bankrupt entity a fresh start.\textsuperscript{142} This process is complex and unpredictable. Although the new Bankruptcy Code\textsuperscript{143} is quite orderly and comprehensive, the bankruptcy courts are given broad powers, and they may "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."\textsuperscript{144} This breadth of power leads to the usual qualification in legal opinions which provides that transaction documents are enforceable "except as may be limited by bankruptcy, insolvency or other similar laws affecting the enforcement of creditors' rights in general."\textsuperscript{145}

\textsuperscript{139} Id. § 303.
\textsuperscript{140} Id. § 301.
\textsuperscript{141} L. JORDAN \& D. WARREN, BANKRUPTCY 165 (1985).
\textsuperscript{142} Id. at 21-26.
\textsuperscript{144} Id. § 105(a).
\textsuperscript{145} NEW YORK COUNTY LAWYERS ASSOC., A Report by the Special Committee on Legal
Initiating a proceeding under the Bankruptcy Code automatically stays any action against the bankrupt debtor and prevents any action to recover any property from that debtor.\textsuperscript{146} Clauses in leases or security agreements which purport to give lessors or secured creditors the right to recover property upon commencement of bankruptcy proceedings, so called ipso facto clauses, are not effective.\textsuperscript{147}

In the case of a debt secured by aircraft collateral, the creditors may bring a petition for relief of the stay. Courts are not likely to grant such relief if the aircraft subject to the security interest is important to the successful reorganization of the bankrupt airline. If relief is denied, the holder of the security interest is entitled to “adequate protection.”\textsuperscript{148} Case law has interpreted this term narrowly; “adequate protection” does not mean interest on the debt during the period of the stay.\textsuperscript{149} It should mean payment to the creditor of an amount equal to the economic depreciation of the equipment security while in the hands of the debtor.\textsuperscript{150}

If the creditor is oversecured, that is, if the value of the collateral exceeds the amount of debt, interest will accrue to the extent of this security cushion. If the value of the collateral is less than the debt, however, the debt will be regarded as unsecured to the extent of the shortfall, and post-petition interest will not accrue.\textsuperscript{151} Ultimately, in the final reorganization plan or liquidation, the secured creditor will be entitled to recover the collateral or receive the equivalent of the secured debt and accrued interest

\textsuperscript{147} Id. § 541(c).
\textsuperscript{148} See id. § 361.
\textsuperscript{149} United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 370 (1988).
\textsuperscript{151} 484 U.S. at 372.
The owner of leased aircraft is in a much better position than a secured creditor during the pendency of bankruptcy proceedings. While the leasehold interest of the bankrupt debtor in the aircraft is regarded as "property of the estate","153 and the automatic stay prevents recovery of the aircraft, the aircraft owner, or the creditor in a leveraged lease acting for the owner, can petition to have the lease assumed or rejected. Any assumption must be in accordance with the terms of the lease, and past defaults must be cured. The owner is entitled to payment for the use of the aircraft while the stay is in effect and the debtor is in possession of the aircraft. Such payment is measured by the current market, and does not necessarily equal the rents specified in the lease. Thus, the owner under a lease, or a creditor standing in the shoes of the owner under a lease assignment, has a greater likelihood of receiving payments and resolving its claims during the pendency of bankruptcy proceedings than a mere secured creditor.

Financing parties do not look upon either of these situations favorably. In the development of the Bankruptcy Code, institutional investors and the airlines which depend on their financing persuaded the drafters to include special protection for aircraft financing obligations based on section 116(5) of the old Bankruptcy Act.157

152 Id. at 371-72.
154 Id. § 362.
155 Id. § 365.
The immediate forerunner of the bill that became the Bankruptcy Code did not have special protection for aircraft financing obligations, although it did contain language derived from the last sentence of section 77(j) of the old Bankruptcy Act, which provided special protection for railroad equipment obligations. This issue received little attention from the Commission on the Bankruptcy Laws or the National Conference of Bankruptcy Judges in their draft bills, so it fell to the staff of the Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee to deal with the lobbyists. The drafters of H.R. 6 felt that aircraft financers were sufficiently protected by the sections of the new law referring to "adequate protection" and "executory contracts and unexpired leases"; that view was not shared, however, by financial interests. Section 1110 was drafted in order to soothe the financers without unduly disturbing the mechanism of the new Bankruptcy Code. The explanation
in the House Report is helpful in understanding section 1110.

This section, to a large degree, preserves the protection given lessors and conditional vendors of aircraft to a certificated air carrier or of vessels to a certificated water carrier under section 116(5) and 116(6) of present Chapter X. . . . It is also modified to give the trustee in a reorganization case an opportunity to continue in possession of the equipment in question by curing defaults and by making the required lease or purchase payments. This removes the absolute veto power over a reorganization that lessors and conditional vendors have under present law, while entitling them to protection of their investment.

The section overrides the automatic stay or any power of the court to enjoin taking of possession of certain leased, conditionally sold, or liened equipment, unless the trustee agrees to perform the debtor's obligations and cures all prior defaults (other than defaults under ipso facto or bankruptcy clauses) within 60 days after the order for relief. The trustee and the equipment financer are permitted to extend the 60-day period by agreement. During the first 60 days, the automatic stay will apply to prevent foreclosure unless the creditor gets relief from the stay.

The effect of this section will be the same if the debtor has granted the security interest to the financer or if the

this chapter, the trustee, subject to the court's approval, agrees to perform all obligations of the debtor that become due on or after such date under such security agreement, lease, or conditional sale contract, as the case may be; and

(2) any default, other than a default of the kind specified in section 365(b)(2) of this title, under such security agreement, lease, or conditional sale contract, as the case may be—

(A) that occurred before such date is cured before the expiration of such 60-day period; and

(B) that occurs after such date is cured before the later of—

(i) 30 days after the date of such default; and

(ii) the expiration of such 60-day period.

(b) The trustee and the secured party, lessor, or conditional vendor, as the case may be, whose right to take possession is protected under subsection (a) of this section may agree, subject to the court's approval, to extend the 60-day period specified in subsection (a)(1) of this section.

debtor is leasing equipment from a financer that has lever-
aged the lease and leased the equipment subject to a se-
curity interest of a third party.\textsuperscript{161}

Before the passage of the new Bankruptcy Code, there
had been no airline bankruptcies to provide case law con-
struing section 116(5), the predecessor of section 1110. Since the new law took effect in 1979, however, a number
of airline bankruptcies and reorganizations have supplied
some judicial gloss for section 1110.

\textit{Purchase-Money Equipment Security Interests}

Section 116(5) of the old Bankruptcy Act protected
"any owner, whether as trustee or otherwise" of aircraft
"leased, subleased, or conditionally sold" to air carri-
ers.\textsuperscript{162} This language was derived from the last sentence
of section 77(j), which dealt with railroad reorganizations
and referred to early 20th century forms of equipment fi-
nancing: conditional sales and equipment trusts, both of
which purported to reserve "title" in a trustee or agent
for the financing parties.\textsuperscript{163} The drafters of the new Bank-
rupcty Code added the phrase "purchase-money equip-
ment security interest" in recognition of the
rationalization of security devices under article 9 of the
Uniform Commercial Code, to avoid confining equipment
financing instruments to outdated forms.\textsuperscript{164}

The Bankruptcy Code does not define the term
"purchase money equipment security interest," but the
similar term, "purchase money security interest" in the
Uniform Commercial Code certainly seems relevant.\textsuperscript{165}

\textsuperscript{161} H.R. REP. No. 595, \textit{supra} note 159, at 240.
\textsuperscript{162} Amendment to section 116 of Bankruptcy Act, Pub. L. No. 85-295, 71 Stat.
617 (1957).
\textsuperscript{163} M. RICE, \textit{supra} note 38, at 65.
\textsuperscript{164} H.R. REP. No. 595, \textit{supra} note 159, at 240.
\textsuperscript{165} U.C.C. § 9-107 (1987).
A security interest is a purchase money security interest to the extent
that it is
\begin{enumerate}
\item taken or retained by the seller of the collateral to secure all or
part of its price; or
\item taken by a person who by making advances or incurring an
The court that oversaw the reorganization of Eastern Airlines was the first to construe the term "purchase money equipment security interest." Although that court recognized the need to look to the Uniform Commercial Code for guidance, it refused to be confined by the UCC term and its particular judicial gloss.\(^{166}\)

In its more prosperous days, Eastern Airlines had established a mortgage indenture under which notes were periodically issued. These notes were secured by a floating pool of collateral, consisting of aircraft, engines, and spare parts. The indenture had a mechanism for adding and releasing collateral, and all of the notes issued under the indenture had the benefit of a ratable share in the collateral.\(^{167}\)

Eastern was the first American customer for the Airbus A-300, a new aircraft manufactured by a new company. When Eastern ordered the aircraft from Airbus Industries, the manufacturer arranged financing with a group of German, French, and British banks as part of the inducement for the order. Eastern placed two orders, for a total of twenty-three aircraft. Instead of conducting separate transactions for the Airbus aircraft, Eastern issued notes under the existing mortgage indenture, and included the new aircraft in that collateral pool. Under the terms of the indenture, the Airbus lenders shared equally and ratably with the existing noteholders in the aircraft in the pool, which included the new Airbus A-300's, the collateral already subject to the lien of the indenture, and any future acquisitions.\(^{168}\)

The original loan of approximately $450,000,000 had been reduced to about $96,000,000 when Eastern Airlines

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obligation gives value to enable the debtor to acquire rights in or the use of the collateral if such value is in fact so used.


\(^{167}\) Id. at 80-81.

\(^{168}\) Id. at 80.
sought the protection of the bankruptcy laws in March of 1989. Early in the proceedings, Eastern divided its equipment obligations into two categories: those protected by section 1110 of the Bankruptcy Code and those not so protected. Eastern agreed to perform the obligations having section 1110 protection, but suspended payment on the others.  

Eastern sought a declaratory judgment that the latter obligations in fact did not have section 1110 protection, hoping that the holders of those obligations would cease their efforts to collect payment on the notes and recover the aircraft collateral. The Airbus lenders opposed the motion, arguing that their interest was a "purchase money equipment security interest," which entitled them to protection under section 1110, and that they should thus receive either their payments or the A-300's.  

Judge Lifland, the Chief Bankruptcy Judge in the Southern District of New York, did not find the arguments of the Airbus lenders persuasive. While their interests were secured, he held that they did not hold the magic and elusive "purchase money equipment security interest" and thus were not entitled to protection under section 1110. There was a relationship between the acquisition of the collateral and the loans made by the Airbus lenders, but mixing the Airbus lenders' interests in the aircraft with those of other lenders under the mortgage indenture created a significant flaw. The other lenders shared in the Airbus collateral, and the Airbus lenders shared in their collateral, but because the other lenders' collateral did not come into the indenture in "purchase money" transactions, it tainted the entire package. The "equal and ratable" scheme of the indenture prevented any allocation of specific collateral to specific lenders.  

The Airbus lenders appealed. Judge Sweet, the district

169 Id. at 80-81.  
170 Id. at 81.  
171 Id. at 89.  
172 Id. at 83-84.
court judge hearing the appeal, thought that Judge Lifland's holding was unduly narrow. He rejected the notion that the term "purchase money equipment security interest" was anything other than a "purchase money security interest" within the meaning of section 9-107 of the Uniform Commercial Code. He then turned to the extensive body of law construing that term, taking considerable guidance from an article by Professor McLaughlin on that point, which developed a theory of "dual status." Under this theory, which Judge Sweet adopted, a secured party may have a purchase money security interest in some collateral, but only an ordinary security interest in other collateral; the latter will not taint the former. Judge Sweet reversed the Bankruptcy Court decision, holding that the Airbus lenders did indeed have a "purchase money security interest" in certain aircraft.

The Eastern case demonstrates that courts will construe section 1110 narrowly; a creditor or lessor will not be given protection unless the interest of that creditor or lessor clearly fits the language of the statute. Thus, only careful and deliberate construction of the transaction to suit the statute and its interpretations will assure section 1110 protection. The parties should make clear in the lease or security agreement that they intend section 1110 protection to apply, and the transaction elements and recitals should clearly conform to the law and the lore of section 1110. A debt transaction must have the elements of a "purchase money" financing, with a clear and close connection between the acquisition and the financing.

Sale-leasebacks

The proximity of the new term "purchase money equipment security interest" in section 1110 to the references to "lessor or conditional vendor," carried over from old

175 123 Bankr. at 173.
section 116(5), has been the cause of considerable wringing of hands and rolling of eyes on the part of lawyers asked to give opinions on the applicability of section 1110 to sale-leaseback transactions. Two factors led to this anxiety: (1) the airlines' practice of financing aircraft by sale-leaseback after purchasing and taking delivery from the manufacturer, sometimes selling to the lessor with a mark-up which reflects a surplus of current market value over the manufacturer's selling price, and (2) the suggestion in the legal literature that the legislative history of section 1110 limits its applicability to those lease transactions used to finance acquisition of aircraft.176

Most lawyers examining this situation believed that the statute meant what it said, and that any bona-fide lessor would be protected whether or not the lease involved equipment new to the carrier.177 Nevertheless, written opinions on this issue usually equivocated by saying that the protection of section 1110 "should be available," something less than the certainty that institutional investors desire.

The recent airline bankruptcies provided some case law that clarified this situation quite satisfactorily. The first decision came out of the second Braniff bankruptcy.178 In the course of Braniff's first bankruptcy and reorganization, the airline conveyed many of its Boeing 727 aircraft to a special liquidating trust, which then leased the aircraft back to the reorganized airline. When Braniff again sought the protection of the bankruptcy laws in 1989, it defaulted on lease obligations which were due on December 1. With the repossession of the aircraft imminent, Braniff sought a declaratory judgment that section 1110


177 See generally Gerstell & Hoff-Patrinos, supra note 165; Sheneman, Equipment Leasing under the Bankruptcy Code, in EQUIPMENT LEASING—LEVERAGED LEASING, supra note 21, at 832-33.

protection did not extend to the lease of those aircraft.\textsuperscript{179}

Braniff argued that section 1110 did not apply because the aircraft subject to the lease were not new to the airline when the lease was arranged; since Congressional intent in enacting the statute was to facilitate acquisition of equipment, not refinancing or reorganization, Braniff concluded that application of section 1110 to this situation would be a perversion of the statute.\textsuperscript{180}

Bankruptcy Judge Corcoran examined the legislative history and agreed that acquisition was an important element of a “purchase-money equipment security interest.” He found no acquisition requirement, however, for leases. The Judge concluded that he “must apply the statutory language as written: Section 1110 is not limited to leases that permit aircraft to be newly acquired by the lessee.”\textsuperscript{181}

Since the Braniff decision was reached in a bankruptcy court in the Middle District of Florida and not appealed, there remained some concern that another court might resolve the issue differently. This concern proved to be well-founded. When Continental Airlines sought the protection of the bankruptcy laws in late 1990, its capital structure included an overwhelming amount of lease transactions. Of its fleet of 365 aircraft, 259 were leased, and lease obligations off the balance sheet exceeded $4 billion. To obtain relief from the burden of meeting these lease obligations, Continental urged the Bankruptcy Court for the District of Delaware to take a very narrow view of section 1110 and to hold that the protection of that section was not applicable to aircraft sale-leasebacks that did not involve acquisition. Judge Balick, in a ruling from the bench on January 30, 1991, accepted Continental’s position and held that a sale-leaseback transaction would not be covered by section 1110 unless a transaction was a “package deal” with the acquisition of the

\textsuperscript{179} Id. at 981-82.
\textsuperscript{180} Id. at 983.
\textsuperscript{181} Id. at 985.
This decision alarmed the aircraft financing community; lease financing was suspended. The affected aircraft lessors appealed. Concerned by the effect of the decision on aircraft financing generally, a group of major carriers filed a brief as amici curiae in support of the lessors, as did the American Association of Equipment Lessors.

Not long after Continental petitioned for protection under the Bankruptcy Code, Pan Am followed suit, filing in the Southern District of New York. The same issue of sale-leasebacks and section 1110 arose in that case because Pan Am’s capital structure, like Continental’s, was dominated by aircraft leases; servicing those leases would be a substantial, perhaps crippling burden on the bankrupt estate.

Because of the surprising decision in the Continental case, counsel for Pan Am and the various lessors briefed the Pan Am matter extensively; the amici curiae in the Continental appeal also filed briefs. On March 18, Judge Blackshear issued an opinion from the bench and entered an order denying Pan Am’s motion. He found that sale-leaseback transactions are indeed covered by section 1110, a result at odds with Judge Balick’s decision in the Continental case but consistent with Judge Corcoran’s holding in the Braniff case. Aircraft financiers rejoiced, and Pan Am appealed.

The District Court for the Southern District of New York promptly affirmed the Bankruptcy Court’s opinion on March 18. Again, Pan Am appealed. The Second Circuit affirmed the District Court decision in a per curiam opinion on April 2. Thus, at the highest appellate level yet reached, section 1110 had been held to cover all lease transactions, including sale-leasebacks.

\[10^{70} \text{JOURNAL OF AIR LAW AND COMMERCE \hspace{1cm} (56)}\]

\[\text{aircraft.}^{182}\]

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\[^{182} \text{In re Continental Airlines, Inc., 123 Bankr. 713 (Bankr. D. Del. 1991).}\]

\[^{183} \text{In re Pan American Corp. 124 Bankr. 960 (Bankr. S.D.N.Y. 1991).}\]

\[^{184} \text{Id.}\]

\[^{185} \text{In re Pan American Corp., 125 Bankr. 372 (S.D.N.Y. 1991).}\]

\[^{186} \text{In re Pan American Corp., 929 F.2d 109 (2d Cir. 1991), cert. denied, —U.S. — (May 28, 1991).}\]
Meanwhile, the appeal from the controversial decision in the Continental case was progressing in Delaware. All of the District Court judges in the district recused themselves, and Judge Gawthrop of the Eastern District of Pennsylvania heard the matter. He reversed Judge Balick, holding that section 1110 of the Bankruptcy Code covers lease transactions whether or not they involve acquisition. Since most financing parties were confident that the Third Circuit would affirm Judge Gawthrop's decision, confirming the protection of section 1110 in all lease transactions, lease financing resumed. On May 9, the Third Circuit delivered the expected opinion.

Although the Continental and Pan Am cases seem to have put the sale-leaseback issue to rest, two other issues emerged from the cases. First, the courts emphasized in both cases that only "true" leases, not disguised loans, would be covered by the language of section 1110. Thus, any transaction styled as a lease that does not have the proper characteristics of a true lease must meet the requirements for a "purchase money equipment security interest" or a conditional sale to qualify for the protection of section 1110. This true lease issue will be severely tested in a transaction-by-transaction analysis of the aircraft leases in both reorganizations. Many of the recent transactions have fixed-price purchase options and other features that could be regarded as aggressive, tempting the court to disqualify those transactions from the coverage of section 1110. The automatic stay would then prohibit repossessing, and the airline would retain the aircraft but be able to defer payment.

The second issue raised by the Continental and Pan Am litigation involves the propriety of the courts' action granting stays pending appeal after the 60-day period specified in section 1110 had run. The granting of such

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189 The Second Circuit Court had granted a stay pending appeal of the District Court decision in Pan Am and extended that stay after its own decision, until April
a stay can be perceived as violating the sanctity of section 1110 and diluting its effect. A stay of enforcement under section 77(j) of the old Bankruptcy Act (the section that is regarded as the grandfather of section 1110) by the court in the Penn-Central reorganization caused a furor in certain circles. That case was the reason for the inclusion of a specific prohibition against stays in section 1110: "The right . . . is not affected . . . by any power of the court to enjoin such taking of possession. . . ."

Certificated Carriers

Section 1110 rights are only available against "a debtor that is an air carrier operating under a certificate of convenience and necessity issued by the Civil Aeronautics Board." This language, carried over from section 116(5) of the old Bankruptcy Act, caused no interpretive problems when the Bankruptcy Code was enacted in 1978 and when the Civil Aeronautics Board (CAB) still existed. In 1985, however, the CAB fell victim to deregulation.

Because of the reduced entry barriers to the airline business resulting from deregulation, not all airlines currently possess certificates issued by the CAB. Equipment financiers of new airlines are not denied the protection of section 1110, however. The Civil Aeronautics Board Sunset Act of 1984 provides that "[a]ny reference in any law to a certificate of public convenience and necessity, or to a certificate of convenience and necessity, issued by the Civil Aeronautics Board shall be deemed to refer to a certificate issued under section 401 or 418 of the Federal

5, to permit Pan Am an opportunity to obtain a further stay from the Supreme Court pending further appeal. Justice Marshall denied Pan Am's request for that stay.


Aviation Act of 1958.\textsuperscript{193}

Since January 1, 1985, the issuance of certificates under sections 401 and 418 of the Federal Aviation Act\textsuperscript{194} has come under the jurisdiction of the Secretary of Transportation.\textsuperscript{195} The range of air carriers certificated under section 401 is broad;\textsuperscript{196} that section encompasses domestic air common carriers of persons or property for compensation between states or territories of the United States and between such places and foreign countries. It also covers mail carriers regardless of where they go. Section 418 is a special section for all-cargo carriers.\textsuperscript{197} These sections do not cover foreign air carriers; their authority to operate in the United States is derived from section 402.\textsuperscript{198}

Section 416 of the Federal Aviation Act\textsuperscript{199} gives the Secretary of Transportation the authority to exempt any class of carriers from the requirement for section 401 certification if he finds that the exemption is in the public interest.\textsuperscript{200} For instance, section 416 specifically exempts air carriers that use only aircraft with a capacity of less than 56 passengers or 18,000 pounds of cargo from the certification requirement.\textsuperscript{201} The Secretary has authority to raise this limit by regulation; current regulations exempt carriers using passenger aircraft with a capacity of up to 60 passengers.\textsuperscript{202}

There are many air carriers that operate without a certificate of public convenience and necessity. Consequently, these carriers are not covered by section 1110. Such carriers include foreign air carriers, wholly intrastate carriers, and regional carriers using medium-size air-
craft, ATR 42s and SAAB SF-340s, and the like. The statute clearly excludes smaller commuter airlines, air taxi operators, helicopter operators, and charter services as well. Those flight operations are subject to Federal Aviation Administration regulation under section 604 of the Federal Aviation Act. Regulation of flight operations, however, is not the same as the regulation of carrier services which sections 401 and the related sections of Title IV of the Federal Aviation Act contemplate.

Assumptions can be dangerous. Some smaller operators do have certificates. For instance, equipment lessors used section 1110 to recover Beech 99's from "scAir" Vermont upon its demise. In an aircraft financing transaction, however, the financing parties should always obtain specific assurances that the carrier in question is certificated under section 401 or 418, unless they plan to proceed without the protection of section 1110. If that protection is available, the financing documents should provide that the survivor of any merger or acquisition must be so certificated.

The first Continental Airlines reorganization illustrated the need for rigorous compliance with the certificated air carrier requirement of section 1110. Continental had financed several aircraft by using an affiliated corporation to enter into the debt obligations; this affiliate then leased the aircraft to the airline. When Continental came under the protection of the bankruptcy laws, that affiliate had no source of revenue and also went into bankruptcy. An equipment creditor of the affiliate, attempting to assert section 1110 rights, discovered that since the affiliate was not a certificated air carrier, section 1110 was not available.

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204 California Chieftan v. Air Vermont (In re Air Vermont), 761 F.2d 130 (2d Cir. 1985); In re Air Vermont, 44 Bankr. 446 (Bankr. D. Vt. 1984); In re Air Vermont, 45 Bankr. 926 (Bankr. D. Vt. 1984).
206 Id. at 857-58.
Agreement to Perform

Under section 1110, the holder of an equipment obligation can be prevented from recovering the equipment in a reorganization case if "before 60 days after the order for relief . . . the trustee, subject to the court's approval, agrees to perform all obligations of the debtor that become due on or after such date under such security agreement, lease, or conditional sales contract . . ." The phrase "agrees to perform" is remarkably similar to the term "assume" used in section 365 of the Bankruptcy Code, which covers executory contracts and unexpired leases. The language, however, is not the same, and it has a different meaning.

The court split these statutory hairs in GATX Leasing Corp. v. Airlift International, Inc. (In Re Airlift International, Inc.), pointing out that assumption of a contract or lease under section 365 means that the debtor becomes liable for that contract or lease as if bankruptcy had never intervened. Agreement to perform under section 1110 does not rise to the level of assumption, and presumably the question of full section 365 assumption (or rejection) will have to be faced in the course of the reorganization even after such an agreement to perform. Agreement to perform under section 1110 does, however, bind the bankrupt estate, and failure to so perform would give the creditor an administrative claim, as well as the right to recover the aircraft collateral.

Thus, section 1110 should not be regarded as an exception to the normal workings of the Bankruptcy Code for secured creditors and lessors, but rather as a refinement of certain sections for the particular case of aircraft financing obligations. Section 1110 establishes both a measure of adequate protection for secured creditors under section 361 of the Bankruptcy Code and a measure of com-

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208 761 F.2d 1503 (11th Cir. 1985).
209 Id. at 1508.
210 Id. at 1510.
pensation for the use of leased property under section 365.

Equipment Obligations in the Airline Capital Structure

An airline reorganization may subject section 1110 protection to extreme stress, the sort of stress that will test a transaction for flaws and may even distort decisions in order to conserve the bankrupt estate for ultimate rehabilitation. Because section 1110 mandates regular payment of all transactions that fit within its limits, section 1110 obligations represent a demand on the cash of the bankrupt airline. So long as section 1110 obligations represent a relatively small proportion of the capital structure of the airline, the airline should be able to meet this cash flow requirement, because other debts will be suspended. In those circumstances, section 1110 works well; protected creditors and lessors are paid in regular course. If section 1110 obligations loom large, however, payment thereof would jeopardize the reorganization, and creditors and lessors face careful scrutiny of transactions to ensure that they comply with the technical requirements of section 1110.

Thus, in considering whether to invest in an obligation for which section 1110 protection is said to be available, the parties to the transaction should carefully evaluate it not only in the light of the statutory language, but also in light of the airline's capital structure, keeping in mind that many leases protected by section 1110 may not be on the balance sheet. Furthermore, if the financial condition of an airline deteriorates, the proportion of section 1110 obligations in the capital structure is apt to increase, as these obligations may be the only lines of credit open to the airline.

Section 1110 thus presents financers with both advantages and disadvantages: a single transaction protected by section 1110 works in favor of the financers of that transaction, but a large proportion of transactions protected by section 1110 in an airline capital structure fore-
shadows a cash-flow crisis of substantial dimensions in an airline reorganization. For equipment creditors, this is a case of "divided you stand, united you fall."

LESSOR BANKRUPTCY

The bankruptcy risk works both ways in a lease transaction. Not only is the financing lessor exposed to the potential bankruptcy of its lessee, but the lessee also risks the bankruptcy of its lessor. Section 365 of the Bankruptcy Code\(^2\) is symmetrical; lessors as well as leasees may assume or reject executory contracts and unexpired leases. Thus, a lessor in bankruptcy could reject an aircraft lease, recover the aircraft from the lessee, and lease or sell the aircraft to some other party if such action would benefit the bankrupt estate.\(^2\) The lessee would then be left with a claim against the bankrupt estate for damages from loss of the leasehold interest.

Accordingly, the lessee of an aircraft (or any other personal property) must be concerned about the financial stability of its lessor. In a leveraged lease, the lender's concern reinforces the lessee's concern. The fear is that in a bankruptcy proceeding involving the lessor, the bankruptcy trustee (or the debtor in possession), after assuming the lease, will seek to interrupt the flow of rent payments, which have been assigned to the lender as security for the debt. Such actions proceed on the theory that assignment of the lease for security does not divest the lessor of all interest therein. Consequently, in a lessor bankruptcy, the lease and its rent stream are treated as "property of the estate," and are subject to the automatic stay and other ramifications of a bankruptcy.

\(^{212}\) A lessee of real property is protected by section 365(h) (1) of the Bankruptcy Code, which has a special provision for unexpired leases of real property. If the lessor is in bankruptcy and the trustee (or debtor in possession) rejects the lease, the lessee may treat the lease as terminated or remain in possession of the leasehold interest for the balance of the term or any renewal term. Licensees of intellectual property are similarly protected, but there is no such protection for lessees of personal property. Id. § 365 (h)(1).
Lenders also fear that the lessor’s rejection of a lease would put an end to the stream of rents that is intended to service the debt. The “hell or high water” language in the usual finance lease should provide some consolation for lenders. Courts have relied on such language to require lessees to continue payment to the lender even after the lessor’s trustee has rejected the lease. This trend, of course, aggravates the concerns of lessees.

Where there is concern about the financial stability of the lessor, many airline lessees will insert in the lease documents a security interest in the aircraft to secure the lessee's leasehold interest and the obligations of the lessor under the covenant of quiet enjoyment. Other techniques that achieve the same result include the use of trusts and special purpose corporations as ownership vehicles to insulate the transaction from financial misfortunes of the lessor.

**Owner Trusts**

Parties to leases often arrange the transaction so that the lessor is an owner trust, which acts for the equity investor and enters into the lease and the debt instrument. The equity participant in the transaction is both the grantor of the trust and its beneficiary. If the trust is properly arranged, the tax incidents of the transaction will pass through to the beneficiary of the trust.

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214 A “hell or high water” clause includes language to the effect that the obligation to pay rent is absolute and unconditional and that the lessee must make payments of rent assigned to a lender under all circumstances, including termination of the lease.

Would an owner trust be effective to insulate a transaction from lessor bankruptcy? Perhaps not. Trusts can put assets out of reach of creditors of the beneficiary if they are properly set up; these are called spendthrift trusts. Wealthy people often use spendthrift trusts for heirs thought to be profligate. Such heirs (and their creditors) are only able to reach such of the income and principal as the creator of the trust chooses to permit through the terms of the trust.

The Bankruptcy Code has a special provision respecting spendthrift trusts. State trust law, however, prevents a person from establishing a spendthrift trust for himself in order to put his assets out of reach of creditors. Many states have specific statutes; Connecticut does not, but case law in that state confirms the same principle. The Bankruptcy Code contains a "strong-arm clause," which gives the trustee of a bankrupt estate the powers of a judicial lien creditor. Thus, any ability of a creditor under state law to reach the bankrupt estate is available to the trustee, and accordingly, the trustee in an equipment lessor's bankruptcy can reach property held in an owner trust created by the lessor for its own benefit. Furthermore, the automatic stay would prevent foreclosure on property nominally owned by the trust.

Partnership trusts, designed to accommodate several equity participants in the same transaction, operate differently. For example, if one of several partner-beneficiaries goes into bankruptcy, an effort by its bankruptcy trustee to interrupt the payment stream by reaching the equity

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217 See, e.g., N.Y. EST. POWERS & TRUSTS § 7-3.1 (McKinney Supp. 1991); see also RESTATEMENT (SECOND) OF TRUSTS § 156 (1957).
218 Greenwich Trust Co. v. Tyson, 129 Conn. 211, 27 A.2d 166 (1942); see RESTATEMENT (SECOND) OF TRUSTS § 156 (1957).
220 Goff v. Taylor (In re Goff), 706 F.2d 574 (5th Cir. 1983); People v. Chicago Title & Trust Co., 75 Ill. 2d 479, 389 N.E.2d 540 (1979).
221 In re Gladstone Glen, 628 F.2d 1015 (7th Cir. 1980); Albion Prod. Credit Ass'n v. Langley (In re Langley), 30 Bankr. 595 (Bankr. N.D. Ind. 1983).
participation in a leveraged lease transaction would clearly interfere with the rights of the other partners; such action would probably not be sanctioned. Partnership trusts are odd creatures; they are hybrids created for their tax effects, and the law is not well-settled as to the rights of parties to such trusts in bankruptcy proceedings or otherwise.

The Delaware Business Trust

A business trust registered under a unique statute in Delaware may insulate a transaction from lessor bankruptcy. This statute, which came into effect in late 1988, contains some strong language: "No creditor of the beneficial owner shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the business trust . . ." 222 Additionally, the Bankruptcy Code provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." 223 Taken together, these provisions should effectively insulate the assets of a Delaware business trust from the bankruptcy of a beneficiary.

No currently reported cases confirm the effectiveness of a Delaware business trust in bankruptcy proceedings. There is, however, a line of cases in connection with pension trusts that casts doubt on its effectiveness. Pension plans ordinarily contain provisions restricting or the ability of creditors to reach plan assets and payments to beneficiaries. Indeed, such provisions are required for qualification of the plan under federal tax law. 224 In Daniel v. Security Pacific National Bank, 225 however, the Ninth Cir-

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222 DEL. CODE ANN. tit. 12 § 3805(b) (Supp. 1990). Although the Delaware Legislature substantially revised the Delaware statute on business trusts in 1990, the quoted language was not changed. S.452, as amended by Sen. amendment no. 1 and House amendment no. 2 (July 5, 1990).


225 771 F.2d 1352 (9th Cir. 1985).
cuit Court of Appeals permitted the trustee in a personal bankruptcy to invade a qualified pension plan (which is a trust) despite the language in the plan prohibiting alienability of the trust. The court recognized the requirements for such language contained in both the Internal Revenue Code\textsuperscript{226} and the Employee Retirement Income Security Act of 1974,\textsuperscript{227} but stated that "the phrase ‘applicable non-bankruptcy law’ in 11 U.S.C § 541(c)(2) was intended to be a narrow reference to state ‘spendthrift trust’ law and not a broad reference to all other laws, including ERISA and IRC, which prohibit alienation."\textsuperscript{228}

The Eleventh Circuit reached a similar result in Lichstrahl v. Bankers Trust,\textsuperscript{229} another case that involved the personal bankruptcies of medical professionals who had established substantial pension plans and wished to keep the assets of those plans out of the reach of creditors in bankruptcy proceedings. In McLean v. Central States, Southeast & Southwest Areas Pension Fund,\textsuperscript{230} the Fourth Circuit reached a result more in line with the language of the statute. In that case, the court upheld the restrictions on alienability in an ERISA qualified pension plan and refused to let a bankruptcy court divert pension plan payments to fund a chapter 13 rehabilitation plan. The court recognized that 541(c)(2) applied only to "spendthrift trusts" but found enough spendthrift trust characteristics in the pension plan, and enough support in Illinois trust law, to give effect to the restrictions on alienability.\textsuperscript{231}

\textsuperscript{226} See I.R.C. § 401(a)(13) (1988). This section states that "[a] trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated." Id.

\textsuperscript{227} See 29 U.S.C. § 1056(d)(1) (1988). This section states that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated." Id.

\textsuperscript{228} Daniel, 771 F.2d at 1360 (emphasis in original).

\textsuperscript{229} 750 F.2d 1488 (11th Cir. 1985).

\textsuperscript{230} 762 F.2d 1204 (4th Cir. 1985).

\textsuperscript{231} Id. at 1207. But see Regan v. Ross, 691 F.2d 81 (2d Cir. 1982). The situation in the various circuits is analyzed in Seiden, Chapter 7 Cases: Do ERISA and the Bankruptcy Code Conflict as to Whether a Debtor's Interest in or Rights Under a Qualified Plan Can Be Used to Pay Claims?, 61 AM. BANKR. L.J. 219, 301 (1987).
The lesson of these cases is that courts generally take a dim view of efforts to sequester assets from creditors in bankruptcy proceedings. Thus, it is difficult to conclude with any confidence that a Delaware business trust would be effective to keep trust assets from the reach of creditors of the beneficiary in such proceedings, although that was the clear intent of the Delaware legislature. Nevertheless, the case law in some circuits is favorable; thus, if the creditworthiness of the lessor is in question, using a Delaware business trust is better than failing to take any precaution.

Single-Purpose Corporations

In an effort to insulate a leveraged lease transaction from bankruptcy of the equity participant, the parties to the transaction often use a single-purpose subsidiary corporation as the owning entity or the beneficiary of an owner-trust, with its stock pledged to the lender. The lender holds the certificates, with transfer duly endorsed, but the equity participant, also the sole stockholder of the single-purpose corporation, votes the stock, elects directors, and receives dividends unless and until a default occurs under the transaction.

In the case of the bankruptcy of the equity participant, two questions arise with respect to the single-purpose corporation: first, whether the stock of the single-purpose corporation will be regarded as "property of the estate" under section 541 of the Bankruptcy Code, and second, whether the debt participants will be required to "turnover" the stock under the provisions of section 542. If the answers to these questions are affirmative, the trustee in bankruptcy of the equity participant may vote the stock and merge the subsidiary into itself, making the assets of the subsidiary corporation available for the reorganization of the parent. A court might take a more direct approach and order the substantive consolidation of the subsidiary into the reorganization of the parent.

The law on the point of turnover is encouraging to
lenders, but it is not ironclad. In United States v. Whiting Pools, Inc., a leading case on the subject of turnover of property in the hands of lienholders, the Supreme Court mentioned in a footnote that if there is no present possessory interest of the bankrupt estate, turnover of pledged property could not be compelled. The Court cites as authority for this conclusion the standard treatise, Collier on Bankruptcy. Ironically, the current edition of the treatise cites the case and the footnote as authority for its conclusion. This is clearly bootstrap authority, but this notion is supported by other case law. In Gulfco Investment Corp. v. FDIC, for example, the court respected a pledge of stock, saying that "consolidation is not to be used to defeat the security of secured creditors."

Without a pledge of stock, the threat of substantive consolidation looms large. Although not specifically authorized by the Bankruptcy Code, a bankruptcy court can use its general equity power under section 105(a) to include a subsidiary in the bankruptcy proceeding of the parent corporation. In such a consolidated proceeding, the court can deal with the assets and liabilities as those of a single entity and essentially "pierce the corporate veil."

Courts generally recite the following factors to determine whether substantive consolidation would be appropriate:

(i) the presence or absence of consolidated financial statements;
(ii) the unity of interests and ownership between the various corporate entities;

233 Id. at 206 n.14.
234 4 COLLIER ON BANKRUPTCY 41.08[9] (L. King 15th ed. 1982).
236 593 F.2d 921 (10th Cir. 1979).
237 Id. at 930.
239 See 5 COLLIER ON BANKRUPTCY 100.06 (L. King 15th ed. 1990).
(iii) the existence of parent and inter-corporate guarantees or loans;
(iv) the degree of difficulty in segregating and ascertaining individual assets and liabilities;
(v) the transfer of assets without observance of corporate formalities;
(vi) the commingling of assets and business functions; and
(vii) the profitability of consolidation at a single physical location.

A single-purpose corporation used as the owner-lessee in a lease transaction is apt to exhibit many of these factors because such corporations are ordinarily funded only for the transaction; they generally have no employees or facilities separate from the parent. Earnest efforts to observe the formalities of corporate organization and accounting and to make the corporate distinction clear to those with whom the subsidiary and the parent deal may be effective in avoiding consolidation. Although the courts recite quasi-objective standards for the appropriateness of substantive consolidation, the decisions are usually driven by subjective notions of fairness.241 If creditors perceive the parent and the subsidiary as a single business entity, or if subsidiaries are used to sequester assets from creditors of the parent, the doctrine of substantive consolidation is a handy way for a court to achieve an equitable result. If these factors are not present, however, a court might be reluctant to consolidate a subsidiary into a parent's bankruptcy proceeding because of the potential for unfair treatment of the subsidiary's creditors. This risk of unfairness makes substantive consolidation a power to be used sparingly.242

240 Sargent, supra note 238, at 1226. These factors were first enumerated in In re Vecco Constr. Indus., 4 Bankr. 407, 410 (Bankr. E.D. Va. 1980). Earlier decisions looked to ten similar factors recited in Fish v. East, 114 F.2d 177 (10th Cir. 1940).
241 See Sargent, supra note 238, at 1226-27.
Failures and near-failures of many highly leveraged acquisitions in the 1980's led institutional investors to seek protection from events leading to massive decline in credit quality, so-called "event risk." In response to market concerns about event risk, financial institutions and managers of public offerings of debt began to insert in indentures for unsecured debt issues covenants designed to reduce event risk, either by making the issuer less attractive as a takeover candidate, or by compensating the lending institutions for the increase in risk. Issuers included these features in financing proposals in order to reach the broadest possible market and obtain the most favorable rates.

The new and burdensome debt that accompanies a leveraged buyout is of primary concern to investors. To avoid this problem, some of the new protective covenants are derived from the traditional debenture covenants that restrict the issuer's debt and dividends and limit the sale of its assets. Others approach the issue indirectly by causing change in control to trigger restrictions. The purpose of many of these covenants is apparently to poison the capital structure and make the obligor less attractive, rather than to offer a realistic remedy.

The most common event risk protective covenant is a put at par upon the occurrence of a designated event, called a "poison put." While a regular poison put can be abrogated by action of the outside members of the board of directors (to accommodate a takeover by a white knight), a "super-poison put" cannot. Another device is a reset of the rate on the issue, triggered by a designated event such as downgrading by the rating agencies. While protective covenants have not been used as extensively in secured transactions as in unsecured debt issues, there is increasing pressure to expand their use. Many of the

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243 See generally CHARLES E. SIMON & CO., POISON PILL II: CORPORATE ANTITAKEOVER DEFENSES 5-9 (Spring 1986).
large institutions regard event risk protection as appropriate for secured transactions and leases; they evaluate the interest rate offered in light of these protective features.

Standard & Poor’s has developed a rating system for event risk covenant protection in investment grade, non-convertible bonds. The other rating organizations have not adopted specific systems for rating event risk, but they consider event risk protection in their analyses of debt issues for investment quality rating purposes. These investment quality ratings can be quite important to the success of an issue in the institutional market. For example, some state laws prescribing “legal” investments for insurance companies turn on these ratings. Additionally, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 restricts savings banks, whether federal or state-chartered, from investing in corporate debt securities not of “investment grade.” The Act defines “investment grade” as “rated in one of the 4 highest rating categories by at least one nationally recognized statistical rating organization.”

In its event risk rating system, Standard & Poor’s favors interest rate adjustments, or resets, tied to investment quality ratings. Standard & Poor’s gave its highest rating, E-1, to a debt issue providing that downgrading to a speculative level of investment quality grade would increase the interest rate by 2.5 percentage points. This provision, according to the rating company, will protect holders of the notes against virtually all untoward events.

Other event risk covenants encountered in debt offerings and rated by Standard & Poor’s include puts at par triggered by rating downgrades coupled with designated events, such as acquisition of a certain percentage of voting power, a change in majority of the board of directors.

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244 Event Risk Covenant Rankings, STANDARD & POORS CREDITWEEK, July 24, 1989.
246 Id.
within two years, merger, consolidation, asset transfer or lease, a certain percentage of stock repurchased within any 12 months, and dividends plus stock repurchases within any 12 months equal to a certain percentage of the issuer's market value. Standard & Poor's also regards as beneficial such provisions as negative pledges, sale-leaseback restrictions, provisions to secure bonds equally and ratably with other secured debt if such secured debt exceeds a certain percentage of assets, and dollar limitations on dividends and stock purchases.

The appropriateness of event risk protective provisions for secured equipment transactions and leases is the subject of current debate. The major financial institutions contend that the secured transactions currently offered in the market have significant credit characteristics, and that covenants to protect the credit elements are just as appropriate as in pure credit (unsecured) transactions. They stress that this is especially true in aircraft transactions, where a financially strong airline with good credit may exact concessions in the collateral-protective aspects of the transactions. While granting these concessions, the financial institutions will want to be sure that the credit standing continues.

The potential effect of puts on the characterization of a transaction as a true lease, an essential element of these tax-oriented transactions, has been an impediment to the wider use of event risk protection in aircraft lease transactions. The very notion of a put is offensive to the concept of a true lease because it removes a significant element of the ownership risk from the lessor. The price of a put and the circumstances permitting its exercise are matters that tax counsel must carefully evaluate.

Furthermore, in a leveraged lease, a put creates a new area of dispute between the debt and the equity participants: who will have the right to exercise the put? The debt participants might be inclined to exercise the put, while the equity participants would rather wait to realize the residual value of the equipment. A put option for the
equity side could be arranged to keep the debt in place, but unless the debt could be refinanced, a put exercised by the debt would collapse the transaction and squeeze out the equity.

For these reasons, the first public offering of aircraft debt to have event risk protection used a rate reset instead of a put. The issue, American Airlines 1990 Equipment Trust Certificates, Series A through D, received an “E-2” rating from Standard & Poor’s, the second best of the five available ratings for event risk protection. American’s parent, AMR Corporation, had recently offered debt securities with event risk protection, which also received an E-2 rating and were well received in the market. This experience suggested that equivalent event risk protection would significantly reduce the coupon rate for equipment debt.

The prospectus for the issue describes the event risk protection in a single sentence, nearly two pages in length, which incorporates defined terms that require an additional four pages. This lengthy provision seems to say that the interest rate on the certificates will be adjusted upward (in accordance with a table of fixed rates) if two things happen: either Moody’s or Standard & Poor’s reduces its rating on the issue to below investment grade or one of a number of triggering events occurs. Triggering events include acquisition by an outsider of more than 25% of American’s stock, a change in the majority of the board of directors in a two-year period, consolidation or merger of American with another corporation, purchase by AMR of more than 25% of its own stock in a one-year period, dividend or stock repurchase by AMR of more than 25% of the market value of its outstanding stock, and purchase by American of more than 50% of the common stock of another corporation for consideration exceeding 50% of the value of American’s assets. The interest rate can also be reset back down, after being reset-up, if the rating agencies revise their ratings upwards.

American and Merrill Lynch Capital Markets, the lead
underwriter, worked out a table of interest rates, expressed as a matrix of rates for various ratings and remaining terms, to be applied to various reset circumstances. Compared to a coupon rate of 10.5% for the longest maturities (21 and 22 years), interest rates after reset range from 11.75%, for downgrade to below investment grade when the remaining term is five years or less, to 15.5%, for downgrade to B+ or B1 or lower when the remaining term is greater than 14 years. There is also a table of rates which applies if both agencies withdraw the rating.

Standard & Poor's gave the issue an E-2 rating because the rate reset is tied to both downgrading by a rating agency and occurrence of one of the triggering events. Issues having an interest rate reset triggered only by a rating company's downgrade, for whatever reason, have been given E-1 ratings. Standard & Poor's usually rates issues that guard against event risk through poison puts in a lower category, E-3 through E-5.

Event Risk Covenants for Secured Transactions

Rate resets and puts are used as event risk protection in unsecured transactions because little else can be done with a naked promise to pay. In a secured transaction or finance lease, however, the range of other covenants provides possibilities for security enhancement, a third type of event risk protection.

Weakness in the collateral-protective covenants is a major concern of institutional investors in the typical aircraft transaction. In recent years these transactions have been characterized by soft maintenance covenants, insurance provisions of questionable integrity, and sublease rights that are nothing short of astonishing. It is not at all unusual to see a transaction that permits the obligor to sublease the aircraft to a foreign carrier and then re-register it under a foreign flag. In those circumstances, there is very little left to sustain the obligation but the credit of the primary obligor. At the commencement of the trans-
action, that credit may be sufficient to sustain the obligation without effective provisions to protect and preserve the equipment collateral, but what if massive credit deterioration-event risk-occurs?

An appropriate remedy for massive credit deterioration in such transactions would be an enhancement of the collateral-protective covenants to a level suitable for transactions involving a weak credit. Such a transaction would have two tiers of covenants: loose covenants in the current fashion while the airline is financially strong, and stricter covenants to go into effect if future events significantly weaken the obligor's financial strength. Triggering events much like those used for rate resets and poison puts might have this effect.\(^{247}\)

In some circumstances, the second-tier covenants should contemplate an imminent declaration of default and recovery of the equipment. There may be some lessons to be learned from operating lessors who successfully lease into decidedly distasteful credit situations. Some suggestions for enhanced collateral-protective covenants include:

- Maintenance covenants written specifically to prevent deferral of airworthiness directives and other maintenance items and incorporating features designed to preserve resale value as well as airworthiness. Expert advice should be sought in developing these covenants.
- Inspection provisions, coupled with an active inspection program, to monitor compliance with the covenants regarding the maintenance of the aircraft and the keeping of appropriate records. Experts should be engaged to conduct these inspections, and the costs should be passed on to the obligor. The agreement should include a mechanism for enforcement and arbitration of disputes in this area, short of declaring default.
- Regular delivery of copies of maintenance records.

\(^{247}\) A similar approach in unsecured transactions was suggested in Winslow, Alternatives to Brinkmanship—Contingent Remedial Covenants in Unsecured Long-Term Loans, 23 A. LIFE INS. COUNS. PROC. 157 (1973).
An aircraft is almost worthless without these records, and it is sometimes difficult to get them from operators *in extremis*.

- Reduced levels of self-insurance limits and other enhancements of insurance coverage, with a regular program of examining policies and monitoring coverage.
- Tightened restrictions on use outside of the jurisdiction of registration, with a prohibition on sublease without consent.

Measures such as these would impinge on the operations of an airline to a considerable extent, and would thus be stoutly resisted at the beginning of a transaction when the airline is financially stable. As remedies for events associated with massive credit deterioration, however, such enhancements would cost the airline less than a rate reset and would be less disruptive than a put.

**Conclusions and Suggestions**

Aircraft financing holds a special attraction for institutional investors. Individual transactions are large enough to satisfy a major portion of investment needs, the collateral is durable and saleable, and the airline business continues to grow. There also seems to be a certain glamour associated with these transactions, partly because the work is demanding, partly because the people involved are stimulating, and partly, it seems, because we like airplanes. But that glamour should not be permitted to overwhelm concerns for certain fundamental issues.

Aircraft financing is a global business, with transactions and collateral crossing international boundaries. The legal basis for these transactions, however, is local, not global. While there is certain international recognition of interests in aircraft by treaty and by tradition, it is neither universal nor reliable. The rights of an owner-lessee appear to be more easily enforced than the interests of a mortgagee.

Aircraft registration in the United States and elsewhere requires compliance with citizenship tests that must be
considered both at the commencement of a financing transaction and during its term. In the United States, perfection of interests in aircraft and aircraft engines requires compliance with technical requirements of both federal and state law. Failure to record properly can be fatal to a financer's interests.

The protection of section 1110 of the Bankruptcy Code is crucial to the success of an aircraft financing for a domestic air carrier. Although courts have now verified that section 1110 protection is not limited to leases that permit an aircraft to be newly acquired by a carrier, sale-leaseback transactions must be regarded as particularly sensitive. We can expect close judicial scrutiny of lease transactions to determine whether they have the necessary elements of a "true" lease. In a debt financing, only a clearly defined "purchase money" transaction will be covered by section 1110. Thus, any transaction intended by the parties to be covered by section 1110 should explicitly so provide.

Although there are legal devices that provide some insulation from lessor bankruptcy, any lessee of aircraft and any party providing debt financing for a leveraged lease should be concerned about the financial stability of the lessor.

Event risk protection by means of rate reset has become an accepted practice in aircraft financing, and the presence or absence of event risk protection can have a significant effect on the interest rate in a transaction.
Comments