

# Negotiating an Operating Lease: Key Topics

*Luca Denora and Zara Machado*

*Pillsbury Winthrop Shaw Pittman, Hong Kong*

pillsbury

pillsbury

# The Aviation Industry: Flirting with leases ...

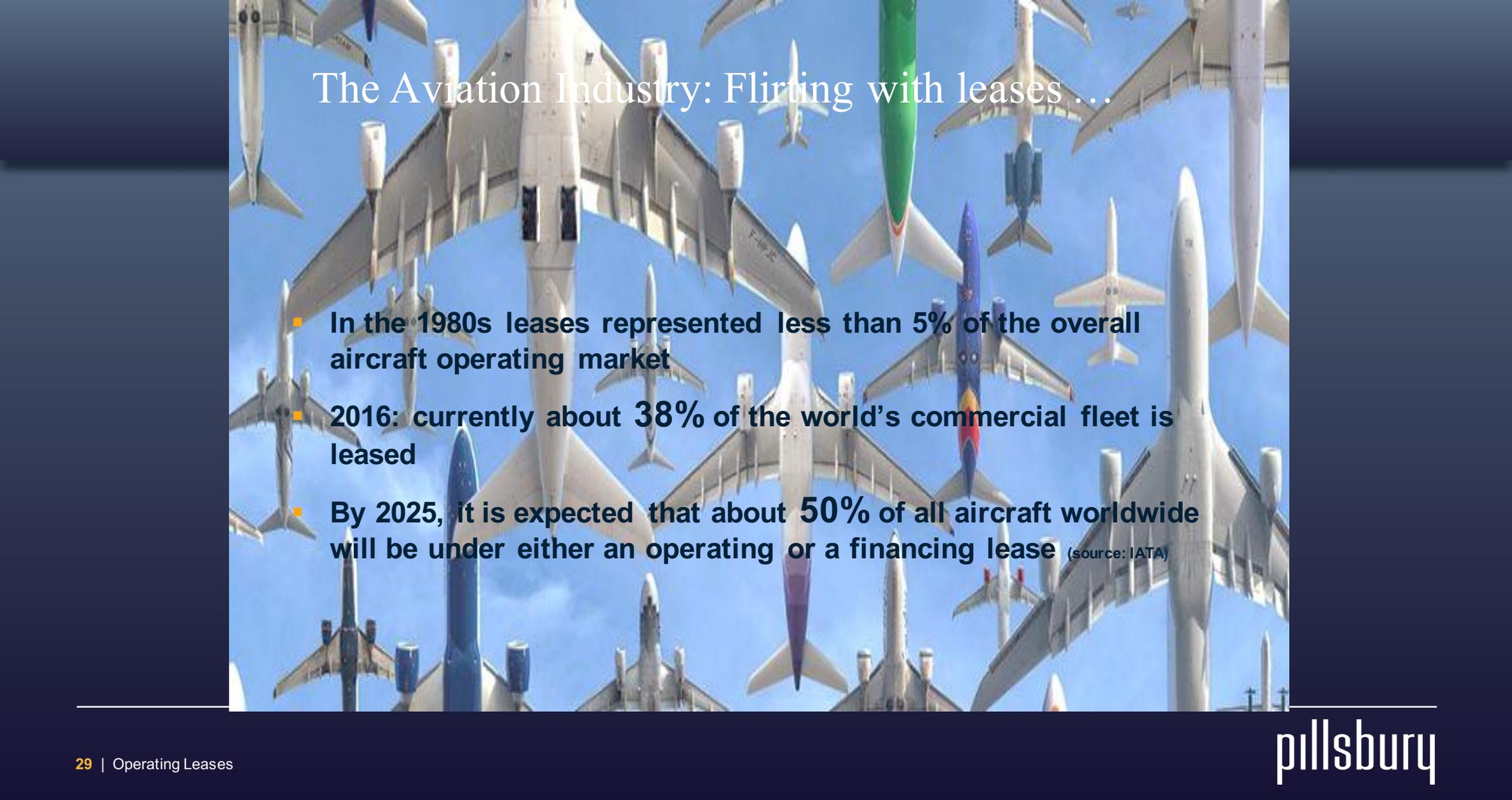
- Aircraft leases have become more and more attractive
- Let's jump back to ... 1963

## AIRCRAFT LEASING

David I. Johnston\*

In the field of aircraft finance as in other fields of business activity in Canada and the United States today, there is a trend towards leasing items of capital equipment instead of purchasing such equipment.<sup>1</sup> Airlines have begun to use the lease as a means of acquiring aircraft, powerplants, spare parts and ground support equipment to expand their fleets and facilities, but at the same time to remain competitive under economic conditions which have made the outright purchase of such equipment undesirable or impossible.<sup>2</sup> There are circum-

\*As of October 31, 1967, the Boeing Airplane Company had on lease 9 B-720B's to Northwest, 2 B-707-120's to Pan-American and 5 B-707-320B's to TWA; Lockheed Aircraft Corporation had on lease 9 1049's to Capitol and 6 B-707-320B's to TWA; Eastern had leased 10 B-720's, Northeast had leased 6 Convair 880's, Swissair had leased 4 Caravelles from S.A.S. and S.A.S. had leased Convair 990's from Swissair. In addition, a recent survey indicates that Pacific Northern, Slick, InterOcean, British West Indian Airways, Air Afrique, Ansett, Air Ceylon and Thai Airways International are among the air carriers currently operating part of their flight equipment under lease arrangements.



## The Aviation Industry: Flirting with leases ...

- In the 1980s leases represented less than 5% of the overall aircraft operating market
- 2016: currently about **38%** of the world's commercial fleet is leased
- By 2025, it is expected that about **50%** of all aircraft worldwide will be under either an operating or a financing lease (source: IATA)

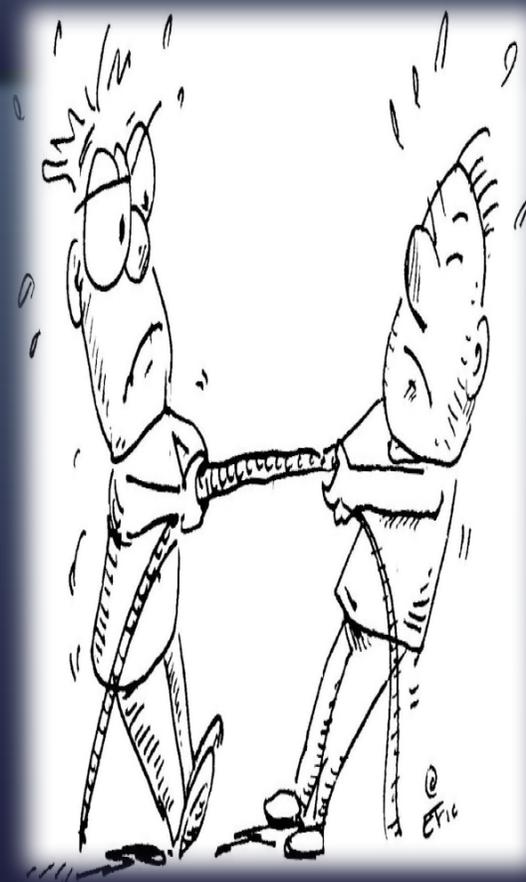
# Why lease?

For a lessee, leases offer:

- flexibility in fleet expansion (the more the better if demand is unstable)
- no responsibility of ownership
- no investment of funds to purchase aircraft
- risk of obsolescence shifted to lessor
- balance sheets: don't look too asset-heavy
- access to new planes and more fuel-efficient aircraft

# Lessor vs. Lessee: Negotiation Objectives

- **Lessor**
  - protect residual value of asset
    - strict operational and redelivery conditions
    - inspection rights
    - control over modifications
  - protect income stream from asset
    - security deposit
    - financial due diligence on lessee creditworthiness
  - protect against operational losses caused by asset
    - indemnities and insurances
  
- **Lessee**
  - maximize operational autonomy
    - quiet enjoyment covenants
    - light-touch operational undertakings
    - achievable redelivery conditions
  - maintain contractual consistency across fleet
    - similar representations and conditions precedent
    - similar undertakings and event of default
  - limit consequences of default



# The Legal Stuff: Architecture of an Operating Lease



- Parties, definition and interpretation
- Reps and warranties
- Conditions precedent
- Delivery and Acceptance
- Disclaimers
- Payment
  - basic rent
  - security deposit
  - supplemental rent: maintenance reserves
- Undertakings
  - operation and maintenance of asset
  - possession and subleasing
  - information undertakings
  - quiet enjoyment
- Indemnities
- Insurances and Events of Loss

# Architecture of an Operating Lease (contd)

- Events of default
- Termination Rights and Remedies
- Redelivery
- Assignment and Transfer
- General Provisions (“boilerplate”)
- Governing Law and Jurisdiction
- Schedules
  - delivery condition
  - insurance requirements
  - acceptance and return certificates

# Getting Started: Delivery and Acceptance

- **Acceptance and Delivery of asset = commencement of lease term**
- **Delivery Condition is key**
  - lessors usually look to:
    - require lessees to accept an aircraft “AS IS, WHERE IS”
    - synchronize delivery and redelivery conditions between successive lessees
  - lessees usually look to:
    - ensure opportunities for a thorough pre-delivery inspection and/or walkaway rights
    - ensure the aircraft complies with fleet technical standards and configuration requirements
    - ensure there is a mechanism for post-delivery correction of discrepancies
  - some considerations:
    - avoid vague, open-ended delivery commitments: “good condition”; “all damage repaired”
    - key parts and components: should these be new or have a minimum remaining life?
    - which defects need to be repaired before delivery? (major vs minor)
    - AD compliance and aircraft documents: specify required standards

# Getting Started: Delivery and Acceptance

- **Delivery and Redelivery**
  - **remember that delivery condition at lease commencement mirrors redelivery condition at lease end**
    - same specification, operational capability and similar configuration
    - a lessor looks for stringent redelivery conditions to protect asset value
    - a lessee argues it should be exempt from rectifying any damage present at delivery
    - **do not underestimate the importance of the lease acceptance certificate:**
      - all non-compliance with the required delivery condition should be documented
      - records supplied and other defects should also be listed

# Undertakings: Lessee

- **Operation and Maintenance**

- **Operation**

- compliance with:
      - permitted use
      - applicable regulation
      - manuals and insurances
    - non-discrimination and proportionality
    - installation and removal of parts

- **Maintenance and Repair**

- compliance with:
      - approved maintenance programmes and approved maintenance performers
      - applicable regulation (ADs, SBs and other legislation)
    - licences, permits and consents
    - aircraft records
    - modifications

- **Inspection Rights**



# Undertakings: Lessee (contd)

- **Possession**

- subleasing rights

- **Protection of lessor's rights in aircraft**

- registration and filings
  - national aircraft registers
  - Cape Town security filings
- nameplates
- no jeopardizing ownership interest in aircraft
  - no creation of third party security in aircraft
    - except for permitted liens
  - labelling of removed parts

- **Information**

- **technical** (periodic reports; notification of maintenance events)
- **financial**

- **Lessee's business**

- preservation of corporate structure
- change of control



# Undertakings: Lessor



- **Quiet Enjoyment**

- Quiet enjoyment undertakings by both lessor and its financiers

- lessee's right to possess, use, and operate the aircraft without any interference from the lessor or its creditors, so long as there is no Event of Default by the lessee under the lease which is continuing.

- **Lessor Payments**

- return of security deposit, rebates, AD cost sharing and return adjustments

- minimum net worth requirements?
    - parent guarantee?

# How much do I owe you?

- **Payments:**

- rent
- security deposit
- supplemental rent (maintenance reserves)
- **payments are typically one-sided:**
  - net leases
  - hell or high water
  - no lessee rights to set-off

- **Rent**

- principal consideration paid by lessee, typically monthly in advance
- fixed, float to fix, floating
- default rate: incentivizes timely payment by lessee

# How much do I owe you?

- **Security Deposit**

- key lessor protection against any non-payment (e.g. can be used to offset failure to meet redelivery conditions)
  - typically two/three times monthly rent
  - interest on the deposit for the benefit of lessor?
  - staggered payments
- to avoid claw-back in the event of lessee bankruptcy, lessors either:
  - take a first priority charge over the security deposit; or
  - re-characterize the deposit as a commitment fee paid to lessor as consideration for taking the aircraft off the market
- to ensure the deposit is returned by lessor at the lease end, lessees may require:
  - security deposit to be placed in a pledged account; or
  - a lessor's letter of credit

# How much do I owe you?

- **Supplemental Rent (Maintenance Reserves)**
  - serves as security to cover lessor's costs if lessee fails to maintain the aircraft
    - typically split out by airframe, engines, landing gear, APU, LLPs
    - calculated by reference to expected usage (FH, FC, calendar time)
    - typically paid (monthly) in arrears based on actual usage
  - **Agreed "reimbursement events"**
    - on completion of a "reimbursement" maintenance event, lessor reimburses lessee with the lesser of actual maintenance costs and the amount earmarked for that event
  - **Highly negotiated because:**
    - lessor needs sufficient reserves to pay maintenance contributions over life of the asset
    - lessee is on the hook for all repair costs other than agreed "reimbursement" events
  - **Lessor's rights to maintenance reserves safeguarded by:**
    - supplemental rent stated to be lessor's absolute property; or
    - charge over maintenance reserves properly registered

# How much do I owe you?

- **Maintenance Reserves – some technical considerations:**
  - LLP reserves and LLP lessor contributions should be tracked on a per-part basis and not as a pool: each part may have a different life-cycle
  - Should lessor's contribution be paid upon replacement of a part with a new part or with a soon-to-expire part?
  - for lease of a used aircraft:
    - clearly specify the start date for calculation of the lessor's credit (easy to ascertain for airframe and landing gear whose checks are calendar-driven; difficult for engines and APU whose performance restorations are driven by operating conditions)
    - carefully consider the method of calculating the credit: lessors prefer the rate-times-hours/cycles/months method; lessees prefer the pro-rata method
    - only for the first reimbursable events during the lease term.



# How much do I owe you?

## Letters of Credit

- in lieu of a security deposit or maintenance reserves
- issued by a bank acceptable to lessor, usually drawable upon an event of default
  - pros:
    - lessee: LOCs free up cash (even if a fee is paid to the issuer)
    - lessor: the issuing bank takes risk on a lessee's bankruptcy
  - cons:
    - lessee: damage to its creditworthiness if LOC is drawn
    - lessor:
      - is an LOC the equivalent of cash? Not quite!
      - neither the issuing bank nor the lessee want the lessor to get paid
      - a broad illegality exception (i.e. the transaction is illegal vs. payment by the bank is illegal) can prevent the issuing bank from paying



# Indemnities and Insurances

## ■ Indemnities

- an indemnity = a promise to pay a party for losses caused by specified events
- lessee gives operational, tax and default indemnities
- operational indemnities are backed off against the lessee's insurances

## ■ Insurances

- specialist area; please consult an insurance adviser
- basic cover required:
  - All Risks Hull and Spares (risk of physical loss or damage to aircraft)
  - War Risks Hull (political risk – confiscation, requisition, etc.)
  - Liability (risk of damage or injury caused by aircraft to third parties)
- industry-standard policy endorsements protecting rights of lessors and financiers
  - lessor to be named as loss payee and additional insured
  - policies are primary without right of contribution
  - severability of interest
  - breach of warranty

# Default and Termination

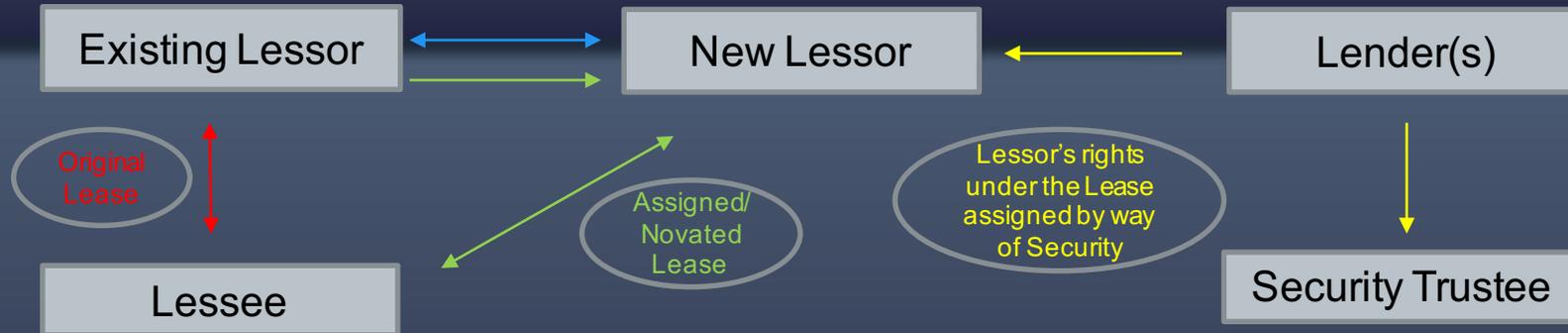
- **Events of default**
  - entitle the lessor to terminate the lease and repossess the aircraft
  - should be carefully drafted (so that lessee is not designed to fail)
    - consider remediation rights and grace periods
    - consider minimum financial thresholds
- **A typical list of defaults would include:**
  - non-payment
  - failure to maintain insurances
  - breach of other obligations under lease
    - redelivery
    - subleasing
    - operational covenants
  - misrepresentation
  - failure to maintain required licenses and permits
  - confiscation or detention of aircraft
  - change of control (without lessor consent)
  - cross-default
  - insolvency
  - material adverse change



# Transfers, Transfers and More Transfers

- Lessors demand greater liquidity and greater flexibility
- Lease transfers are now more frequent
- Transfer = the act of giving property by will
- typically include:
  - assignments
  - novations
- **Assignments and novations** are mechanisms to change the parties to a contract
- An alternative option is to **transfer the Aircraft Owner Entity**: there is no change of the original parties to the lease in this case.

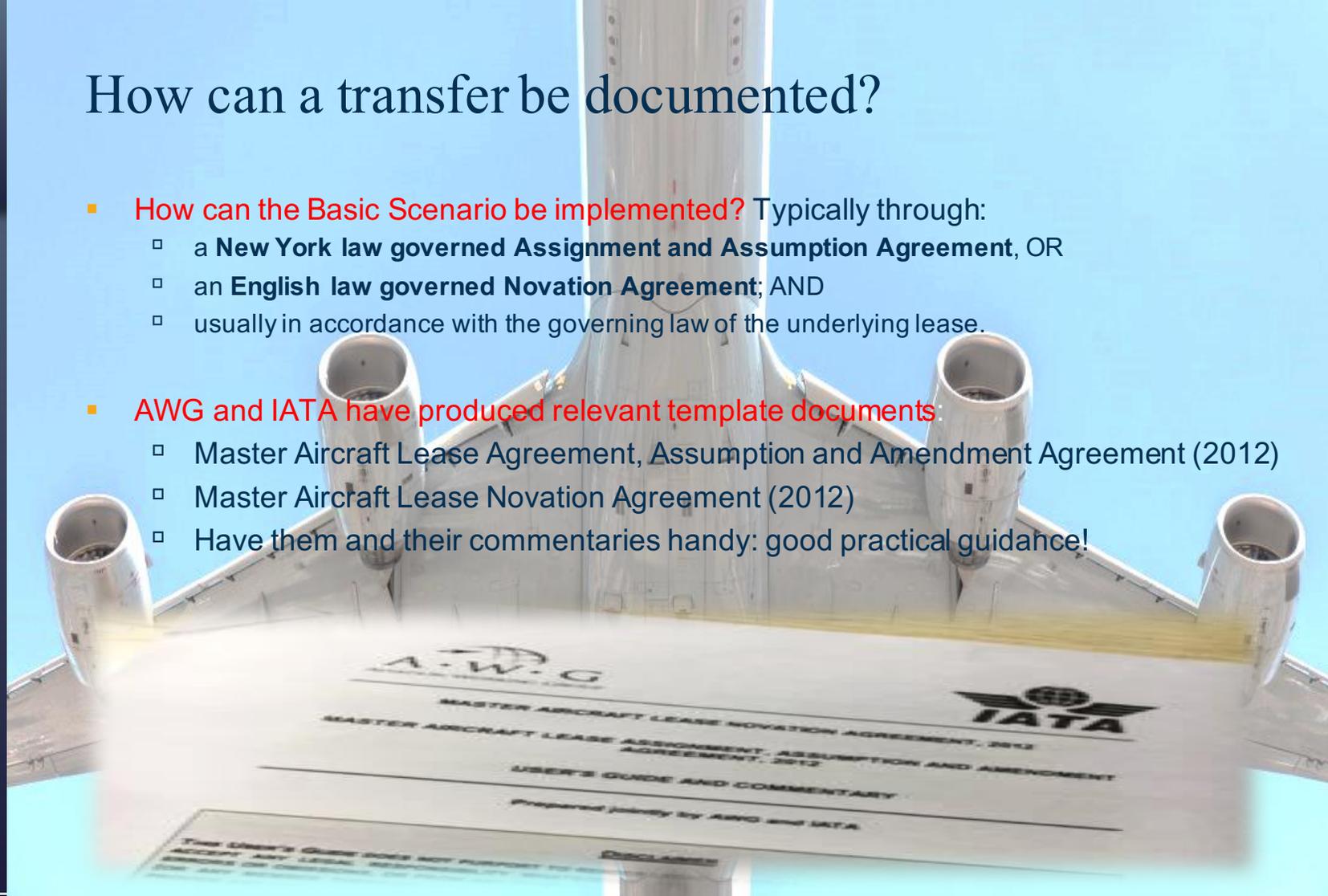
# Basic Scenario



- (1) **Operating Lease** between Existing Lessor and lessee
- (2) **Sale Transaction**: Existing Lessor transfers title to the Aircraft to New Lessor
- (3) **Assignment/Novation Transaction**: (a) Operating Lease assigned to New Lessor, (b) Operating Lease novated in favor of New Lessor
- (4) likely: **Financing Transaction**: lessor's rights under the Assigned/Novated Lease are assigned as security for the loan

# How can a transfer be documented?

- **How can the Basic Scenario be implemented?** Typically through:
  - a **New York law governed Assignment and Assumption Agreement**, OR
  - an **English law governed Novation Agreement**; AND
  - usually in accordance with the governing law of the underlying lease.
- **AWG and IATA have produced relevant template documents.**
  - Master Aircraft Lease Agreement, Assumption and Amendment Agreement (2012)
  - Master Aircraft Lease Novation Agreement (2012)
  - Have them and their commentaries handy: good practical guidance!



# A&A / Novation Agreements: Basic Provisions

- **A&As/Novations raise concerns for the lessee**
  - require lessee involvement, even though lessee has no choice in selection of new lessor
    - long negotiations
    - new CPs and ancillary documents
    - risks: is the **New Lessor** (which lessee cannot choose) **reliable**?
    - lessee is asked to make **new Representations** and Warranties
    - re: Insurances, the Existing Lessor can require a “**Tail Coverage**” for a certain period
- **NO INCREASE IN LESSEE'S OBLIGATIONS**
  - **Lessor may at any time assign** its rights in the lease without prior consent of lessee **provided that:**
    - all cost (legal, tax, other) are borne by lessor
    - any **assignee** + any **Financing Party** of lessor shall provide an **undertaking of quiet enjoyment** (ideally in the same terms as those set out in the Lease)
    - lessee shall have **no greater financial obligations** (including in respect of Taxes) **or** [materially] **more onerous obligations and** shall enjoy **no fewer rights under the lease as a result of the transfer** than lessee would have had if such transfer had not taken place (based on applicable laws in effect as at the date of such transfer).

# For a Smooth Lease Transfer

- **The Ideal Transferee/New Lessor**
  - not another airline or existing/potential competitor of lessee
  - experienced in aircraft leasing (not a new player)
  - satisfactory credit status or financial backing (should provide financial information)
  - not from a jurisdiction that will change lessee's tax indemnification obligations;
  - minimum net worth
    - should be maintained throughout the entire lease period, not just fulfilled as of the date of the transfer → lessors' net worth can be very volatile
    - should be at least equal to the value of the aircraft
- **Parent Company Guarantee**
  - If New Lessor is an SPV, a Guarantee for all monies and performance of New Lessor's obligations under the lease should be provided
  - issued by New Lessor's parent company
  - including a repeating representation and a covenant for the Guarantor to have and maintain a minimum net worth throughout the entire lease period
  - negotiations can be hard and require certain commercial power from lessee
- **No resulting illegality event or breach of applicable law**



# For a Smooth Lease Transfer

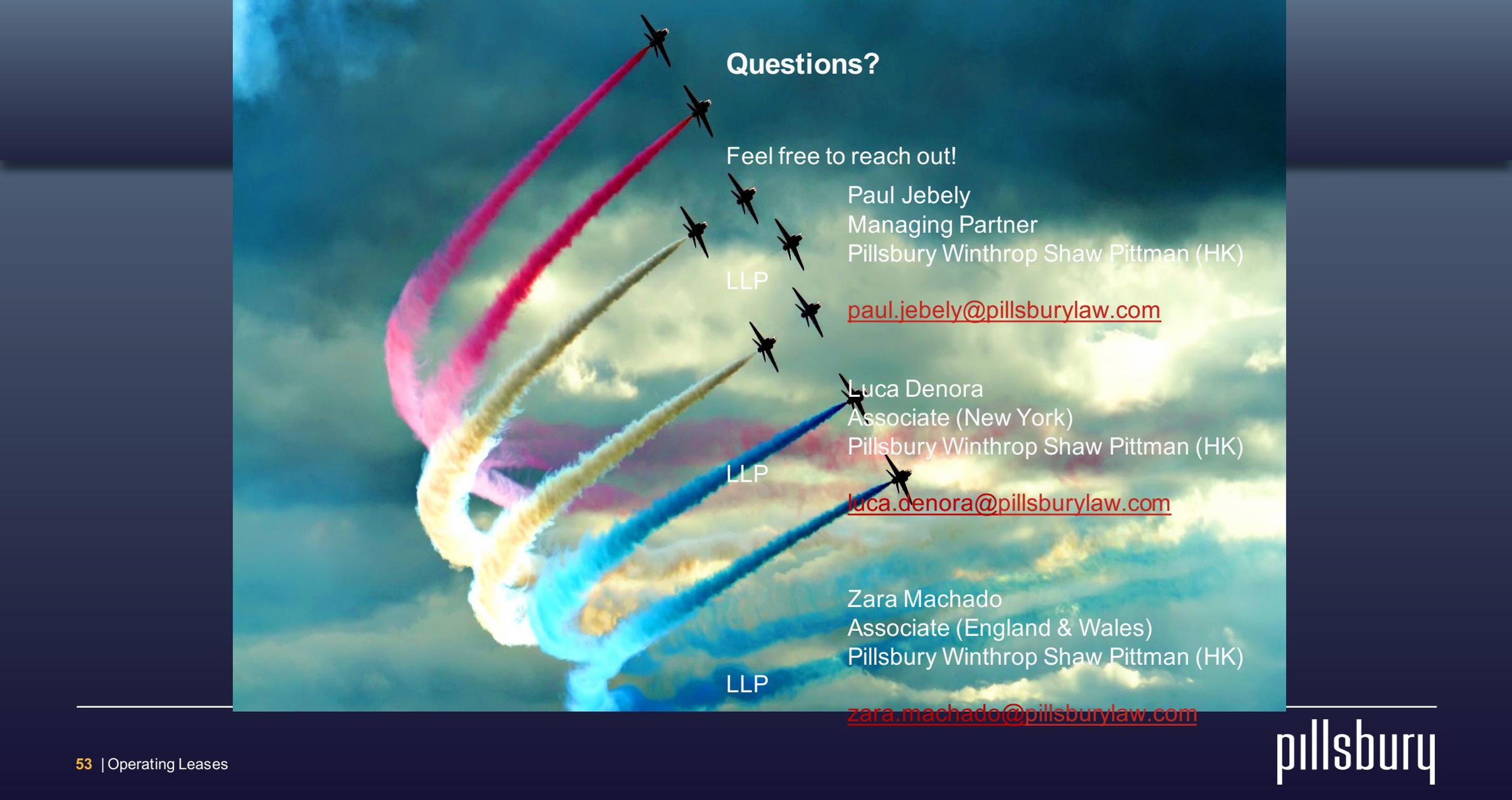
- **Quiet Enjoyment Undertakings**
  - appropriate quiet enjoyment undertakings are given by the New Lessor AND its financiers
- **Deposit and Maintenance Reserves**
  - should be treated as paid to New Lessor
  - their amounts should be specified in the A&A / Novation agreement
  - transferred to New Lessor by Existing Lessor on the Effective Time or netted against payments owing from New Lessor to Existing Lessor (i.e. the purchase price of aircraft).
- **Maintenance Reserves**
  - New Lessor and lessee should agree the per-hour/cycle/month reserves amounts in effect at the Effective Time: because maintenance reserves are usually stated to be base amounts subject to adjustment and variation, what is the correct amount on closing?
- **Lessor Contributions** when the aircraft was delivered used to lessee:
  - New Lessor and lessee should agree (i) the actual dollar amounts and include them in the A&A / Novation agreements (ii) which Lessor Contributions have already been satisfied;
  - Lessee should obtain any reimbursements relating to the period prior to the Effective Time from Existing Lessor



# For a Smooth Lease Transfer

- **Representation and Warranties** could involve difficult negotiations:
  - Existing Lessor, New Lessor and lessee provide standard reps: due incorporation, capacity, due execution and consents;
  - New Lessor usually requires Existing Lessor AND lessee to rep no EoD under the lease;
  - Lessee:
    - does not like to repeat reps (although reps are usually repeated on every rent payment);
    - **"No-EoD" rep should be limited to EoD under the lease**; no vague, unascertainable reps which refer to any default whatsoever





## Questions?

Feel free to reach out!

Paul Jebely  
Managing Partner  
Pillsbury Winthrop Shaw Pittman (HK)

LLP

[paul.jebely@pillsburylaw.com](mailto:paul.jebely@pillsburylaw.com)

Luca Denora  
Associate (New York)  
Pillsbury Winthrop Shaw Pittman (HK)

LLP

[luca.denora@pillsburylaw.com](mailto:luca.denora@pillsburylaw.com)

Zara Machado  
Associate (England & Wales)  
Pillsbury Winthrop Shaw Pittman (HK)

LLP

[zara.machado@pillsburylaw.com](mailto:zara.machado@pillsburylaw.com)