

December 2, 2016

Applicability of U.S. Risk Retention Rules to Structured Aircraft Portfolio Transactions

By Clifford Chance LLP; Hughes Hubbard & Reed LLP; Milbank, Tweed, Hadley & McCloy LLP; Pillsbury Winthrop Shaw Pittman LLP; and Vedder Price P.C.

The purpose of this White Paper is to provide general guidance to transaction participants and practitioners in their consideration of the application of the provisions of Section 15G of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) and the federal interagency credit risk retention rules promulgated thereunder, codified at 17 C.F.R. Part 246 (the “CRR Rules”), to a typical issuance of securities by a newly formed special purpose vehicle that owns or will own, among other things, a portfolio of aircraft and related leases (a “Structured Aircraft Portfolio Transaction”). This White Paper was prepared by the law firms named above, but does not reflect the view of any law firm in the context of any particular transaction. The guidance set forth in this White Paper is for informational purposes only, and is subject to change in light of future federal interagency decisions interpreting the CRR Rules or applicable legislative or judicial action. Neither this publication nor the law firms that authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship.

Introduction

On December 24, 2016 the CRR Rules will come into effect for all classes of asset backed securities, except for asset-backed securities collateralized by residential mortgages (for which the CRR Rules came

into effect in December of 2015). The CRR Rules require that each securitizer of “asset-backed securities” must retain an economic interest in a portion of the credit risk for all assets that the securitizer transfers, sells or conveys to a third party through the issuance of asset-backed securities. The CRR Rules apply only to issuances of “asset-backed securities”, as defined in Section 3(a)(79) of the Exchange Act (referred to herein as “Exchange Act ABS”). Thus, the gating question is whether a typical Structured Aircraft Portfolio Transaction constitutes an issuance of:

“a fixed-income or other security collateralized by any type of *self-liquidating* financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend *primarily* on cash flow from the asset...”¹ (emphasis added)

For the reasons discussed below, we believe that the securities issued in a typical Structured Aircraft Portfolio Transaction do not constitute Exchange Act ABS and accordingly, the CRR Rules would not be applicable.

Anatomy of a Structured Aircraft Portfolio Transaction

In a typical Structured Aircraft Portfolio Transaction, an aircraft leasing company (the “servicer/seller”) sells a portfolio of aircraft (together with any associated operating leases) to a newly formed special purpose vehicle (the “Issuer”). The Issuer is an orphan special purpose vehicle, owned, in almost all instances, entirely by a charitable trust. The Issuer finances its acquisition of the portfolio of aircraft through the issuance of one or more classes of debt securities and, in many cases, a sale of its residual (or equity) interests to a third-party purchaser in the form of a profit participating note (e.g., an E note). If the transaction includes a sale of equity interests (or an E note) to a third-party, the purchaser performs extensive due diligence on the servicer/seller, as well as on the aircraft and leases owned or to be purchased by the Issuer, an exercise similar in many respects to the due diligence investigation that a buyer would perform in connection with the acquisition of a target company.

The Issuer is generally managed by a Board of Directors (the “Board”) and engages third parties to manage its business. The servicer typically manages the leasing and disposition of the aircraft on behalf of the Issuer pursuant to a servicing agreement, and other third parties often provide administrative and financial management services to the Issuer and its Board. Subject to the terms and conditions of the applicable third-party agreements (including the servicing agreement), the Board has the authority to terminate the third-party agreements. In addition, as further set forth in the third-party agreements, the Board retains certain approval rights over specific types of transactions, such as the disposition of aircraft assets.

¹ Exchange Act ABS “(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

- (i) a collateralized mortgage obligation;
- (ii) a collateralized debt obligation;
- (iii) a collateralized bond obligation;
- (iv) a collateralized debt obligation of asset-backed securities;
- (v) a collateralized debt obligation of collateralized debt obligations; and
- (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company”.

Upon the acquisition of the aircraft, the Issuer generates income from (a) rent and related payments under operating leases of the aircraft to various commercial airlines and (b) by the sale, part-out or other final disposition of the aircraft themselves. These cash flows from the Issuer's business activities are used by the Issuer to pay operating costs and expenses, to pay debt service on its debt securities and to make distributions to equity. Importantly, each aircraft is typically expected to be re-leased one or more times over the life of a Structured Aircraft Portfolio Transaction and, in many cases, ultimately sold or parted-out. In any case, the expected cash flows from the initial leases are generally inadequate to repay the debt securities in the absence of re-leasing or selling most or all of the aircraft. Therefore, the Issuer's ability (through the servicer, its Board and other service providers) to remarket off-lease aircraft for lease, to manage maintenance expenses and transition costs and ultimately to sell the aircraft is essential to the performance of a Structured Aircraft Portfolio Transaction.

Definition of Asset-Backed Security

SEC Guidance

Although the Securities and Exchange Commission ("SEC") has not expressly interpreted the definition of Exchange Act ABS, it has expressed certain core principles that it considers inherent to an "asset-backed security" (generically, "ABS") in the context of Regulation AB, including "a general absence of active pool management" and an emphasis on "the self-liquidating nature of pool assets that by their own terms convert into cash."² Prior to the adoption of Regulation AB, securities backed by assets which require active behavior to acquire cash – such as the sale of non-performing assets and physical property, were generally considered not to constitute asset-backed securities under the existing registration, disclosure and reporting regime governing asset-backed securities. In 2005, the SEC codified the predecessor regime in Regulation AB, and in doing so, not only expressly acknowledged its belief in these core principles but also recognized that its existing definition of asset-backed security (the "pre-2005 ABS definition") would need to be amended if the SEC desired to include lease-backed securities that had characteristics which were inconsistent with the core principles. As discussed below, the drafters of Section 15G of the Exchange Act and the CRR Rules affirmatively elected not to adopt the SEC's amended definition of asset-backed security under Regulation AB, choosing instead to use a definition that is strikingly similar to the pre-2005 ABS definition.

In 1992, as a part of amendments to Form S-3, the SEC originally adopted the pre-2005 ABS definition of "asset-backed security", meaning a security that is "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders". In 2005, as a part of Regulation AB, the SEC expanded the scope of the pre-2005 ABS definition to include certain transactions backed by leases for purposes of the rules and forms for the registration, disclosure, and reporting requirements for asset-backed securities under the Securities Act and the Exchange Act (the "Regulation AB definition").³ Regulation AB and the predecessor rules for reporting, registration and disclosure are not the only context in which the SEC has considered the meaning of an asset-backed security. The SEC also defines "eligible assets"⁴ within the meaning of

² Asset-Backed Securities; Final Rule, SEC Release No. 33-8518, 34-50905, 70 Fed. Reg. 1506, 15 t3 (Jan. 7, 2005) (the "2005 ABS Adopting Release").

³ The Regulation AB definition means "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; **provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases...**" (emphasis added)

⁴ "Eligible assets" means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

Rule 3a-7 of the Investment Company Act of 1940, as amended (the “’40 Act definition”), a definition which is generally considered functionally equivalent to the pre-2005 ABS definition.⁵

Although Dodd-Frank did not adopt any of these pre-existing definitions of asset-backed security⁶, the definition of Exchange Act ABS is similar to both the pre-2005 ABS definition and the ’40 Act definition in that (a) the primary assets collateralizing the applicable securities must be “self-liquidating”, a phrase the SEC has often used interchangeably with “converts into cash within a finite time period”⁷ and (b) in contrast to the Regulation AB definition, none of these definitions expressly includes securities backed by leases which do not self-liquidate. Accordingly, just as most securities backed by leased assets were excluded from the scope of the pre-2005 ABS definition and continue to be excluded under the ’40 Act definition today, we believe that securities that are substantially dependent on active management of physical assets for payment, including the re-leasing, sale or other disposition of such assets, are not within the scope of Exchange Act ABS.

In 2005, when the SEC expanded the pre-2005 ABS definition in order to include lease-backed ABS where part of the cash flows to repay the securities was anticipated to come from the disposal of the physical asset underlying the lease, the SEC was clear that the change was made as a special accommodation to the pre-2005 ABS definition solely for purposes of bringing such lease-backed ABS into the Regulation AB registration, reporting and disclosure regime.⁸ The SEC was also clear that the change did not represent a shift in the SEC’s fundamental belief in what types of securities should constitute an “asset-backed security”. In expanding the definition of “asset-backed security” under Regulation AB, the SEC acknowledged that the inclusion of any significant amount of residual value represented a deviation in one of the core principles of the meaning of an asset-backed security, explaining at the time:

“However, as we explained in the Proposing Release, even though we are recognizing the growth in lease-backed ABS that include securitizations of residual value, such securitizations are subject to additional factors that are not present in securitizations backed solely by financial assets that convert into cash. Residual value is often determined at the inception of a lease contract and represents an estimate of the leased property’s resale value at the end of the lease. Assumptions and modeling are necessary to determine the amount of the residual value. In addition, the transaction is not simply dependent on the servicing and amortization of the pool assets, but also on the capability and performance of the party that will be used to convert the physical property into cash and thus realize the residual values.

The higher the percentage of cash flows that are to come from residual values, the more important these other factors become and the less the transaction resembles a traditional securitization of financial assets for which our regime for asset-backed securities is designed. Although some commenters did not believe we should have any limits on residual values, we continue to believe, as discussed above, that the core principle that an asset-backed security should be primarily serviced by financial assets that by their terms convert into cash should be retained. At the same time, we believe

⁵ SEC Release No. 33-6964 (Oct. 22, 1992) [57 FR 48970].

⁶ See discussion of the legislative history below.

⁷ Id at 5.

⁸ As stated in the 2005 ABS Adopting Release: “[t]he one change we proposed making to the basic definition of “asset-backed security” is to expand the definition to include securitizations backed by leases where part of the cash flows backing the securities is to come from the disposal of the residual asset underlying the lease (e.g., selling an automobile at the end of an automobile lease). In that instance, the asset-backed securities are not backed solely by financial assets that “by their terms convert into cash,” because the transaction also involves a physical asset that must be sold in order to obtain cash. As a result, securitizations where a portion of the cash flow to repay the securities is anticipated to come from the residual value of the physical property do not fall within the current definition of “asset-backed security” in Form S-3 and thus are often registered on a non-shelf basis on Form S-1.”

a defined limited exception to this general principle is appropriate and consistent for access to the alternate regulatory regime for certain lease-backed ABS.” (2005 ABS Adopting Release)

Indeed, the SEC sought to mitigate any adverse effects of this deviation from this core principle:

“As we explained in the Proposing Release, we are addressing concerns with the deviation from the core principle in two principal ways. First, we are adopting disclosures... on how residual values are estimated and derived, statistical information on historical realization rates and disclosure of the manner and process in which residual values will be realized, including disclosure about the entity that will convert the residual values into cash. Second, we are establishing limits on the percentage of the securitized pool balance attributable to residual values in order to be considered an “asset-backed security.” We believe these changes will expand eligibility of lease-backed transactions for shelf registration and appropriately permit lease-backed transactions under our new rules while continuing to apply the core principles underlying the definition of “asset-backed security.” (2005 ABS Adopting Release)

The intent to exclude certain asset-backed securities from the definition of Exchange Act ABS that have characteristics which are inconsistent with the core principles is also evidenced by the fact that the '40 Act definition has not been amended in a manner similar to the Regulation AB definition and, accordingly, asset-backed securities that are substantially dependent on the residual value of the leased assets for repayment are generally outside the scope of the '40 Act definition. As stated by the American Bar Association in its November 2011 response to the SEC's notice of proposed rulemaking regarding Rule 3a-7:

“The current definition of “eligible assets” in Rule 3a-7 limits the ability to execute certain lease securitizations. This definition covers only financial assets that “by their terms convert into cash within a finite time period.” Virtually all auto leases, and a significant portion of equipment leases, permit the lessee to return the vehicle or leased equipment upon lease termination in lieu of purchasing that property. The residual value of the auto or equipment that is realized upon liquidation of the returned auto or equipment is an important part of the securitization value of the leasing arrangement. This residual value, however, does not currently fall within the definition of “eligible asset,” because such residual value is not itself a financial asset that “convert[s] into cash within a finite time period.”

Legislative History

The legislative history also supports the view that the differences between the definitions of Exchange Act ABS and '40 Act definition, on the one hand, and the Regulation AB definition, on the other hand, are not accidental. The final House Bill (H.R. 4173) (Dodd Frank) originally proposed using the Regulation AB definition, which would have without a doubt included such lease-backed ABS within the scope of an “asset-backed security” and definitively established a bright line test of greater (or less) than 50% of residual value⁹. The Senate however rejected the proposed definition of “asset-backed security” used in the final House Bill in favor of the alternative definition of Exchange Act ABS, which notably does not include any language that would expressly expand its meaning to include lease-backed ABS to the extent dependent on the sale (or other disposition) of the leased asset for repayment. Therefore, on the basis of the previously understood meanings of the pre-2005 definition, the Regulation AB definition and the '40 Act definition, together with the SEC's statements regarding the characteristics of an asset-backed security in those contexts, we believe that the drafters of the CRR Rules deliberately excluded lease-backed ABS which does not self-liquidate from the definition of Exchange Act ABS.

⁹ We note that the overwhelming majority of recent Structured Aircraft Portfolio Transactions would also fall outside of the scope of the Regulation AB definition for this reason.

Application of Definition to Structured Aircraft Portfolio Transaction

Are Assets in a Structured Aircraft Portfolio Transaction Self-Liquidating Financial Assets?

On the plain meaning of the words, an aircraft is not a financial asset, and there is no guidance or interpretation from the SEC to indicate that aircraft or similar physical assets are financial assets. Accordingly, the presence of the aircraft leases alone would presumably need to satisfy a principal requirement of Exchange Act ABS that the “assets” consist of self-liquidating financial assets “that allow[s] the holder of the security to receive payments that depend primarily on cash flow from the asset”. We do not believe this to be the case.

Neither Section 15G of the Exchange Act nor the associated CRR Rules define all of the terms used in the definition of “asset-backed security”, including “self-liquidating” and “primarily”.

However, the term “self-liquidating” has been defined by the courts for nearly a century:

“The mechanism is called a self-liquidating loan because when the banks purchase the notes, they also purchase the right to receive interest payments before the notes mature. Thus, the money expended to buy a note will be repaid by the interim interest payments and the final principal payment.” *United States v. Esogbue*, 1996 U.S. App. LEXIS 45265, No. 94-20615 (5th Cir. Feb. 12, 1996).

“A self-liquidating project may be defined as one wherein the revenues received are sufficient to pay the bonded debt and interest charges over a period of time.” *Kelley v. Earle*, 325 Pa. 337, 345 (Pa. 1937).

Further, although the SEC has not separately defined “self-liquidating”, it has used the phrase to describe an asset that “converts into cash payments within a finite time period.”¹⁰

Based on the foregoing, the generally accepted legal meaning of “self-liquidating” refers to an asset that will independently generate income sufficient to pay back its original cost. The presence of any meaningful dependence on additional cash flows that are contingent on the success of future business activities (such as the level of active management required for a Structured Aircraft Portfolio Transaction, as described above) is inconsistent with that meaning of “self-liquidating”, and therefore we do not believe that the leases backing a typical Structured Aircraft Portfolio Transaction are “self-liquidating”. In addition to the cash flows from the initial aircraft leases being insufficient to repay the original cost of the aircraft (and initial leases) in a typical Structured Aircraft Portfolio Transaction, an aircraft operating lease does not “convert into cash” because upon the expiry of a typical lease, the aircraft is expected to be returned to the Issuer.

Does Repayment Depend Primarily on Cash Flow from Self-Liquidating Financial Assets?

The securities in a typical Structured Aircraft Portfolio Transaction bear greater similarity to corporate bonds issued by an operating company and secured by all of its assets (or a selected portfolio of its equipment and related assets) than they bear to securities backed by a defined pool of financial assets. In the case of a typical Structured Aircraft Portfolio Transaction, like any secured corporate bond, repayment of the Issuer’s debt depends on management’s ability to generate sufficient operating income through the successful operation of its business as discussed above.

¹⁰ “[T]he basic definition [of asset backed security] is sufficiently broad to encompass any self-liquidating asset which by its terms converts into cash payments within a finite time period.” *Id* at 5.

As described above, the ability of the securitized “financial assets” to generate sufficient cash to service the securities is the defining characteristic of ABS. However, in a typical Structured Aircraft Portfolio Transaction, the cash flows from the initial leases are not only insufficient to repay the original acquisition cost of the aircraft (and initial leases) but are also significantly less than the amount required to repay the Issuer’s securities.

In addition to having the financial resources necessary to incur significant out-of-pocket expenses in connection with redelivery, refurbishing and repositioning any aircraft for a new lease or sale, successfully remarketing an aircraft also requires marketing, maintenance, and other aircraft management expertise. The costs and resources involved in managing the leasing, re-marketing and maintenance of an aircraft, whether on- or off-lease, are inconsistent with a principal requirement of Exchange Act ABS that repayment of the securities must rely *primarily* on cash flows generated from a pool of *self-liquidating* financial assets.

This remains true even if aircraft operating leases were considered separately from the value of the physical aircraft and could be independently characterized as “self-liquidating financial assets”. It would still be inaccurate to describe repayment of the securities in a typical Structured Aircraft Portfolio Transaction as depending *primarily* on the cash flows from the initial leases. Rather, ultimate repayment of the securities depends on the servicer’s ability to re-lease and ultimately dispose of the aircraft.

Conclusion

For the reasons discussed above, we believe that, if properly interpreted and applied, the definition of Exchange Act ABS would not include a typical Structured Aircraft Portfolio Transaction. The “assets” in a Structured Aircraft Portfolio Transaction should not be considered *self-liquidating* financial assets and, although the SEC and other relevant federal agencies have yet to interpret the definition of Exchange Act ABS, the principles discussed by the SEC in the context of the pre-2005 ABS definition, the Regulation AB definition and the ’40 Act definition should equally apply to an analysis of the securities in a Structured Aircraft Portfolio Transaction with the result that a typical Structured Aircraft Portfolio Transaction would not be subject to the CRR Rules.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Mark N. Lessard ([bio](#))

New York

+1.212.858.1564

mark.lessard@pillsburylaw.com

Jonathan C. Goldstein ([bio](#))

New York

+1.212.858.1888

jonathan.goldstein@pillsburylaw.com

Vanessa C. Gage ([bio](#))

San Francisco

+1.415.983.1040

vanessa.gage@pillsburylaw.com

About Pillsbury Winthrop Shaw Pittman LLP

Pillsbury Winthrop Shaw Pittman LLP is a leading international law firm with offices around the world and a particular focus on the energy & natural resources, financial services, real estate & construction, and technology sectors. Recognized by *Financial Times* as one of the most innovative law firms, Pillsbury and its lawyers are highly regarded for their forward-thinking approach, their enthusiasm for collaborating across disciplines and their unsurpassed commercial awareness. For more information, visit pillsburylaw.com.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2016 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.