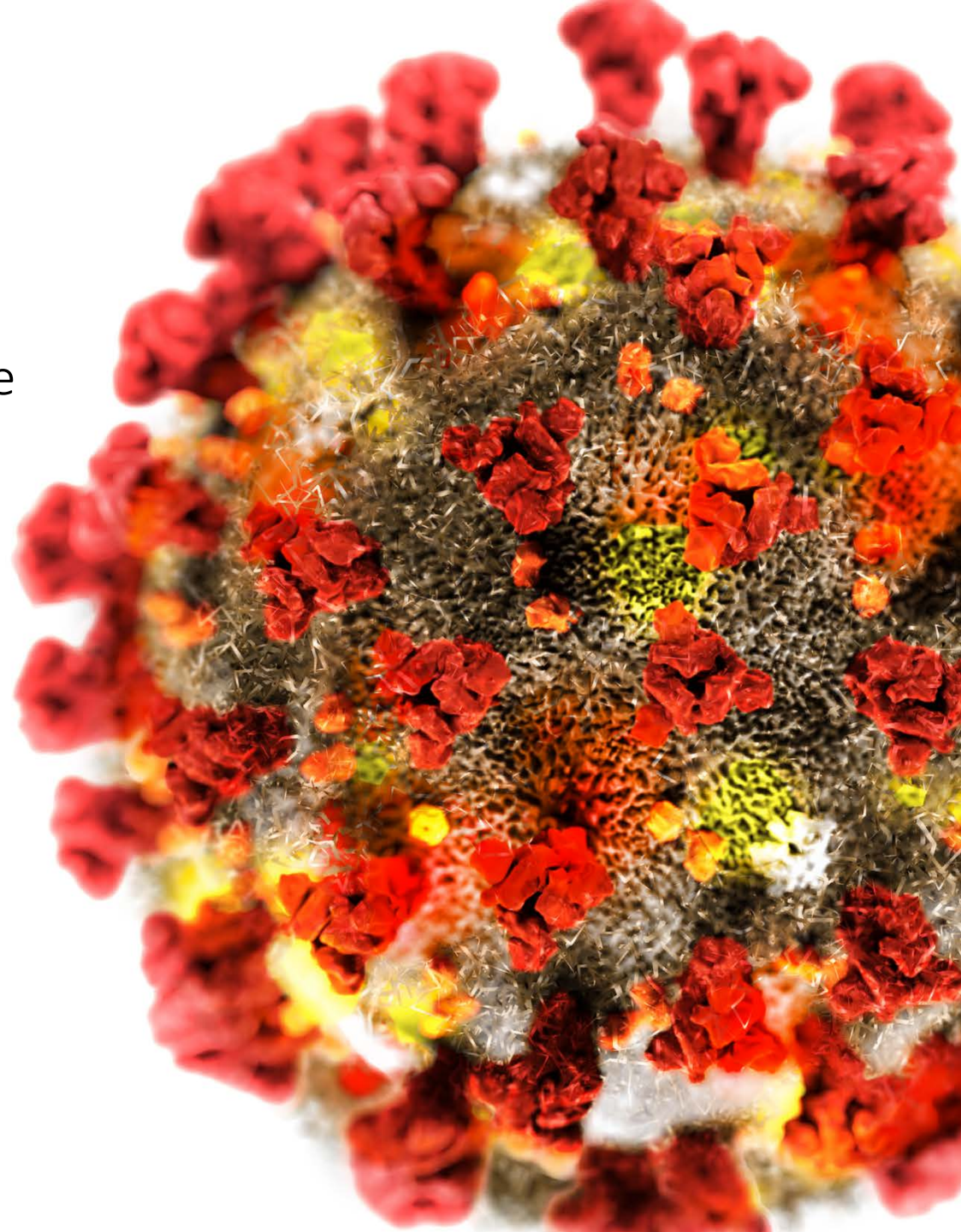


Real Assets Roundup

Assessing Default and Enforcement Dynamics in the Real Estate, Project and *Aviation* Debt Markets

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pillsbury





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Agenda

- Current Market Dynamics
- Lessor Secured Financings
 - Overview of Transaction Structures
 - Base Case: Back-Leveraged Operating Lease (Single Aircraft)
 - Workout Scenarios
 - Portfolio/Warehouse Considerations
 - Capital Markets Considerations (ABS)
- Airline Secured Financings
 - Overview of Transaction Structures
 - Base Case: Mortgage Term Loan
 - Workout Scenarios
 - Capital Markets Considerations (EETCs)
- Bankruptcy Considerations (Chapter 11)

Current Market Dynamics

- Compared to prior recessions/down cycles this is uncharted territory with mass groundings and demand shock casting doubts on long term valuations and lease rates
 - Prior down turns have been followed by fairly rapid and consistent recoveries
 - With many people not earning, a return to travel may be a lower priority
 - Business travel budgets may be reduced with increased viability of alternatives
 - Travelling public may remain wary of travelling for some time
- Ten major US airlines have reached a deal with US Treasury for payroll support program (USD \$25B covering period through October)
 - 30% of advances for majors repayable over 10 years at low interest rate
 - Remainder forgivable if employees remain on board
 - Warrants equal to 10% of advanced amounts
- Lessors are also making a massive push for liquidity where available
- Many banks' cost of funds is exceeding base rates, new deals generally on hold until more certainty as to credit and asset risks (relationship lending only)

Current Market Dynamics – Lessors

- Looking to ride out temporary market dislocation, avoid cash crunch
 - Lessors drawing on existing facilities and pledging unencumbered assets
 - Portfolio deals likely to have at least some collections, providing more options
 - Discussions with lenders, but no general template for deferrals or forbearance
 - LTV resets coming down the pike
- Capital Markets
 - ABS vehicles preserving liquidity; cushion exists with reserves and liquidity facilities
 - Rent deferral dynamic blunted, but not eliminated, by portfolio effects
 - Secondary markets update
- Managed Assets / Funds
 - Existing funds with dry powder open to opportunistic acquisitions at right moment
 - Maybe funded with cash; investors watching closely, with caution
 - Others will demur; expect slowdown in new fund launches for time being

Current Market Dynamics – Airlines

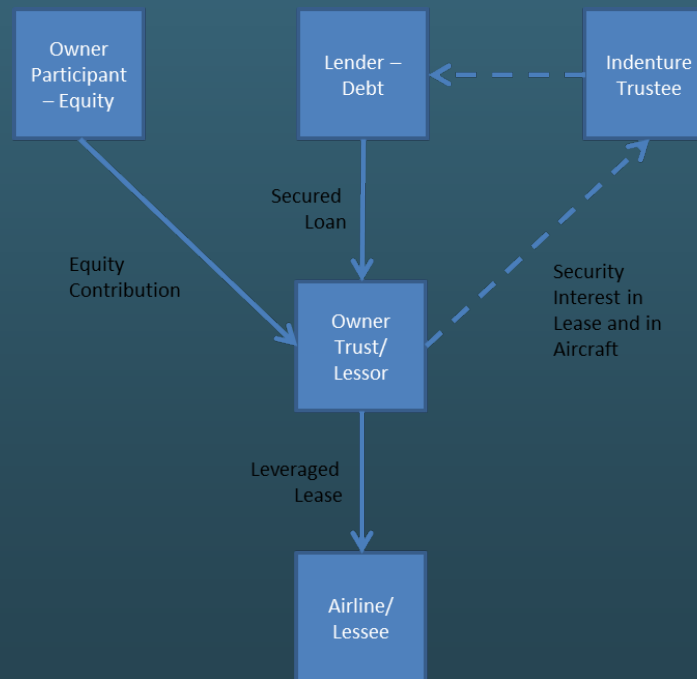
- Airlines looking to cut expenses and raise liquidity
- Secured loans may be available—at a price, with the right assets.
- Existing EETC transactions seeking B tranches subject to investor appetite. One B tranche closed, others awaiting market conditions.
- Operating Leases
 - Sale-and-leaseback opportunities may exist for investors.
 - Lease payment restructurings ongoing globally.
 - Deferral of part of basic rent, repaid with or without interest in 2021.
 - Deferral of maintenance rent for aircraft being operated on cargo routes

Lessor Secured Financings

- Secured Loans
 - Term loans (banks / private placements)
 - Warehouse facilities
- Capital Markets
 - ABS / Structured Portfolio Issuance
- Managed Assets
 - Funds / Sidecars

Base Case: Back-Leveraged Operating Lease

- Aircraft is typically owned by a special purpose company borrower
- Loan is secured by the aircraft and shares in the SPC owner; lease and related cash flows, aircraft warranties and insurance are assigned to secured party



Recourse vs. Non-Recourse

	Non-recourse	Partial recourse	Full recourse
Guaranty	Loan is secured by aircraft and related lease cash flows; no guaranty or other recourse	Guarantee of certain representations, covenants and indemnities <u>other than</u> payment of principal and interest	All loan obligations guaranteed by recourse against the guarantor
Covenants	Loan to Value; Prepayment upon Lease Default (subject to some remarketing period where P&I are paid)	Loan to Value; Prepayment upon Lease Default (subject to some remarketing period where P&I are paid)	More flexibility depending on creditworthiness of guarantor
Cash Collateral	Obligations to maintain full collateralization of expenses and transaction obligations	Some flexibility to release reserves and deposits, subject to turnover events and downstream refund obligations	More flexibility to release reserves and deposits, subject to turnover events and downstream refund obligations; possible co-mingling of cash flows
Lease Amendments	Lender consent to reduce rent	Lender consent to reduce rent	Typically lender consent to reduce rent in single aircraft transactions, more flexibility in portfolio transactions

Considerations Following Lease Default, 1 of 2

- Are all filings and registrations up to date?
- Is there a cross-default to another lease? Other indebtedness?
- What are the remarketing period triggers?
- When is the next loan payment date?
- What are the borrower's cure rights? Any limits?
- Are there any turnover events and what are the triggers?
- Do the lenders have the right to force a lease termination or otherwise step into the lessor/borrower's shoes?
- What are the borrower's ongoing notice obligations?
- What are the lenders' inspection rights?
- Is lender consent required for lease amendments/rent reductions?
- What are the conditions for applying deposits and/or drawing letters of credit?

Considerations Following Lease Default, 2 of 2

- What is the aircraft and engine type?
- What is the market for the aircraft?
- What is the maintenance condition of the aircraft?
- What is the status of maintenance reserves?

Workout Scenarios

- Base case involves a 6-month remarketing period during which P&I must be paid
- Mandatory prepayment at the end of such period if no successful remarketing
- Borrowers starting to discuss/request potential forbearance or payment deferrals with lenders

	Lender	Borrower
CONTEXT	Faced with what it perceives as a “temporary” – and in this case “systemic” – crisis	Faced with default that puts equity value at risk; guarantors mindful of exposures
GOAL	Improving the likelihood and level of repayment; avoiding costly remedies, especially where no higher or better use is available	Gaining operational “breathing room” that allows it to retain control of the asset until revenue streams resume – and preserving equity
SEEKING	<ul style="list-style-type: none"> • Additional collateral (reserves) or guaranties • Improve lessee financial reporting • Inspection / new appraisals • Collateral maintenance (storage/insurance) • More control over lease negotiations • Fees/expenses and breakage indemnity 	<ul style="list-style-type: none"> • Debt service deferrals • Covenants waivers to avoid further defaults • Obtain use of reserves for debt service and maintenance • Maximize flexibility and optionality to deal with lessee (restructure lease) or terminate lease and remarket aircraft

Portfolio / Warehouse Considerations

- Significantly more flexibility afforded in dealing with individual lessees as a result of cross-collateralization
- But also more covenants and tests:
 - LTV: Tested on a portfolio wide basis; mandatory prepayments; appraised value haircuts for off-lease
 - DSCR: Typically on a 3-mnth trailing basis; results in cash trap/sweep
 - Concentration Limits: Aircraft cannot be re-leased in breach of CLs without lender consent
 - Utilization Test: % of aircraft on lease
 - Maintenance look-forward; typically no turnover obligations
- Hedges are typical in many deals and reduction in cashflows could trigger hedge defaults
 - Hedge exposure may be mitigated by current rate environment
- Servicer termination events in some cases triggered by portfolio performance
- Term Requirements: W.A. age, lease terms, minimum portfolio
- Drawstops on revolvers where lease payment or bankruptcy EOD

Capital Markets Considerations

- Managed vehicles with a board that includes independent and equity directors (often third party equity, sometimes widely held)
 - Fiduciary duties to the company
 - Heavy reliance on servicer, subject to board approval requirements:
 - E.g. new leases; aircraft sales; unbudgeted maintenance; settlement of claims
 - Servicers have general ability to agree lease modifications, subject to “Standard”
 - No LTV Test but DSCR and concentration limits apply
- Rated debt instruments: Timely interest, ultimate principal payment
 - No EOD for failure to pay principal, just interest on senior notes
 - Liquidity facility available for expenses and senior interest

Capital Markets Considerations (Cont'd)

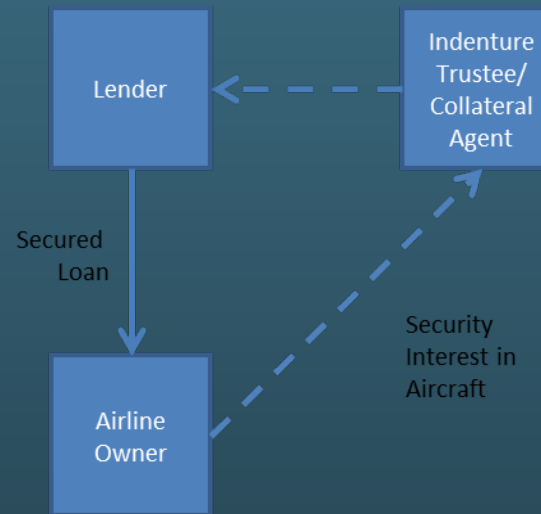
- Foreclosures rarely occur even on defaulted deals
 - Much more efficient for senior noteholders to direct board/servicer to implement a liquidation or monetization plan
 - Parties need to be mindful of junior classes, although senior class is likely the “controlling party”
- Structures intended to be bankruptcy remote, so that is not an option
 - In certain “stranded asset” scenarios, we have successfully petitioned the Delaware Chancery Court for a wind up
- In some cases consent solicitations are required to implement the necessary covenant relief to monetize the assets

Airline Secured Financings

- Secured Loans
 - Mortgage Term Loans (banks / private placements)
 - Revolving Credits
- Pass Through Certificates
- Enhanced Equipment Trust Certificates (EETCs)
- Leveraged Leases / JOLCOs
- Operating Leases

Base Case: Mortgage Term Loan

- Direct secured loan to U.S. carrier, benefits from Section 1110
- May be syndicated (bank or private placement) and pooled with other aircraft



- In other jurisdictions, loans may be made to an SPV with a finance lease to the airline

Enforcing on Aircraft Collateral: Typical EODs

- Some Typical Events of Default:
 - Failure to pay rent/loan amount within X days of due date
 - Failure to pay other amounts within X days of notice
 - Failure to comply with covenants remaining uncured for X days
 - Inaccuracy of representations or warranties
 - Loss of air carrier license
 - Voluntary or involuntary insolvency petitions
 - Failure to insure
 - Loss or invalidity of security
 - Cross-Defaults (other aircraft or indebtedness)

Enforcing on Aircraft Collateral: Remedies

- UCC Remedies:
 - Repossession and remarketing (including self-help without breach of peace)
 - Foreclosure and de-registration
 - Commercial Reasonableness
- Cape Town Convention
 - In the U.S., most Cape Town remedies also covered by existing law
- Lessee/Borrower cooperation is often critical to preserving collateral values and achieving lender objectives

Workout Scenarios

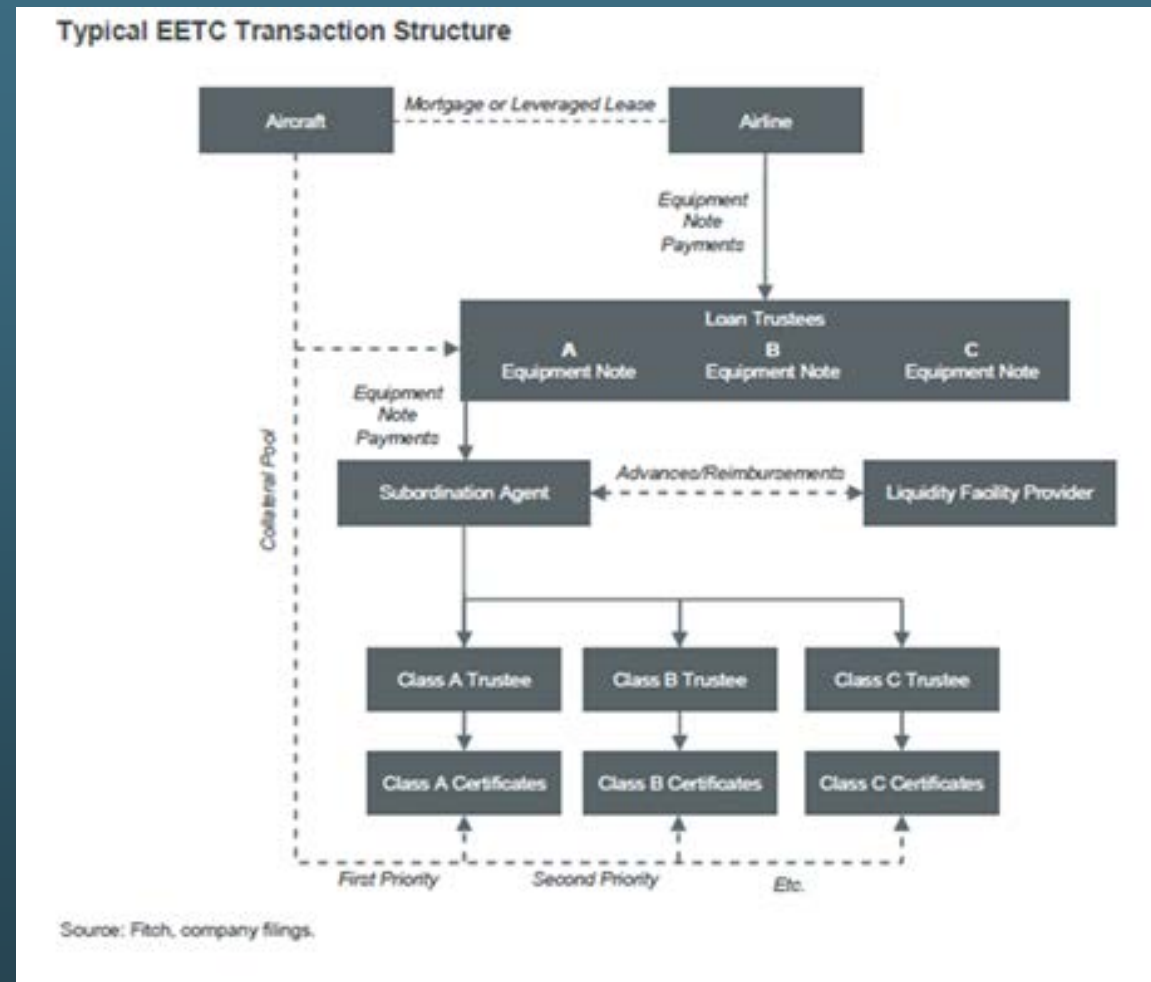
- Airlines are seeking rent holidays from operating lessors and in many cases principal deferrals from lenders (3-6 months)

	Lender	Borrower
CONTEXT	Faced with what it perceives as a “temporary” – and in this case “systemic” – crisis	Faced with default and ultimately bankruptcy
GOAL	Improving the likelihood and level of repayment; avoiding costly remedies, especially where no higher or better use is available	Generating much needed liquidity in a time of severe crisis
SEEKING	<ul style="list-style-type: none"> • Clear and realistic turnaround plan (targets) • Equity injections or government support • MFN clause on participation and concessions • Inspection / new appraisals • Snap-back of obligations following EOD/filing • Fees/expenses and breakage indemnity 	<ul style="list-style-type: none"> • Debt service and lease payment deferrals • Covenants waivers to avoid further defaults • Orderly and fair process to maintain credibility • Avoid one-offs and tailored deals • Rapid execution

EETCs – Legal Structure

- Pooling of cash flows: typically airline issues one or more series of Equipment Notes, including subordinated series (e.g. Series AA, A, B, C)
- Equipment Notes issued under indenture for each aircraft, secured by that aircraft with cross-collateralization / cross-default to all aircraft in the deal
- Class [AA] Trust purchases the related Series [AA] Notes and issues Class [AA] Certificates to Investors, and so on
- Certificates are rated and traded as U.S. Public SEC Registered or Private Placement (144A or 4(2)) transactions
- EETC Paper is traded on Secondary Markets
- Liquidity Facility supports up to 18 months interest following default
- Pre-Funding structures available for future delivery streams (negative carry)

EETCs – Legal Structure



EETCs – Credit Enhancements

- EETC structure designed specifically to survive airline bankruptcies (Bankruptcy does not, itself, trigger non-payment)
- Credit Enhancements:
 - S. 1110/Alternative A Protection
 - Liquidity Facility
 - Cross-Subordination
 - Cross-Collateralization
 - Cross Default
- Over 99.9% by original par value of EETC Senior Tranches issued since 1995 have received full repayment

EETC Default Scenario

- Payment EOD unlikely outside Chapter 11
 - Missed payment on the EETC would trigger cross-defaults under the airline's other corporate facilities; airline will want to control timing of insolvency.
- Bankruptcy event is only a triggering event if there is a missed payment on the certificates
 - Structure intact if airline makes Section 1110(a) election and cures
- In case of missed payments on more than 35% of notes (which are cross-defaulted in any case), liquidity facility is fully drawn
 - Senior bondholders control exercise of remedies

Chapter 11 – Basic Bankruptcy Considerations

- Automatic Stay: Creditor “stayed” from remedies
- Adequate Protection: Creditor will encounter difficulty lifting stay on remedies unless there is a risk of harm to the value of collateral
- Section 1110: Mandates the expiration of the automatic stay for aircraft, engines and parts after 60 days, no matter what, subject to
 - 1110(a): Airline may elect to perform pre-petition contract
 - NB, not an “assumption”
 - 1110(b): Airline and creditor may consensually restructure terms
 - NB often will be done on a temporary basis coupled with a term sheet to permanent restructuring
 - 1110(c): Creditor takes back the aircraft, airline must “surrender and return”
 - Come and get it; value of aircraft may be less than debt burden
- Section 1110 is not all-powerful
 - Only applies to secured loans and leases of aircraft, engines and parts, e.g., does not apply to ramp equipment, gates, slots and other types of collateral
 - Only applies where borrower or lessee is a US “certificated air carrier”
 - Special problems arise if section 1110 and non section 1110 property are in the same collateral pool

Chapter 11 – Workout Scenarios – The Players

- The airline
- Creditors committee
- Lessor/equity holder in aircraft
- Lender(s) to lessor
- Lender(s) to airline
- Liquidity facility provider (EETCs)
- Servicer (ABS and similar transactions)
- Indenture trustees and collateral agents

What Happens Next?

- Section 1110 issues take the stage early
- Intense but not necessarily final negotiations
- Fleet rationalization
- Potential competition among lessors/lenders to keep their aircraft in service
- Often during the “1110” period only preliminary deals are struck

Who Gets to Decide – Debt/Equity issues

- Old leveraged lease structure – debtholders controlled
- ABS and operating lease structures less black and white
- Equity may have cure rights and squeeze protection as long as debt service is current

Debt/Equity Issues

- Forbearance/Standstill Agreement
 - Trustee/servicer under lender instruction agrees not to foreclose in exchange for some form of consideration; IT, OT, OP and holders should be parties
 - Consideration may be cure, fee, pre-payment, agreement to keep debt whole, reimbursement of fees/expenses,
 - Principal and interest pay-down must flow through the Trustee and the waterfall
- Control over Collateral; Application of Payments
 - IT must retain lien over collateral until obligations fully paid
 - Equity may obtain additional control over restructuring
 - Trustee needs clarity on application of payments (waterfall)
- Do 1110(b) payments go to pre-pay debt or to equity?
 - Waterfall amendment can require unanimous holder consent
 - Generally should be post-default waterfall since equity is not the debtor

Debt/Equity Issues – Equity Buy Out

- Equity Pay-Off
 - Equity right to redeem until foreclosure
 - Notice to debtholders and/or make-whole premium may be required
 - Indenture terminates automatically when proceeds paid out
- Equity Buy-Out
 - Owner participant purchases notes for a price equal to the outstanding secured obligations
 - Typically private deals only; requires holder participation
 - Formalities may be truncated;
 - Indenture stays alive unless specifically terminated
- Re-Financing
 - Amortization schedule must be fixed to automate payments
 - Collateral account if airline still in bankruptcy

Debt/Equity Issues - Foreclosure

- Commercially reasonable disposition
 - IT prefers not to exercise discretion, but remains the secured party
 - Equity need not sue to enjoin disposition; statute of limitations allows suit for damages years later
 - Once collateral sold and proceeds distributed, IT can only rely on holder indemnity (which entails trustee risk)
 - Equity can request accounting from IT after disposition
 - Evaluate relationship between debt balance and probable value.
- Credit Bidding
 - Indenture may allow credit bids either by the holders individually or by IT on behalf of the holders
 - Individual holder credit bids at auction can raise liquidity issues (cash required for portion of purchase price)

Debt/Equity Issues – Post - Foreclosure

- Holder Takes Beneficial Title; Indenture Terminated
 - Trustee can designate holder-owned grantor trust to take title to the aircraft and the assignment of related documents
 - Notes are delivered, final fees paid, claims transferred, final distribution made, liens released, indenture terminated
 - Trustee must retain any right to indemnity for itself or liability insurance proceeds
 - Rights in collateral go directly from equity to new owner trust; Indenture Trustee releases lien but does not transfer
- Trustee Takes Beneficial Title; Indenture Remains
 - Trustee can be sole owner participant on behalf of holders
 - Holders are still beneficial owners for tax purposes
 - There should be no income tax withholding so long as grantor trust status is maintained (i.e. liquidating trust)
- Consider tax issues with respect to foreign holders, i.e. possible loss of portfolio interest exemption from withholding

Questions



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