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The ABCs of PDPs: Advance Rates, Bankruptcy Risks and Collateral Management

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This article examines various legal aspects of negotiating, documenting, and closing an aircraft pre-delivery payment facility, addresses the dynamics between the manufacturer and lender in a default scenario and focuses on issues of import to the borrower in the management of its aircraft order during the life of the facility.

Since early 2004, the number and size of civil aircraft pre-delivery payment ("PDP") financings have increased dramatically. Airlines view them as a way to enhance liquidity during the aircraft production cycle. Bankers view them as a way to get short-term exposure to aviation assets and deepen relationships. Manufacturers view them as a way to facilitate sales. With significant appreciation in aircraft values and improvements in customer credit during this period, these transactions made increasing commercial sense.

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In the last 18 months, however, manufacturers have been taking new approaches to limit their risk in light of this proliferation. This article examines various legal aspects of negotiating, documenting and closing a PDP facility in this new setting. It begins with some brief background then summarizes the principal issues arising from the complex, tri-partite negotiations between the borrower, the lender and the manufacturer.

The first section, entitled "Advance Rates," looks at the core issues that a lender should focus on in attempting to contain its exposure. The second section, entitled "Bankruptcy Risks," addresses the dynamics between the manufacturer and lender in a default scenario. The last section, entitled "Collateral Management," focuses on issues of import to the borrower in the management of its aircraft order during the life of the facility.

BACKGROUND

A PDP financing involves the establishment of a credit facility in favor of an aircraft purchaser to finance a portion of the significant progress payments due on an aircraft order. These progress payments can run into the hundreds of millions of dollars for large orders and are especially significant for Airbus and Boeing aircraft. Often, the facility involves an initial draw to reimburse the borrower for a portion of the PDPs it has previously deposited with the manufacturer. Further PDPs are then partially funded by the lender directly to the manufacturer on each PDP due date, with the aircraft purchaser making up any shortfall. The loans for an aircraft typically mature on the delivery date for that aircraft.

The lender is secured by a first priority lien on portions of the aircraft purchase agreement and has the right to step in and purchase the relevant aircraft if the borrower defaults. In cases where there is a separate engine purchase agreement, it must be assigned as well. PDP loans relating to several aircraft are cross-collateralized so that the lender need only purchase as much equipment as is necessary to cover the debt secured by that facility. For legal purposes, this is a collateral assignment of contract rights to purchase the aircraft, as opposed to a security interest in the aircraft itself. This is because the borrower does not own the aircraft, or even its constituent parts — the manufacturer does. One can also imagine the difficulties involved in attempting to identify, trace and encumber the various aircraft parts during the production cycle and the unacceptable restraints on the manufacturer's operations that would entail.

As a result, perfection of the lien in the United States is achieved by filing a UCC-1 financing statement in the appropriate jurisdiction; no FAA or Cape Town filings are required since these special notice systems relate to aircraft or aircraft objects only. It is not easy in any jurisdiction to determine with certainty how enforcement will take place, but it is always important for a lender to seek advice from local counsel in the borrower's jurisdiction. Parties who set up a special purpose borrower in a friendly enforcement jurisdiction to hold the purchase agreement rights should be wary of consolidation issues and taxable gains on the transfer of the purchase agreement.

The borrower, the lender and the manufacturer enter into a consent and agreement, pursuant to which the assigned purchase agreement terms and the rights of the parties are defined. Confidentiality, control over delivery slots and aircraft pricing are the key drivers for the manufacturer, which typically requires the right to buy-out the lender in a default scenario and imposes certain limitations on transfer of the asset. Negotiating this key document with manufacturers can be trying if the customer and lender have limited leverage against the manufacturer. But market standards are emerging.

"A" STANDS FOR "ADVANCE RATES"

In a PDP facility, the lender's exposure is determined not only by the rate of its advances against the PDPs, but by the purchase price the lender ultimately would need to pay for possession of the aircraft (i.e., the loan-to-cost ratio). The exact purchase price for the customer is highly confidential and will usually not be disclosed to the lender. Instead, manufacturers typically offer a discount to the list price that makes it economically sensible for the lender to participate. But even with an agreed discount, lenders should bear in mind a number of factors that can influence the loan-to-cost ratio, including the following:

- *Escalation*: Have the escalation factors been locked down? If so, are they assignable? If not, what are the variables? Does the agreed discount apply before or after escalation? Does escalation apply during an excusable delay in delivery of the aircraft?
- *Equity and Set-Off*: How much equity does the borrower have in the form of paid-in PDPs? Has the manufacturer agreed not to set-off any unrelated borrower obligations against the paid-in equity? Has the borrower agreed that all PDP reimbursements will go directly to the lender? Upon delivery of one aircraft, is the borrower equity released or re-allocated to other aircraft?
- *Purchase Option*: What time period does the manufacturer have to exercise its right to buy-out the lender? When does that period commence? What amounts, if any, are excluded from the buy-out price? Are there any caps on interest?
- *Cherry-Picking*: Can the lender assume the right to purchase less than all of the relevant aircraft? Can the manufacturer exercise its buy-out right with respect to less than all of the aircraft?
- *Standstill Period*: How much notice must the manufacturer give to the lender before terminating the purchase agreement as it relates to the aircraft? Is the manufacturer required to enter into a substitute purchase agreement?
- *Aircraft Options and Configuration*: What is the maximum amount by which the lender's purchase price can be increased without its consent? Can the borrower exceed that limit and fund the difference to the manufacturer or to the lender as a prepayment of the loan? Does the same standard apply for FAA-mandated or other regulatory changes?
- *Warranties and Product Support*: Is the standard warranty and support package available to the lender and their potential transferees? Are the engine warranties available through the airframe manufacturer or does the lender need an assignment from the engine manufacturer? Is the manufacturer offering performance guaranties or remarketing assistance?

Just as each lender has its own pre-occupations, each deal has its own characteristics and it sometimes takes a while for the parties to achieve the right commercial balance. Escalation caps and performance guaranties, if they exist in the first instance, are contract features that are usually treated — like the purchase price itself — as highly confidential. As a result, these should be negotiated up front along with the purchase price discount. The manufacturer waiver of its right to set-off any PDPs against unrelated customer obligations is both standard and essential for the protection of the lender, as is the cap on modifications resulting in a purchase price increase. The exact wording and mechanics surrounding the purchase option, cherry-picking and standstill period are heavily negotiated in a typical PDP financing.

"B" STANDS FOR "BANKRUPTCY RISKS"

The most likely enforcement scenario for a PDP lender involves an airline bankruptcy, and there has been no shortage of those since the early 1990s. Yet a recent search of the Westlaw and Lexis-Nexis databases revealed no reported U.S. cases dealing with an adversarial enforcement by a PDP lender. This can partially be explained by the fact that PDP financings were out of fashion with U.S. airlines for a large part of the 1990s, but also by the fact that manufacturers typically prefer to restructure their purchase arrangements on a consensual basis (the manufacturer's option to take out the lender can be helpful in this regard). In addition, assumption by a lender of the purchase contract carries significant risks, including foreclosure risk and remarketing risk, and requires large outlays for the purchase price balance and reconfiguration. But it is certainly possible the day will come when a bankruptcy court faces the competing claims of the parties to a PDP financing.

Automatic Stay and Adequate Protection

In order to understand the risks to the parties in a U.S. bankruptcy scenario, one should go back to the basics. The purchase contract, which has been partially assigned as security, forms part of the debtor's estate in a Chapter 11 case. This includes any rights of the airline to obtain reimbursement of PDPs under the purchase contract, which rights have also been pledged. Upon filing by an airline of a petition under Chapter 11, the lender will be stayed from foreclosing on, or stepping into, the purchase agreement. In addition, the manufacturer will be stayed from terminating the purchase agreement itself. Section 1110 of the Bankruptcy Code, which mandates the expiration of the automatic stay for aircraft after 60 days, does not apply to general intangibles such as the purchase agreement rights.

The PDP lender will be treated like any other secured creditor in bankruptcy. To the extent that the airline has equity in the purchase contract *(i.e.*, the combined value of the aircraft and the paid-in PDPs exceeds the debt), or that the aircraft at issue will form core assets of the restructured entity, a lender will likely encounter difficulty lifting the stay on remedies unless there is a risk of harm to the value of the collateral. U.S. bankruptcy law allows a secured creditor to ask the court for adequate protection against diminution in value or other harm in the value of the property during the bankruptcy case. If the debtor fails to provide court-ordered adequate protection, the court can terminate the automatic stay, thereby permitting the secured creditor to repossess the collateral.

The principal scenario where the collateral could face diminution in value is where the manufacturer is suffering or will imminently suffer damages from the non-performance of the airline under the purchase agreement (*e.g.*, significant overdue PDPs, failure to take delivery). This is because the lender, as assignee of purchase agreement, must make the manufacturer whole to take the aircraft; thus the lender's purchase price increases with each claim for damages by the manufacturer under the purchase agreement. In this situation, the manufacturer may petition to lift the stay and terminate the purchase agreement so that it can proceed to mitigate its losses. The lender may also petition to lift the stay on remedies so that it can foreclose and prevent the accretion of damages. If manufacturer damages truly are imminent (as in the case of an aircraft on the tarmac), it is possible that a judge would require the airline either to assume or reject the purchase agreement. It should be noted that bankruptcy courts, as courts of equity, could allow a debtor to perform on an aircraft-by-aircraft basis as they come up for delivery, even though the purchase contract and PDP facility covers several aircraft. If the airline assumes the purchase agreement as it relates to an aircraft, cures any defaults and continues to perform, then the risk of immediate harm to the manufacturer would abate and the automatic stay would remain in place. If the airline's assumption of the purchase agreement was not accompanied by an assumption of the related PDP loans, a lender would still need to petition the court for the stay to be lifted or for the repayment of the related PDP loans at delivery.

Rejection of the Purchase Contract and Enforcement Dynamics

When an airline rejects the purchase contract as it relates to an aircraft, either the manufacturer will move to terminate or the lender will move to exercise remedies. In the first case, the lender will have the agreed upon standstill period to determine whether to assume the contract as it relates to the affected aircraft. In both cases, the lender's exercise of remedies will trigger the manufacturer's buy-out option.

If the manufacturer exercises the buy-out option, it will be free to remarket the aircraft to a third party and claim damages, including incidental costs and any shortfall between the contract price and the price achieved in the market (subject to any legal duties to mitigate such damages). The PDPs held on account of such aircraft can be applied by the manufacturer against any such damages. It appears unlikely that a manufacturer would be entitled to retain PDPs in excess of its actual damages, either as liquidated damages or otherwise, although that would need to be determined on a case-by-case basis. The lender would release its lien upon receipt of the buy-out amount and retain an unsecured claim against the borrower for any shortfall between the amount received and the outstanding secured obligations relating to such aircraft.

If the manufacturer does not exercise the buy-out option, then the lender will become bound to purchase the aircraft (to the extent it has so elected). Assuming the airline's right to receive PDP refunds is properly pledged to the lender and that the manufacturer has agreed not to set-off such PDPs against unrelated obligations, the lender should get credit for all PDPs previously paid to the manufacturer on account of such aircraft. However, until foreclosure occurs and the interest of the airline in the purchase contract is extinguished, the airline can theoretically make a claim for the return of its paid-in PDPs. Initially, the lender and the manufacturer would have competing claims to those funds, but the manufacturer's claim would become moot if the lender agrees to perform under the purchase agreement. Clearly, the lender will seek to enforce its lien on those reimbursement rights and will argue with vigor that the rejection of the purchase agreement constituted abandonment of its right to claim reimbursement of the PDP equity. After all, the lender is still bound to conduct commercially reasonable foreclosure proceedings and to account to the airline as regards the proceeds of the collateral. However, this is untested ground and there are no guarantees that the bankruptcy court will rule in favor of the lender, especially if the court finds the lender to be over-secured (though it may seem abhorrent for a lender to be over-secured when it faces enforcement expenditures that dwarf the size of the loans). Manufacturers are increasingly seeking to make sure they do not get caught holding the bag if, after giving the lender credit for PDPs, the bankruptcy court requires the manufacturer to disgorge them to the airline.

This so-called "claw-back" risk has become a sticky issue for many lenders, who do not view bankruptcy litigation as part of their collateral package. One should hope that lenders and manufacturers will realize that their interests are aligned in ensuring that all PDPs be applied to the purchase price and agree in the documentation to take all reasonable steps to make it so.

Foreclosure and Remarketing

The Uniform Commercial Code prohibits a borrower from agreeing to a strict foreclosure prior to the occurrence of a default. Therefore, an "assumption" by the lender of the purchase contract after an event of default pursuant to pre-negotiated agreements would technically remain subject to the airline's equity of redemption until such time as a foreclosure is properly conducted. This generally entails a commercially reasonable sale of the collateral. Given the nature of the collateral (a contractual right to purchase an aircraft), commercial reasonableness could require a targeted remarketing effort as opposed to a public sale, though in both cases the lender would be entitled to bid in its debt. Alternatively, the lender may seek a consensual foreclosure.

If no foreclosure is completed on the purchase agreement, the lender may still as mortgagee-in-possession take delivery of the aircraft by putting up the purchase price. At that point the collateral will include the aircraft and the secured obligations will increase with the lender's expenditures. However, the airline's equity of redemption would remain intact. Foreclosure would be effective upon completion of the sale of the aircraft, at which point the proceeds would flow through the waterfall in the credit agreement and go to reimburse the lender for all enforcement expenses (including remarketing commissions) and all principal, default interest and other fees and amounts due under the document. The remainder, if any, would go the borrower.

If a foreclosure on the purchase agreement has properly been conducted, the proceeds of the foreclosure sale would similarly flow through the waterfall. However, the purchaser (which could be the lender so long as the sale was commercially reasonable) would take the purchase agreement rights free and clear of the borrower's interest. The owner of the purchase agreement would then be free to sell on the purchase agreement (subject to transfer limitations) or to take delivery of the aircraft by putting up the purchase price. In each case, any upside or downside would be for the account of the purchaser.

"C" STANDS FOR "COLLATERAL MANAGEMENT"

The tenure of PDP facilities rarely exceeds two or three years, though the average has been increasing in tandem with manufacturer backlogs. From the time PDPs are advanced until the delivery date of the aircraft, the airline and the manufacturer must work closely together to manage the manufacturing process and prepare for the incorporation of the aircraft into the airline's fleet. In addition, the airline must arrange or finalize long-term financing for the aircraft. All of this requires significant flexibility for the airline in the management of its purchase agreement.

Amendments and Options

The crucial element for the manufacturer is that it have "one master" at all times. If there has been no event of default, the guiding principle is that the lender should not interfere with operational aspects. It is quite common for an airline to make changes to the aircraft being delivered under the purchase agreement prior to delivery. Whether it is by amendment, waiver or election, the airline and manufacturer must finalize the aircraft configuration and options, address regulatory changes and performance standards and coordinate the installation of buyer-furnished equipment. Airlines need the flexibility to adapt the aircraft and lenders usually are willing to accept some fluctuation so long as the lender's purchase price is not increased by more than an agreed cap. If for any reason that cap is exceeded as a result of a change, the airline can usually proceed and pay the manufacturer up front or prepay the loans by the amount of the excess (the latter choice makes more economic sense if the amounts are not yet due to the manufacturer). The lender's consent is nevertheless required for major changes that have an impact on the nature or value of the collateral, such as a change in aircraft type, cancellation of a delivery slot or amending the PDP due dates or scheduled aircraft delivery dates.

Buyer-Furnished Equipment

Assigning security in the buyer-furnished equipment ("BFE") purchase agreements can be time consuming and, in some cases, futile. It is generally not practical to get an assignment of all BFE contracts where they require the consent of the BFE manufacturer. In addition, BFE is tailored for the airline that is financing PDPs; the cabin configuration is likely to be altered in the event of a repossession and disposition to a third party. For example, the in-flight entertainment equipment may be incompatible and the seating configuration sub-optimal. On the other hand, a passenger aircraft without seats or galleys is of limited use. Where the BFE involved is core to the operation of the aircraft in revenue service, a lender may wish to obtain a security assignment of those two or three core purchase agreements so that it has the option and benefit of the airline's price. Airlines should take care when negotiating BFE contracts to obtain the right to assign them as security without the BFE manufacturer's consent.

Take-Out Financing and Delivery

An airline entering into a PDP facility should make sure that its ability to secure long-term financing is not hampered by the lien on the purchase agreement. Entry into a conditional sale or other financing commitment during the term of the PDP facility should be a permitted encumbrance, so long as the consummation of such long-term financing transaction remains subject to payment of the amounts under the PDP facility that relate to the relevant aircraft.

Since the timing of the delivery is never etched in stone, the airline should have the option of rolling over the loans from the scheduled delivery date until the actual delivery date. Conversely, if the delivery takes place early the airline may need to pay breakage, unless it has arranged for a shortened interest period. Either way, the manufacturer will be keen to make sure that when the aircraft comes up for delivery, the lender releases its lien on the purchase agreement as it relates to that aircraft whether or not it has received all payments owed under the facility. This can sometimes result in discomfort for lenders who are not accustomed to agreeing to release any liens until they are paid in full. But manufacturers typically will not deliver an aircraft if the PDP lien remains in place because it cannot take the risk of having any remaining obligations toward the lender after the aircraft is delivered to the borrower. Ultimately, it is the airline's responsibility to make sure the lien on the purchase agreement is released prior to delivery. Some airlines have found it practical to repay the PDP loans out of available corporate funds a day or two before the aircraft delivery in order to avoid last minute complications.

CONCLUSION

The principal factors involved in negotiating a PDP credit facility are: containing a lender's exposure, understanding bankruptcy risks and allowing the airline to manage its assets. As deal volumes have increased, parties have focused increased attention on getting the balance right. Airbus and Boeing have recently adjusted their approach to these financings and market standards appear to be emerging. But for so long as the model is untested in bankruptcy, each PDP facility will remain the product of a unique negotiation.