Working out those ABS

Pillsbury partner Mark Lessard and associate Melissa Jones-Prus analyze the resolution of Embarcadero Aircraft Securitization Trust (EAST).

After a fallow post-crisis period, investors in the hunt for yield are once again taking a close look at aviation asset-backed securities (ABS), or similarly structured asset-backed loans. These rated instruments represent non-recourse debt backed by a diversified portfolio of aircraft (or aircraft engines) on operating leases around the world. The ratings are based on projected cash flows that can be generated by the asset servicer in the worldwide aircraft leasing market, as well as the projected residual or disposition values of the assets in the portfolio. These transactions are subjected to modeling stresses by rating agencies and structured with various forms of credit support to smooth payment profiles. While day-to-day lease management and

remarketing is handled by the servicer (typically a leasing company), more fundamental decisions such as assets sales are left up to a board comprised of equity representatives and an independent director.

This article examines one particular legacy transaction - Embarcadero Aircraft Securitization Trust, or "EAST" - and the manner of its novel judicial unwinding after years of underperformance. We open with a brief survey of the evolution in transaction structures over the years and then turn to EAST in order to understand where that particular transaction encountered limits. We will review the EAST board's pioneering efforts to maximize the value of a poorly performing aircraft pool by accelerating the disposition of assets, reducing overhead and ultimately returning cash reserves to bondholders. The article concludes by examining how current vintage transactions are being structured to incorporate some of the lessons learned.

EVOLUTION OF AIRCRAFT PORTFOLIO SECURITIZATIONS

Structures have evolved significantly since the first aircraft portfolio securitizations in the early 1990s. One defining feature of aviation ABS remains their long-dated final maturities, which can extend well beyond 20 years. This is because aircraft have long useful lives during which they can generate revenue to repay debt. However, the transactions are modeled using expected repayment dates that are usually 5-8 years out, based on a soft bullet that corresponds with an anticipated refinancing date. In other words, there is no default if the issuer fails to refinance the portfolio on expected maturity; instead, the transaction goes into full cash sweep mode, which entails sequential pay-down of notes by class and a freeze on all equity distributions. In addition, the notes will accrue additional interest at a step-up rate. These features were put in place to incentivize the issuer to refinance on the expected maturity date. However, repayment on that date is not guaranteed, especially when market conditions change.

Before the more recent spate of activity, analysts distinguished between "pre-9/11" and "post-9/11" transactions. The pre-9/11 issuances (which included EAST) typically had multiple tranches and high initial leverage, with the A classes often split into a first amortizing class and a second-pay security with a soft bullet. Cash reserves made up the primary credit support. Issuers were not permitted to sell more than a small percentage of aircraft in any given year for less than the amount required to repay all debt pertaining the aircraft being sold (such required amount is called the "Note Target Price"). While this can seem a logical investor protection, it significantly limits an issuer's ability to dispose of non-performing assets. Following the post-2001 aviation downturn, junior cash reserves on pre-9/11 deals dried up and junior classes ceased receiving cash flows. The expected refinancing of several transactions never materialized, resulting in a cash sweep and step-up interest on the senior notes of 50 or more basis points. The notes on many of these deals suffered serial downgrades.

The post-9/11 transactions were more simple, often with a single senior tranche that was wrapped by a monoline and rated AAA. Leverage was lower and financial triggers (debt service coverage or loan-to-value ratios) were emphasized. The somewhat slower amortization of the senior classes allowed for free cash flow to the equity prior to the anticipated refinancing date, while step-up coupons after expected maturity were increased. Liquidity facilities were favored as a more efficient form credit support to cover potential interest shortfalls, though cash reserves did not altogether disappear.

The last two years have seen a re-emergence of the asset class with structures similar to the post-9/11 transactions, though subordinated tranches are now common and there is of course no financial guaranty. Increasingly, issuers, underwriters and investors are focused on improving operational flexibility in order to maximize the value of such long-dated assets in a dynamic environment. The story of EAST illustrates why this is the case.

EAST ISSUANCE AND DOWNTURN

EAST was formed in August of 2000 and shortly thereafter issued $792.6 million of Class A-1, A-2, B, C and D asset-backed notes (the "Notes"), using the proceeds to purchase thirty-four aircraft from affiliates of Lehman Brothers Inc. and GATX Financial

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Corporation. EAST's business consisted of the leasing and sale of its aircraft in order to repay the notes and generate returns for owners. The assets were serviced by GATX Financial Corporation until January 2007, at which point the servicing role was assumed by Macquarie Aircraft Leasing.

The EAST transaction went to market approximately one year before the onset of severely trying times. Commercial aviation was drastically impacted by the attacks of September 11, 2001. The subsequent military action in Afghanistan, the war in Iraq and the SARS crisis combined to further adversely impact the industry. With passengers less willing or able to fly, several carriers filed for bankruptcy, while others, including many of EAST's lessees, faced severe financial difficulties. Starting in March 2002, maintenance costs increased dramatically, resulting in a drain on available cash flows to service the Notes. Much of the increase was attributable to major overhaul or repair costs associated with the large number of aircraft that were either returned by, or repossessed from, defaulting lessees. The time between redelivery and re-leasing of aircraft increased significantly, lease rates upon re-leasing declined and extensions of leases were executed at lower rentals.

The Notes suffered a series of downgrades reflecting continued cash flow deterioration as a result of these and other factors, including higher jet fuel costs and the erosion of available cash reserves. Beginning in February 2005, EAST lacked sufficient cash to pay interest on the Class B, Class C or Class D notes in full, or to pay Class A "step-up" interest. The failure of EAST to meet its interest obligations in full on the Class B, Class C or Class D Notes constituted a default with respect to those Notes; however, given the soft amortization provided for under the indenture, the trustee was not entitled to exercise remedies against EAST so long as EAST continued to pay interest on the Class A Notes.

ACCELERATED DISPOSITION AND EXPENSE REDUCTION

The double-whammy of increasing maintenance costs and decreasing lease rates wreaked havoc on EAST's cash flows. In many cases for EAST, it became economically advantageous to sell aircraft at prices well below the Note Target Price because the sales proceeds at the time exceeded the present value of expected future cash flows. As this was largely prohibited under the transaction documents, in July 2008 and September 2010 EAST obtained noteholder approval for successive amendments to the trust indenture. These removed limitations on the number of aircraft sales EAST could conduct in any given year and provided more remarketing flexibility, notably in lowering minimum sales prices for aircraft and eliminating lessee concentration limits (in effect expanding the pool of available lessees). At the same time, EAST struck a new deal with the servicer in order to create new incentives for the accelerated disposition plan.

The amendments also eliminated the requirement for rating agency confirmations (as the Notes had already been downgraded below investment grade) and permitted EAST to reduce expensive hull insurance coverage to levels commensurate with the current value of the assets. The senior cash reserve was also reduced by 40% in light of the accelerated disposition plan, allowing EAST to return additional cash to investors immediately. Finally, EAST was permitted to enter into leases with purchase options and consignment agreements for the sale and parting out of

obsolete equipment. EAST was the first portfolio securitization to implement such a covenant relief package and other moribund securitizations quickly followed suit.

Over a five year period following the enactment of these amendments, EAST systematically disposed of all its aircraft assets. The sale proceeds were applied first to satisfy EAST's operating expenses and then to pay the holders of Class A notes interest and principal, resulting in significant amortization to the Class A Notes. Following the disposition of its aircraft assets, EAST's sole remaining assets consisted of the senior cash reserve ($15,000,000), and a projected expense account ($3,500,000). The indenture amendments called for the cash collateral account to be distributed to the Class A noteholders six months after the date on which the EAST Group no longer owned any aircraft assets and had discharged all of its actual and contingent obligations and liabilities (other than the notes). However, neither the indenture nor the trust agreement provided for the early termination or orderly winding-up of the EAST Group. Even a noteholder release would not have sufficed for definitively discharging all of EAST's liabilities.

Such contingent liabilities extended to indemnification obligations that EAST owed to the board, the transaction trustees and the other service providers, none of whom were willing to release their claims against EAST without certainty that they themselves will not be subject to any third party claims or liabilities. Therefore, absent a full and legally binding discharge of all claims against not only EAST but also against the various service providers having indemnification claims against EAST, EAST's only course of action would have been to remain in existence and continue paying monthly interest and overhead expenses on the senior class until all cash collateral was fully depleted, at which point EAST would not have had any resources remaining to proceed with an orderly wind-up. This would have prolonged EAST's existence to the final maturity date of 2025 and resulted in material unnecessary overhead expenses, depleting the remaining cash reserves and reducing the already impaired returns noteholders could receive on the Notes. In this scenario, the potential creditors of EAST would ultimately find themselves without recourse to any collateral or assets in any case (and without having been formally notified of this fact or given the opportunity to assert any claims through an orderly judicial process).

PETITION AND PLAN OF RESOLUTION:

The board of EAST therefore petitioned the Court of Chancery of the State of Delaware in equity on September 17, 2013 for a resolution and judicial accounting of the outstanding obligations and liabilities of the EAST and all of its remaining subsidiaries (the "EAST Group"), with a view to distributing EAST's remaining assets to the noteholders and subsequently winding-up the EAST Group. The board was careful not to characterize the petition as a request for the liquidation of EAST, because to do so would have triggered an event of default under the indenture. This would have required the security trustee to undertake an expensive and fruitless exercise of remedies. The goal was to maximize the value of the collateral and to return it to the noteholders in an orderly manner while avoiding such costly and futile alternatives.

The petition filed with the court was without precedent and called on the court to approve a sui generis resolution process consisting of (1) a final judicial

accounting; and (2) the establishment of a liquidating trust. The matter was assigned to the Hon. Leo Strine, Jr. (who was incidentally appointed Chief Justice of the Delaware Supreme Court just hours before the hearing In re: EAST). The preliminary steps were to identify and settle the accrued and outstanding obligations of the EAST Group, to identify possible future and contingent liabilities of the EAST Group and to establish a bar date for the submission of claims. On October 10, 2013, the court granted a preliminary order setting a bar date of December 20, 2013. A notice of bar date was published in several newspapers with a copy mailed to historical transaction parties, including lessees, aircraft purchasers and service providers with which the EAST Group had contracted. The notice advised these groups and the general public of the proposed plan of resolution and of the bar date for claims. The petition and notice of bar date were made publicly available on EAST's website. The only claims received in response were precautionary claims filed by the indenture trustee for amounts owed to the noteholders and by the administrative agent for fees and expenses owed to the service providers. An Irish subsidiary of EAST separately received an unrelated claim from the insolvency administrator of an old aircraft lessee, but this claim was disputed by EAST and separately provided for.

Following the bar date, EAST's controlling trustees submitted a formal Plan of Resolution to the court, which the court approved in its confirmation order dated February 14, 2014. The plan included provisions releasing and discharging (i) the Notes and all liabilities, present or future, actual or contingent, of the EAST Group other than those expressly provided for in the Plan of Resolution; (ii) the Indenture and all related documents and collateral arrangements; (iii) to the fullest extent permitted by law, the board of EAST, the transaction trustees, the service providers and other related parties from all liability relating to the EAST Group. Importantly, the indenture trustee did not at any point object to the Plan of Resolution. All parties present agreed that the process was to the benefit of the noteholders, who had been separately notified well in advance of the proceedings and proposed course of action by EAST and the indenture trustee. The equity participants and junior noteholders had been out-of-the-money on the EAST transaction for a long time and did not after receiving notice participate in or object to the proceedings.

Under the Plan of Resolution, EAST had 90 days following the confirmation order to get its affairs in order. This included accounting for all operating expenses and allowed claims and establishing a liquidating trust with a duration of up to 18 months. On the effective date, the liquidating trust was funded with a limited amount designated for payment of fees and expenses throughout the remaining life of the trust as well as a contingency reserve. The remaining assets of EAST were conveyed to the indenture trustee for distribution to the senior noteholders. EAST and its subsidiaries were dissolved. Pursuant to the court order, the obligations of EAST under the indenture and the notes were deemed discharged, as were all other present and future claims against the EAST group. The controlling trustees and other service providers involved in the transaction were also released and discharged of all claims and liabilities.

The liquidating trust is intended to remain in place for 18 months, though it may be terminated earlier if the liquidating trustee deems that it

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Mark Lessard

is no longer required, and it may also be extended if the liquidating trustee considers that substantial potential sources of additional assets become recoverable for noteholders. The liquidating trustee is empowered during the life of the trust to, among other things, resolve and satisfy any remaining claims against EAST and to collect any outstanding sums owed to EAST in order to maximize the cash available to the noteholders upon termination of the trust. Upon termination of the liquidating trust, its remaining assets will be conveyed to the indenture trustee for one final distribution to the noteholders.

CONCLUSION:

The life and evolution of Embarcadero Aircraft Securitization Trust highlight how well-meaning investor protections sometimes need to be adjusted when circumstances change and how early liquidation is sometimes the best path to maximizing value. Luckily, the board of EAST was in a position to implement a covenant relief package with the consent of noteholders, which allowed EAST to accelerate the disposition of non-performing assets and reduce the expense drag on the transaction. In largely dispersed issuances, or transactions where the outstanding balance of the junior tranches may exceed that of the senior tranche, such rational behavior cannot always be assumed.

More recent portfolio securitizations, some of which involve older vintage aircraft, include more built-in operational flexibility than legacy deals. For example, concentration limits have been loosened as the credit standing of airlines and legal protections (i.e. the Cape Town Convention) in emerging jurisdictions have improved. Issuers also have more flexibility to substitute aircraft into the transaction during the life of the transaction. Tellingly, the cash flow base case in some of these transactions even assumes the sale or part-out of a significant number of aircraft upon expiry of their initial leases. In those cases, issuers need flexibility to sell assets below their Note Target Price.

But this has not meant a carte blanche approach to assets sales. Increased freedom to sell assets has sometimes been counter-balanced with more focus on maintaining loan-to-value ratios before releasing free cash to the equity. The new generation of transactions also preserves the debt-service coverage ratio, which must typically be met before any sales below Note Target Price can be effected. Finally, in the vein implemented by EAST, the board of the issuer must in the exercise of its fiduciary duties come to the conclusion that such sale would be beneficial. This is not a perfunctory standard as these securitization vehicles are actively managed by experience professionals advised by counsel.

Current generation transactions are also less reliant on cash reserves as a means of liquidity, instead relying on credit facilities. In addition, maintenance reserve accounts have a ratchet feature which allows them to shrink as projected maintenance expense decreases with asset dispositions. All of these factors make it less likely that today's portfolio securitizations will find themselves petitioning a court of equity (in whichever jurisdiction) for the release of stranded cash as was sought by EAST. Nevertheless, the commercially-minded Court of Chancery of the State of Delaware has shown that, where flexibility is lacking in the existing agreements, there is a path to resolving the outstanding assets and liabilities of a moribund securitization entity, to facilitate its early wind-up and to return value to investors.