

## Structuring a PDP Loan to Protect the Lender From an Airline Bankruptcy

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### Overview

The purchase agreement between an aircraft manufacturer and its customer will call for the customer to pay installments of the purchase price between the time the agreement is entered into and the delivery of the aircraft. These installments are called progress payments or predelivery payments (“PDPs”) and can be significant, especially in regard to a fleet purchase over many years. Normally the aircraft buyer pays the PDPs with its own funds. It may finance the PDPs, particularly if it also wishes to conclude a longer-term debt or sale-leaseback financing for the ultimate purchase of the aircraft at delivery.

A PDP financing is a secured financing. It is not secured by the aircraft, however, because the aircraft has not yet been manufactured and delivered. It is instead secured by an assignment of the rights of the customer in the purchase agreement. The rights reflect the property interest of the customer in the purchase agreement itself, including the aircraft delivery position. Subject to the consent of the aircraft manufacturer seller, the finance party may be assigned the right of the customer to purchase the aircraft when it is complete after an event of default under the PDP financing or the right to a full or partial refund of the PDPs.

In a recent US bankruptcy case, *King v. Bombardier Aerospace Corporation, et al.* (Case No. 2:17-bk-21386-SK, Adv. No. 2:19-ap-01147 SK (October 15, 2020), US Bankruptcy Court for the Central District of California, Los Angeles Division) (“*King v. Bombardier*”), the court considered the financing of PDPs for the purchase by the debtors of new Bombardier aircraft for their fleet. The court considered whether the assignment of the aircraft purchase agreement to the PDP financier constituted an absolute assignment or merely an assignment for security. The distinction was crucial: If the assignment were an absolute assignment, the PDP financier would be able to recover all of the PDPs it had paid to the manufacturer, less an amount to be retained by the manufacturer under the purchase agreement as liquidated damages. By contrast, if the assignment were merely an assignment for security, the refund from the manufacturer would be distributed among all of the customer’s unsecured creditors – including the PDP financier, with the result that the PDP financier’s recovery would be expected to be much lower.

### The Case

In 2017, charter-jet company Zetta Jet USA, Inc., a California corporation (“Zetta USA”) and its affiliate Zetta Jet PTE, Ltd., a Singapore company (“Zetta PTE,” together with Zetta USA, the “Debtors”), filed for protection as debtors under Chapter 11 of the US Bankruptcy Code. The case was later converted to a Chapter 7 liquidation.

AVIC International Leasing Co., Ltd. (“AVIC”) provided financing, supported by Export Development Canada (“EDC”), for the purchase by Zetta USA of four new Bombardier Global 6000 aircraft. For this purpose, AVIC formed a special-purpose subsidiary called CAVIC Aviation Leasing (Ireland) 22 Co., Designated Activity Company (“CAVIC”).

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In 2015, Zetta PTE entered into an Aircraft Purchase Agreement (the “APA”) with Bombardier Inc. for the manufacturer and sale of four new Bombardier Global 6000 aircraft. The APA stated that it was to be governed by New York law.

In 2016, CAVIC (as borrower) and EDC (as agent, security trustee and lender) entered into a PDP Facility Agreement for one of the aircraft under which EDC agreed to make available to CAVIC a revolving credit facility in the amount of \$30 million. The PDP Facility Agreement stated that its purpose was for CAVIC to apply all amounts it borrowed to finance the PDPs due Bombardier under the APA.

Zetta PTE (as assignor), CAVIC as (assignee) and Bombardier entered into an assignment of the Aircraft Purchase Agreement (the “APA Assignment”). The APA Assignment also stated that it was to be governed by New York law.

Bombardier, EDC, CAVIC and the trustee under an owner trust intended to be the titleholder of the aircraft once delivered, entered into a consent in which Bombardier consented to the grant of the security interest in the APA in favor of EDC, and to a forward purchase agreement between CAVIC and the owner trustee. Bombardier also agreed that when the APA called for a refund to the buyer of advance payments, Bombardier would pay the PDPs to be refunded to EDC.

CAVIC and EDC also entered into a security assignment by which CAVIC granted EDC a security interest in the rights of CAVIC in the APA under the APA Assignment.

Through the forward purchase agreement, a head lease and a sublease, each aircraft once delivered by Bombardier would come to be owned by the owner trust of which CAVIC would be the beneficiary, leased under a finance lease to another trust of which Zetta PTE would be the beneficiary, and subleased to Zetta USA. The head lease had a bargain purchase option, making the lease structure a disguised secured loan.

For one of the four aircraft, before that aircraft was delivered new by Bombardier, but after \$30 million for that aircraft had been lent by EDC and paid to Bombardier in PDPs, the Debtors sought Chapter 11 protection. The bankruptcy constituted an event of default under the APA, leading Bombardier to terminate the APA, which required that Bombardier return an amount equal to the PDPs for the undelivered aircraft funded by EDC, less an amount for liquidated damages specified in the APA (the “Refund Amount”).

CAVIC argued to the court that (subject to EDC’s security interest) CAVIC was the absolute owner of the Refund Amount by virtue of the APA Assignment because the APA Assignment was an absolute assignment and not merely an assignment for security. CAVIC pointed out that the APA Assignment stated that the assignment was absolute, and that CAVIC became the sole buyer of the aircraft under the APA, obligating CAVIC to purchase the aircraft and pay the balance of the purchase price. CAVIC noted it was also obligated to repay the \$30 million loan extended by EDC to finance the payment of the PDPs. CAVIC additionally pointed out that Bombardier had signed a consent that stated that if the Refund Amount became payable, Bombardier would pay it directly to EDC as secured lender, not to either of the Debtors.

In response, the bankruptcy trustee administering the Debtors’ estate argued that the Refund Amount was the property not of EDC or CAVIC, but of the Debtors’ estate, and accordingly should be turned over by Bombardier to the trustee so the trustee could distribute it to all of the Debtors’ unsecured creditors, not just to EDC or CAVIC. The trustee claimed that the APA Assignment, rather than being an absolute assignment, was actually an assignment for security only, and that it would have to have been perfected by CAVIC when the loan was extended in order for CAVIC to have priority against the Debtors’ unsecured creditors. The trustee argued that because the interest of CAVIC was actually unperfected, it was subject to avoidance under section 544 of the Bankruptcy Code. Once CAVIC’s interest was avoided, neither CAVIC nor its security assignee EDC would have any security interest in the Refund Amount and the Refund Amount would be distributable to the Debtors’ unsecured creditors *pro rata*. The trustee further reasoned that the court should determine what type of assignment the APA Assignment was by determining the parties’ intent and by looking beyond the words of the agreements, including disregarding the words stating that the assignment was absolute. In this regard, the trustee pointed out that Zetta PTE remained jointly liable with CAVIC for the obligations of the “buyer” under the APA, and that the Debtors could extinguish CAVIC’s rights in the Refund Amount by repaying the EDC’s PDP loan. Finally, the trustee

argued that the fact that the assignment of the APA to CAVIC was made at the same time as the security assignment from CAVIC to the EDC suggested the APA Assignment was itself also a security assignment.

The court in *King v. Bombardier* ultimately rejected the arguments of the trustee and found that the APA Assignment was absolute, and not a security assignment that could be set aside if not perfected. In reaching its decision, the court noted that other courts in a variety of cases have applied a number of factors to determine if an assignment is absolute or only an assignment for security. These factors are:

- The plain language of the assignment agreement.
- The timing of the assignment and of the making of the related loan.
- Whether the payments received under the assignment would be applied to reduce the principal amount of the loan.
- Whether the assignment will be a source of payment if the loan is not repaid.
- Whether any excess paid on the loan will be remitted to the assignor.
- Whether the assignee retains a right to deficiency if the assignment does not satisfy the amount of the loan.
- Whether the assignee's rights in the assigned property would be extinguished if the assignor paid the debt from another source.
- Whether in a bankruptcy the assignee filed proofs of claim or other documents asserting it was a secured party.

(*King v. Bombardier*, pp. 47–52.) This is a wide variety of factors and, viewed with a critical eye, does not provide a roadmap to assure at the time a transaction is entered into, that an assignment will ultimately be determined to be an absolute assignment or assignment for security. The court apparently was not completely comfortable analyzing a structured financing, and called the agreements a “patchwork.” Ultimately, the court ruled that the assignment was an absolute assignment and not one merely for security. The court relied heavily on the first factor cited above — i.e., the fact that the APA Assignment recited that the assignment from the original buyer Zetta PTE to CAVIC was an “absolute” assignment of all of Zetta PTE’s “rights, interests, liabilities and obligations” under the APA and did not formally recite that it was an assignment for security.

Although the court found that the assignment was an absolute assignment and not merely one for security, the court could easily have gone the other way and found from the facts that the APA Assignment was actually one for security only. Another court, presented with similar facts, could readily find that the APA Assignment was for security. In the APA Assignment, Zetta PTE purported to assign absolutely all of Zetta PTE’s rights and obligations under the APA to CAVIC, the counterparty to the APA. However, Bombardier consented to this assignment because Zetta PTE also agreed to remain jointly and severally liable with CAVIC to perform the obligations of the buyer under the APA. Therefore, as far as Bombardier was concerned, its original buyer, Zetta PTE, remained obligated to pay the full purchase price of the aircraft and otherwise perform the covenants of the buyer under the APA. A release of Zetta PTE apparently would not have been acceptable to Bombardier; CAVIC was not an operating company, but only a special-purpose entity formed for the purpose of participating in the structured financing of Zetta PTE’s purchase of the aircraft. Accordingly, Zetta PTE remained liable for its bankruptcy event of default even after the effectiveness of the APA Assignment. One could argue that if the parties really had intended the assignment under the APA Assignment to be an absolute assignment, so that the rights and obligations of the purchaser under the APA were fully transferred to another party, perhaps they would not have provided that the bankruptcy of the original purchaser would cause the APA to terminate. An assignment that does not transfer the ultimate obligations of the assignor is a typical element of an assignment for security only.

Another factor that could have been viewed to weigh in favor of finding the APA Assignment a security assignment rather than an absolute assignment is the role of the assignee in the structured financing. If the assignee had been an equity investor in the aircraft, taking residual risk, it would be more logical for it to receive an absolute assignment. In the case at

hand, by contrast, the aircraft financing for Zetta was entirely a debt financing. Neither EDC nor CAVIC was intended to have any residual interest in the aircraft once the financing was repaid. Instead, once the financing was repaid, EDC and CAVIC were to release their interests in the APA and the other transaction documents, and Zetta PTE would become the owner of the aircraft and the owner of any remaining rights under the APA.

As noted above, if the court had accepted the arguments of the trustee and ruled that the assignment were merely one for security, the result would have been that the “security interest” of the APA Assignment would have been disregarded. This is because CAVIC had not taken any action to perfect this security interest. Therefore the Refund Amount would have become the property of the Debtors’ estate, distributable to the Debtors’ unsecured creditors rather than to CAVIC for onward payment to EDC to be applied to the repayment of the EDC loan. The fact that EDC itself had a perfected security interest would not have changed the result because EDC’s rights were derivative of CAVIC’s; EDC could not have a perfected security interest in the PDPs if CAVIC did not.

To protect against the possibility that a purportedly absolute assignment is recharacterized as a security assignment, the assignee may on a precautionary basis take steps to perfect before it extends the loan. CAVIC could have considered the following: (1) having Zetta PTE, a Singapore company, execute a Singapore-law pledge or assignment in favor of CAVIC, and filing that agreement in the appropriate charges registry in Singapore; (2) creating and taking possession of a chattel-paper copy of the APA; and (3) filing a precautionary UCC-1 financing statement in the United States (with the District of Columbia Recorder of Deeds because Zetta PTE was not a US entity).

## Recommendations

Although the court in *King v. Bombardier* ultimately ruled in favor of CAVIC and EDC, the facts that (1) the original buyer, Zetta PTE, remained jointly and severally liable to perform the obligations of the buyer under the APA; (2) the assignee was a special-purpose entity with no creditworthiness; and (3) a bankruptcy of Zetta PTE triggered a default under the APA, allowed the trustee to mount the argument that the APA Assignment was an assignment for security, despite the recitation in the APA Assignment that it was an absolute assignment. Therefore it is advisable that a secured PDP lender using a structure with an assignment of rights under a purchase agreement take reasonable steps to perfect a security interest in the assigned rights on a precautionary basis.

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