Katten

AVIATION ADVISORY

Protecting the Financer of the Conversion of a Passenger Aircraft to a Freighter

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KEY POINTS

- The rights of an aircraft lessor or lender financing the conversion of a passenger aircraft to a freighter aircraft will be specified in agreements between the borrower, financer and conversion facility.
- The parties will negotiate protections for the financer against a default by the aircraft owner or lessee that is the customer under the conversion contract.
- The documents also will include provisions to protect the financer even in the absence of a default.

Overview

A large market has developed recently, particularly since the onset of the COVID-19 pandemic, for the conversion of mid-life or older Airbus A330-200 and -300, Boeing 767-300, and other widebody and narrowbody passenger aircraft to full-freighter configuration. This market is driven by the burgeoning demand for shipment by air of consumer goods, medical supplies and the like. Conversion slots are being reserved years in advance of the date on which the aircraft will be inducted for its conversion.

The freighter conversion customer might be an airline with a passenger aircraft in its fleet that the airline would like to repurpose for freighter operations. The customer might also be a leasing company that has an off-lease aircraft that it would like to lease out as a freighter aircraft.

The customer may desire to obtain financing for the conversion. The financer might be the lessor of the passenger aircraft to the customer airline. It could also be the lender to a leasing company that has an off-lease aircraft or on-lease aircraft to be converted. It might very well be a lender to the airline customer that owns the aircraft to be converted.

The conversion agreement normally will call for installments of the conversion price to be paid to the conversion facility on completion of certain milestone events in the conversion. The financer will provide a loan to the conversion customer for all or a portion of one or more installments.

The Conversion Agreement

The customer and the conversion facility will have entered into an agreement for the conversion facility to perform the conversion according to a Federal Aviation Administration (FAA)- and European Union Aviation

Safety Agency (EASA)-approved supplemental type certificate developed by the original equipment manufacturer (OEM) or the conversion facility and a conversion specification. The agreement will provide for a conversion slot: i.e., the time slot at a facility reserved for the conversion of each aircraft covered by the agreement, measured by the period from the date the customer is scheduled to deliver the aircraft to the conversion facility to the date the conversion facility is scheduled to redeliver the converted aircraft to the customer. The agreement will provide the price for the conversion, and may provide that the customer may elect additional work such as weight upgrades (maximum takeoff weight, etc.), or repair of parts discovered during the conversion to be unserviceable. This will cause extra costs to be incurred and potentially delay scheduled redelivery date.

The agreement will provide that except in the case of a specified excusable delay, the failure of the customer to tender the aircraft, in serviceable condition, at the conversion facility for its conversion will allow the conversion facility, after a grace period, to terminate the slot. In such case the customer may have to pay liquidated damages or costs incurred by the conversion facility to prepare for the conversion. The agreement will provide for after-conversion support and warranties by the conversion facility. It will provide for termination by either party in case of an unremedied default by the other.

Funding of Conversion Price

The customer will prefer that the financer fund each installment of the conversion price as and when payable by the customer to the conversion facility. This will allow the customer to avoid making a payment out of pocket to the conversion facility.

Repayment of Funding

The funding may be repayable in installments of principal and interest. Alternately, in the case of a leased aircraft, the funding may be repaid by an increase in the rent that was payable or would have been payable for the aircraft in passenger configuration.

Security Agreement

The conversion financing should be a secured financing. Under the security agreement between the customer and the financer (or a security trustee on its behalf), the customer will grant the financer a security interest in the rights of the customer under the conversion agreement, to secure the obligation of the customer to repay the conversion loan or to pay rent and otherwise perform under the lease of the aircraft as applicable. The principal rights of the customer are the right to have the conversion facility convert the aircraft for a specified price, warranty and after-conversion service, and the right to receive a termination payment from the conversion facility in certain circumstances in which the conversion is not completed in accordance with the conversion agreement.

Consent of the Conversion Facility

This is an agreement among the customer, the conversion facility and the financer. In this agreement the conversion facility will consent to the granting by the customer to the financer of the security interest in the customer’s rights under the conversion agreement. The parties will agree that the customer will remain solely liable to the conversion facility to perform the obligations of the customer, notwithstanding the security assignment, unless and until the financer elects to pay the balance of the conversion price pursuant to the terms of the consent.

The key protection for the financer is the “step-in” option set forth in the consent. The financer is allowed to exercise this option in two circumstances: (i) if an event of default occurs and is continuing under the loan or lease agreement between the customer and the financer, or (ii) if the conversion facility plans to terminate the conversion agreement as to the aircraft for any reason, including events of default which are stated in the conversion agreement. The two events can overlap — e.g., a bankruptcy or insolvency event of the airline can be both a loan or lease agreement event of default and a conversion agreement termination event. Other termination events might include a force majeure event that delays the completion of the conversion past a given grace period. Moreover, the termination of the conversion agreement can be a loan or lease event of default, although the borrower or lessee may negotiate a cure period following termination to reinstate the conversion agreement. The conversion facility should agree in the consent to give a certain number of days' notice to the financer before the conversion facility exercises a termination right. During the notice period, the financer may by notice to the conversion facility exercise the step-in option. If the financer does so, the financer will preempt the conversion facility's termination right and assume the rights and obligations of the customer under the conversion agreement, including the obligations to pay for the conversion and take redelivery of the aircraft at the completion of the conversion. The conversion facility will give the financer the benefit of the conversion price installments already paid, even if other amounts are then payable by the customer to the conversion facility. The conversion facility may give the financer the benefit of the conversion price set forth in the conversion agreement, or at least a determinable price that is agreed for the step-in.

The consent should provide that at all times, whether or not circumstances arise that give the financer the opportunity to exercise the step-in right, the customer and conversion facility will not amend the conversion agreement and the customer will not make material elections under the conversion agreement, without the consent of the financer. Material elections include the customer's ordering extra work over and above the conversion, a change to the freighter conversion specification, and a change to the scheduled induction or completion date for the conversion. The customer should also not be allowed to exercise any right to terminate the conversion agreement without the consent of the financer (such as in the case of a default by the conversion facility or an extended force majeure event).

The customer may prefer not to disclose the commercial terms of the conversion agreement to the financer at closing. In particular, the customer may have negotiated a lower actual conversion price with the conversion facility than the list price of the conversion which the financer is willing to finance. This is not materially different from a situation where a financer is willing to finance the purchase of a new aircraft on a purchase price that is supported by an appraisal rather than the actual lower purchase price that the airline or leasing company has negotiated with the manufacturer, or in the context of a progress payment loan facility used to finance the progress payments under a new aircraft purchase agreement. In any event, if the copy of the conversion agreement provided to the financer at closing is partly redacted, the parties should agree that if the financer has the right to exercise the step-in, the financer may request, and the conversion facility will provide, the unredacted conversion agreement before the deadline for the financer to exercise the step-in right. Otherwise the financer would not know the conversion price that it is agreeing to pay by exercising the step-in right.

The conversion facility should agree to make any termination payment it may owe to the customer under the conversion agreement to the financer, for application to repayment of the loan. The conversion facility should also allow the financer the right to inspect the aircraft during the conversion and should agree to provide the financer a copy of each report that the conversion facility provides to the customer and any other information on request.

The financer should ask that the conversion facility acknowledge the scheduled delivery date and scheduled redelivery date if not already disclosed in the redacted conversion agreement.

The consent should include a copy of the conversion agreement and applicable warranties along with each amendment to the conversion agreement, in each case subject to agreed redactions, as an exhibit.

Disposition of the Aircraft

If the financer exercises the step-in option, and the financer is the owner of the aircraft with the customer as lessee and is simultaneously repossessing the aircraft under the lease, the financer does not have to account to the lessee/customer with respect to the aircraft. If on the other hand the customer is the owner of the aircraft, the customer will have equity in the aircraft. There will have to be a procedure by which the financer remarkets the aircraft for sale or lease. The proceeds will be distributed according to a waterfall. After remarketing expenses, the financer will be repaid principal and interest. The balance, if any, can go to the customer. If the aircraft were already subject to secured financing at the time the conversion agreement financing is entered into, the conversion financer and the aircraft financer (if different) will enter into an intercreditor agreement that will provide for remarketing, buyout rights, and distribution of proceeds of remarketing.

Possibility of Structural Enhancement

As noted, a comparison can be drawn to aircraft predelivery payment (PDP) financing, in which a financer finances the predelivery payments payable to an aircraft manufacturer in connection with the purchase of a new aircraft. In such a financing, the financer may have the aircraft purchase agreement between the airline and the manufacturer novated or absolutely assigned to a special-purpose bankruptcy-remote entity. The original customer under the aircraft purchase agreement (an airline or leasing company) would issue a guarantee to the manufacturer of the performance of the payment and other obligations of the special-purpose entity. The reason for the novation or assignment is to mitigate the following risk: if the original customer were to become a debtor in a bankruptcy or insolvency proceeding before delivery of the aircraft, the financer would want the predelivery payments (which it had financed) repaid or credited to it according to the terms of, and as may or may not be permitted by aircraft purchase agreement as assigned to the financer under the security assignment of the customer's rights under the purchase agreement. But there is a risk that the bankruptcy court may either delay the credit or payment by the manufacturer to the financer if due under the assigned purchase agreement or order that the manufacturer or financer return the predelivery payments to the customer for distribution to its unsecured creditors. The structural enhancement of a novation or assignment is possible with a conversion financing as well. However, even without this structural enhancement, the bankruptcy risk should be mitigated in that unlike a payment for a yet-to-be-delivered aircraft, the payments to the conversion facility usually represent payment for services performed on, and adding value, to an aircraft already owned by or in the fleet of the customer rather than a security deposit. Moreover, as long as the conversion facility agrees to credit the financer for the previously paid installments toward the conversion price, a risk that the financer will not receive a payment of cash does not apply. However, in any case in which the financer is not already the owner of the aircraft, the financer may still wish to consider transferring the title to the aircraft to a bankruptcy-remote entity as part of its structuring of the transaction, to facilitate the eventual repossession and sale of the converted aircraft in the case of a default by the credit party in the freighter-conversion financing.

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