In the current market, the sale-leaseback can be an effective tool for airlines to raise cash, transition an aircraft model out of the fleet, or manage residual-value risk. For example, it has been reported that (1) Southwest Airlines has recently agreed to sale-leasebacks for 10 Boeing 737-800 and 10 Boeing 737-MAX 8 aircraft in transactions expected to raise $815 million in proceeds; (2) Altavair and KKR have signed a sale-leaseback with Delta Air Lines for 6 Airbus A321-200s; and (3) BOC Aviation agreed with United Airlines on a sale-leaseback of 6 Boeing 787-9 aircraft.
and 16 Boeing 737-MAX 9 aircraft. In this Aviation advisory, we present some traditional, and some not-so-traditional, issues for lessors to consider in sale-leasebacks.

The Basic Documents

As between the airline and the lessor, the two principal transaction documents are the Sale Agreement and the Lease. For each aircraft, ancillary documents may include a warranty bill of sale, insurance assignment, warranty assignments, lessee parent guarantee, lessor parent guarantee, owner trust agreement, deregistration power of attorney, security deposit letter of credit and escrow agreement. There will also be credit and security documents if the lessor or equity investor employs debt to fund a portion of the price to purchase the aircraft from the airline.

The Sale Agreement

In negotiating the Sale Agreement, it is important to keep two things in mind: (1) the sale will be immediately followed by a lease back to the seller; and (2) although the lease will normally be structured to be a true lease for tax, accounting and legal purposes, the sale-leaseback is a financing for the benefit of the airline in which possession, operation and maintenance of the aircraft do not change when the closing occurs. Accordingly, certain risk allocations that would apply to a sale of an aircraft with an accompanying transition of possession do not apply, and in fact should be reversed:

- **“As-Is, Where-Is.”** In a stand-alone sale of a used aircraft, the seller makes standard organizational representations and warrants that at closing it conveys good title to the buyer free of liens other than those created by the buyer. If the seller is an airline, and the sale is not part of a sale-leaseback, it is sometimes possible to obtain several representations from the seller that relate to the condition of the aircraft that a seller which is a leasing company would not give—for example, that the airline seller had maintained the aircraft pursuant to its airworthiness-authority-approved maintenance program. In exchange for the limited representations from the seller, the buyer will have the right to perform a customary “pre-buy” inspection of the aircraft, including its technical records. Such inspections could include full front-to-back video borescope inspections of the engines, engine maximum-power-assurance runs and a demonstration flight. The buyer may receive the aircraft’s existing certificate of airworthiness and, if the aircraft is being reregistered in another jurisdiction, a freshly issued export certificate of airworthiness, in each case issued by the airworthiness authority of the existing country of registration. The buyer therefore can confirm the aircraft is airworthy at the time of inspection and delivery. However, there is typically no assurance that the aircraft will remain airworthy even for one more cycle of operation following the closing. However, when the aircraft is leased back to the seller — even for a short period — the buyer will get the benefit of a full set of return conditions in the lease, including, among other things, that the aircraft be serviceable, maintained in accordance with the approved maintenance program and be airworthy. The airline seller therefore bears the continued operational risk of the aircraft and agrees to repair it at lease end, even if the specific condition that caused the aircraft to be unairworthy or
unserviceable relates back to conditions that were developing when the sale-leaseback closing occurred, and which would otherwise have been buyer risks in a sale without a leaseback. For this reason it is better for a buyer to structure a transaction to transition an aircraft type out of an airline as a sale-leaseback rather than as a sale or forward sale with immediate deliveries or deliveries over time.

**Transfer Tax.** In a sale agreement that is not part of a sale-leaseback, the buyer typically bears the risk that the sale is subject to transfer tax — generally defined as any tax imposed with respect to the sale other than the seller’s income taxes. In exchange, the buyer is not obligated to close unless it verifies that at the time of closing, the aircraft is located in a place previously agreed by seller and buyer to be an acceptable closing location. Where a closing can occur in the United States, it is usually possible to find a location in a state with a sales-tax exemption. For a closing outside the United States — where the transfer tax is usually a high-rate VAT — a closing while the aircraft is over international waters is often chosen. In such event, the aircraft location generally must be selected along the lessee’s existing flight schedule for the aircraft (and depending on the buyer’s level of risk tolerance also the flight schedule of the airframes on which the specific engines which are being sold are installed, if different). Even if the closing is to be in international airspace, there are a number of risks the buyer may not be able to completely avoid, such as if the country of registration takes the position that the registration itself confers the right to tax the sale or if a closing over international waters is done pursuant to a round-trip ferry flight that has no other business purpose it will be disregarded, and the sale will be deemed to occur in the jurisdiction in which the beginning or end point of the flight is located. In a sale-leaseback, however, the buyer should insist that the airline seller bear the transfer tax risk for the following reasons: (1) the airline has control of the aircraft’s flight schedule and can schedule the closing for any location on the route schedule or ferry the aircraft to an acceptable location; and (2) if one views the ultimate purpose of the sale-leaseback to be a financing for the benefit of the airline, the risk allocation is no different from a borrower’s customary broad indemnification of a lender against any cost that would diminish the lender’s anticipated return.

**Mutual Operating Indemnities.** Often in a sale agreement that is not part of a sale-leaseback, each of the seller and buyer agrees to indemnify the other against third-party liability claims that relate to acts or events that occur, respectively, before or after the sale closes, with respect to the possession, maintenance or operation of the aircraft. This is often hard for a seller or buyer who is not itself the aircraft operator to agree to. This indemnity is generally backed by the liability insurance maintained by the seller or buyer (or the buyer’s lessee), respectively. With a sale-leaseback, the seller’s indemnity in favor of buyer remains applicable after the closing because the aircraft will continue to be operated, maintained and insured by the seller under the lease. For this reason, the buyer’s indemnity in favor of the seller should carve out the period during which the aircraft is on lease to the seller, or even better, be eliminated entirely.
• **If the Seller Is an Affiliate of the Airline.** With a number of airlines, particularly those that are privately held, aircraft may be owned by an affiliate of the airline and leased to the airline. If the seller is such an affiliate it may be appropriate to negotiate covenants in the sale agreement pursuant to which the seller or its controlling shareholder agrees to transfer the sale price to the airline as a contribution of capital rather than pay it out as a dividend. Alternately, the seller or shareholder may guarantee the obligations of the airline under the sale-leaseback transaction documents. Each may support the argument that the airline has received consideration in exchange for its new obligations to pay rent and maintenance reserves to the buyer.

• **Consider Placing the Purchase Price in a Pledged Account.** Depending on the relative bargaining positions of the lessor and lessee, in light of current economic conditions it may be worth considering placing all or a portion of the purchase price into a special-purpose account at closing, in which the lessor would have a perfected security interest and which can be used as additional security for the seller’s obligations under the lease. Disbursements from the account would require lessor consent. The lessor and airline could agree that the purchase price would be released to the airline in installments at agreed intervals, perhaps subject to the airline’s satisfying specified financial covenants at the time of release.

• **Expenses.** In a sale agreement without a leaseback, each of seller and buyer typically bears its own expenses incurred in negotiating and documenting the sale, including fees and expenses of counsel and costs of conducting the aircraft inspection. However, if one again views the sale-leaseback as a financing for the airline’s benefit it should be possible to have the airline bear the lessor’s transaction expenses as is the standard in a typical debt financing.

**The Lease Agreement**

The lease in a sale-leaseback will be quite similar to other operating leases (or, if applicable, finance leases). However, certain considerations arise from the sale-leaseback structure.

• **Restrictions on Use of Purchase Price or Other Funds.** The airline will expect that the purchase price may be used by the airline for general corporate purposes. Nevertheless, depending on the creditworthiness of the airline, the importance of the sale-leaseback to its financial health, and whether it is closely held, certain restrictions may be negotiated to keep the purchase price or other funds from being used for purposes that do not support the business of the airline, including paying rent. For example, the buyer/lessor may seek to impose restrictions on share buybacks and payment of dividends for a negotiated period (not necessarily the full term of the lease). Similarly, restrictions could be placed on executive compensation. These restrictions would not be typical, but these are not typical times and such restrictions are similar to the conditions for airlines and related companies to obtain grants and loans under current US government programs such as the Payroll Support Program under the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in response to the coronavirus.
• **Enhanced Reporting Requirements.** Typically the nonpublic airline lessee will be required to provide the lessor annual audited financial statements and unaudited quarterly financial statements. Given the need to monitor closely the financial health of the lessee in these difficult times, and to quickly identify financial distress, it may be worthwhile to require that the quarterly financial statements be audited too, at least for a limited period. The lessor could also require that the airline report to the lessor any facts, events or circumstances that arise that may materially adversely affect the airline’s business or prospects or ability to comply with the terms of the lease. The lessor could further require access to the airline’s personnel to discuss financial matters and access to the financial records including tax returns of the airline. Finally, the lessor could require that the airline tighten its records-retention policy, including retention of electronic mail that would otherwise be routinely deleted.

• **Stagger Deliveries and Redeliveries.** For a sale-leaseback of more than one aircraft, the preclosing inspections by the lessor of the aircraft — including technical records — will have to be spread out sufficiently so as not to overtax the lessor’s or airline’s technical personnel. The redelivery procedures and inspections will be more extensive, because they involve lessee’s complying, and lessor’s verifying compliance, with the return conditions in the lease. Although by the end of the lease terms the aircraft may after aircraft sales have different owners, the lease expiry dates should likewise be staggered, ideally by at least 60 days between aircraft.

• **Enhanced Inspection of the Aircraft and Technical Records.** Unless a lease event of default has occurred and is continuing, typically the lessor may conduct only a ramp inspection of the aircraft and only once per year, at a time that does not interfere with the aircraft’s flight schedule. In difficult times such as we are in now, a lessor may consider increasing this to two inspections per year and state in the lease that the lessee will provide the lessor regular electronic updates of the aircraft technical records. This will allow the lessor to identify any maintenance lapses promptly and protect the ultimate residual value of the aircraft. It may also help avoid third-party liability for an accident that victims or insurers may allege was caused by inadequate policing by the lessor of the maintenance on the aircraft.

• **Maintenance Reserves and Lessor Contributions.** In the typical operating lease to an airline outside the top tier, the airline pays the lessor maintenance reserves as a sinking fund toward the cost of airframe heavy maintenance checks, engine performance restoration, engine life limited part replacement, landing gear overhaul and auxiliary power unit overhaul. In the case of a used aircraft, for the first shop visit in each of such categories, the lessor may pay a portion of the cost of such shop visit called the “lessor contribution.” The lessor contribution reflects the utilization of the aircraft or engine or other component between the date of the last shop visit before the lease term began and the date the lease term began. In the case of a sale-leaseback the lessor can contend that no such contribution should be paid because the same airline used the aircraft before and after the transaction closed. This can then be reflected in a lower purchase price for the aircraft and increased maintenance
reserves. It is also a prudent move for credit reasons, in that the lessor may choose to effectively reserve the capital which would have otherwise been used for the lessor contribution so that it is available to be applied to the cost of any initial required shop visit for a down-stream lessee.

- **Indemnification for Events Occurring Prior to the Lease Term.** In a typical aircraft operating lease, the lessee agrees to indemnify the lessor and related parties against most claims including arising out of the use, operation or maintenance of the aircraft during the term. Such an indemnity would normally exclude claims relating to acts or events that occurred before the beginning of the term. In a sale-leaseback, this exclusion should not appear, or should exclude only the period before the airline became the operator of the aircraft. The lessee was the operator of the aircraft before the closing. This aligns with the discussion above on the mutual operating indemnity in the sale agreement. This is particularly important because if lessor A does a sale-leaseback with an airline and one year later sells the aircraft to lessor B, lessor B will insist on receiving an operating indemnity from lessor A for the period prior the commencement of the term of the lease if that period is excluded from the airline’s indemnity under the lease. Lessor A may be able to turn around and assert the same claim against the airline under the sale agreement between the airline and lessor A, but that does not remove lessor A from being liable to lessor B.

**Considerations for Loan Documents**

A lessor may fund the purchase of the aircraft from the airline entirely with equity capital. Alternately, the lessor may use debt such as that drawn from a secured credit facility arranged specifically for the sale-leaseback, or from a warehouse or ABS facility. If the purchase of the one or more aircraft in a sale-leaseback is to be financed by a credit facility dedicated to the sale-leaseback, careful attention should be paid to the rights of the lessor if a lease event of default occurs (which will automatically be a loan event of default). The lessor should negotiate provisions to provide it some control over the exercise of remedies or negotiation of a workout with the airline. These provisions should include the right to cure a certain number of rent and other lease payment defaults, a long period to remarket the aircraft following repossession, the right to veto lease amendments proposed by the lender, and “squeeze protection” (the obligation of the lender as security assignee of the lessor to exercise lease remedies if, after whatever standstill period is provided in the loan documents, it forecloses against the equity) in order to avoid the lender’s making an end-run around the equity investor and negotiating with the airline directly.

©2022 Katten Muchin Rosenman LLP

National Law Review, Volume X, Number 142