Split Closings: A Divide in the Methods

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The inclusion of engine pooling arrangements and rigorous maintenance requirements in operating leases frequently results in engines which formed part of a leased aircraft at delivery (for the purposes of this article, the Original Aircraft) being “off-wing.” Off-wing engines create complications for transaction parties attempting to execute a sale of an aircraft. While these complications are not insurmountable, the marketplace has developed different approaches to address the off-wing engine scenario. This article explores the issue, the related approaches and the attendant risks to transaction parties.

The Off-Wing Issue

The successful conclusion of a sale and purchase transaction may be put in jeopardy if one or both of the original engines is off-wing at the time of closing, as it may not be possible for the purchaser to acquire title to the airframe and the original engines simultaneously. In cases where each object is located in a tax-friendly location at the intended closing time (for the purposes of this article, a Closing Location), then an “all-in-one” closing may still be possible. However, the more common scenario is often one in which each object forming part of the Original Aircraft arrives at its Closing Location at different times, leading the parties to an impasse where the documentation does not provide for a mechanism to resolve such a closing conundrum.

Furthermore, the age, utilization rates, condition and maintenance records of the original engines will have formed part of the Original Aircraft’s overall valuation at the pricing stage of the transaction. If in the lead-up to closing it transpires that one or both of the original engines are off-wing and in a jurisdiction that is unsuitable for a closing of the intended sale transaction, the parties would need to consider alternative approaches. Some of these will necessitate revisiting their pricing calculations at a frustratingly late stage in the transaction.

The Split Closing

The purpose of the “split closing” mechanism is to allow the transacting parties to navigate through the issues caused by off-wing engines without compromising the lessee’s flight schedules or the purchaser’s funding arrangements. The mechanism effectively entails a series of title transfers by way of a corresponding number of bills of sale for the relevant airframe and each engine. Each title transfer takes place sequentially as and when the airframe and engines forming part of the Original Aircraft arrive at their respective Closing Locations. By the end of the process, the purchaser should be in possession of up to three (or five, depending on the aircraft type) released bills of sale which, when collated, would effectively evidence transfer of title to the entire Original Aircraft.

Using the example of an airframe and one original “on-wing” engine (together, the Airframe and On-wing Engine) and one “off-wing” engine (the Off-wing Engine) each arriving at their separate Closing Locations at different times, this article describes two commonly used methods of documenting a split closing.

Approach 1 – The Side Letter and Lease Back Approach

Under this approach, the seller and purchaser enter into a sale and purchase agreement side-letter (intentionally leaving the lessee, the novation and the effective time notice out of the equation). The side letter would exhibit a short-form lease agreement (the Lease), a split bill of sale and a return bill of sale and would document the following sequence of events:
1. Upon the arrival of the Airframe and On-wing Engine at the agreed Closing Location, the seller would transfer title to the Airframe and On-wing Engine to the purchaser utilizing the split bill of sale (the face of which would refer to the Airframe and On-wing Engine only). The seller will not have received any payment at this stage and in fact, none of the seller’s conditions precedent to the transfer (including receipt of any portion of the purchase price) will need to have been satisfied until transfer of title to the Off-wing Engine (as described in step 3 below). The seller’s protection during this interim leasing period stems from the provision described in step 4 below.

2. Because the situation in paragraph 1 results in the purchaser becoming an owner of an airframe and engine without having paid for it or necessarily delivered any other conditions precedent to the seller, the purchaser is compelled to immediately lease the Airframe and On-wing Engine back to the seller pursuant to the Lease.

3. Upon the arrival of the Off-wing Engine at its own Closing Location and assuming that all conditions precedent (including receipt of the purchase price by the seller) have been satisfied, title to the Off-wing Engine would pass under a second split bill of sale (the face of which would refer to the Off-wing Engine only). Contemporaneously, the Lease would automatically terminate and the purchaser would become the owner of the complete Original Aircraft. A single effective time notice (covering both the Airframe and On-wing Engine and the Off-wing Engine) under the novation would then be released by the seller, purchaser and lessee.

4. The side letter would also include a “fail-safe” provision for the seller’s benefit. The purchaser would be required to execute, leave undated and pre-position with the seller a return bill of sale for the Airframe and On-wing Engine in favor of the seller. The seller has the right to date this return bill of sale and effectively transfer title to the Airframe and On-wing Engine back to itself in the event that the transaction is jeopardized between the occurrence of steps 1 and 3 (as described above) and closing can no longer take place.

The benefit to the transaction parties of using the side letter and leaseback approach is twofold:

(a) although it may wish to do so in advance, the purchaser need not pay the purchase price until immediately prior to the arrival of the Off-wing Engine at its Closing Location; and

(b) the lessee remains oblivious to the process throughout.

One disadvantage is that because the new insurance documentation may not yet have been issued (as conditions precedent do not need to be satisfied until step 3), it may be the case that the purchaser will not be insured for third-party liability during the period of ownership of the Airframe and On-wing Engine and the leasing thereof back to seller under the Lease. In such an instance, the purchaser may wish to obtain its own short-term insurance for this period, review its own existing fleet policy for any comfort which it may be able to provide or rely on the general indemnity which ought to be provided by the seller in the sale and purchase agreement.

**Approach 2 – The Split Effective Time Approach**

The principle distinction between this approach and Approach 1 is that where the latter relies on a side letter to the sale and purchase agreement between the seller and purchaser (leaving the lessee, the novation and the effective notice at bay until step 3), this approach focuses on the novation and splitting the effective time notice itself. Typically, the novation would contain a provision envisaging a split closing pursuant to which the parties agree to have all conditions precedent (including payment and receipt of the purchase price) satisfied in advance of the arrival of the Airframe and On-wing Engine at its Closing Location (and the release of the effective time notice for the Airframe and On-wing Engine).

To satisfy the payment condition precedent, the purchaser would pay the entire purchase price pursuant to a refund undertaking given by the seller. This undertaking would entitle the purchaser to an immediate refund of the purchase price in the event that the transaction fails to close as a result of, for example, the Off-wing Engine failing to reach its Closing Location within a pre-agreed time frame.

A well drafted split closing clause in a novation would document that following the transfer of title to the Airframe and On-wing Engine from the seller to the purchaser and the release of the effective time notice for the Airframe and On-wing Engine, the lease will be deemed to have been novated with respect to the Airframe and On-wing Engine only. It would also provide that until such time as the Off-wing Engine arrives at its Closing Location, it shall remain subject to the existing lease with the seller/existing lessor as its continuing lease counterparty. To avoid any unintended consequences that may arise out of a prolonged split leasing arrangement for the Airframe and On-wing Engine and the Off-wing Engine, prudent parties would agree that they may only commence the closing process once they are fully satisfied that both objects will arrive at their respective Closing Locations within a twenty-four hour window.

Upon receipt of the full amount of the purchase price by the seller and following the arrival of the Airframe and
On-wing Engine at its Closing Location, the first effective time notice (the face of which would refer to the Airframe and On-wing Engine only) would be released. The parties would then wait for the Off-wing Engine to reach its destination following which the second and final effective time notice (the face of which would refer to the Off-wing Engine only) would also be released, resulting in the purchaser becoming the owner and new lessor of the entire Original Aircraft.

The upside to Approach 2 is that it is less document-intensive than Approach 1 as the procedure is covered by the novation itself, without the need for a separate side-letter, lease and return bill of sale. The downside is that the purchaser needs to pay the full amount of the purchase price prior to delivery of the first object, although the risks arising from this can be mitigated with a well drafted refund undertaking.

**Conclusion**

Assuming that a split closing is desirable and/or necessary, the transacting parties should familiarize themselves with the risks and ramifications inherent in the process by working closely with legal and tax advisors. There are pitfalls in both methods described in this article and the parties should be sure to carefully document their intentions (irrespective of which approach they opt for) so as not to create any unintended consequences.

Ultimately, the choice of approach for conducting the closing will depend on a number of factors including, for example, the sophistication and/or cooperation of the lessee. If the lessee is defensive and uncooperative to the process (something that parties normally obtain a sense of early in the negotiation) then perhaps Approach 1 would be the better choice. If all parties are experienced in aircraft sale transactions then perhaps Approach 2 would lead to a smoother outcome.

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