TRANSPORTATION FINANCE DIGEST

A PUBLICATION OF PILLSBURY WINTHROP SHAW PITTMAN LLP

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IN THIS ISSUE:

Introducing Pillsbury's Transportation Finance Digest

Greetings! And welcome to the inaugural edition of Pillsbury's Transportation Finance Digest.

The goal of this publication is to provide our clients and the industry with probing insights into recent legal developments affecting transportation finance and leasing. It will be published at least annually.

The law is a heavy business, and we make no bones about the deeply substantive nature of this digest. We have striven here, however, as we do every day with our clients, to boil the legal principles down to their essence and to apply them to real-world, commercial situations.

In this edition, my colleague and I argue that the adoption of the Cape Town Convention has rendered lease chattel paper irrelevant. This is not reflective of any pro-debtor or pro-creditor stance; indeed, Pillsbury represents all its lessor, bank, airline and OEM clients with equal zeal. This is a pro-industry position, which advocates letting the Cape Town Convention do what is intended: simplify aircraft financing laws and make them more uniform.

The hallmark of our Transportation Finance Digest is the various case digests, contained in the right-hand column. In this issue, seven key U.S. legal decisions that affected aircraft finance, leasing and trading in 2012 have been summarized by our highly regarded team of associates.

The year 2012 was filled with achievement and recognition for our deep and widely-regarded bench. We have highlighted some of these in snippets throughout; however, we have given special prominence in two cases. Our Export Credit Q&A with Michael Schumaecker, Charlotta Otterbeck and Mara Abols looks at trends and perspectives in this space on the back of a year where Pillsbury acted for airlines, lenders and underwriters in connection with over $6 billion in U.S. export credit transactions. Our "Deal of the Year" feature highlights the ground-breaking efforts by a team of over 25 lawyers led by Pillsbury Partner Bill Bowers in order to close an 80+ engine re-securitization for long-time firm client Willis Lease.

Transportation Finance is a capital-intensive and highly fluid industry. It requires the work and cooperation of hundreds of finance, leasing, legal, insurance, technical, remarketing and other professionals across the globe to finance the world's ever-growing fleet. Pillsbury is proud to be a long-standing contributor to this process.

Thank you for reading our publication!

—Mark Lessard

pillsbury

All Hat and No Chattel:

Does Aircraft Lease Chattel Paper Still Matter After Cape Town?

By Mark Lessard and Melissa Jones-Prus

It has long been common practice for financiers to perfect security in an aircraft lease by taking possession of a single, original chattel paper counterpart of the underlying lease, in addition to recording their interests in various—and sometimes overlapping—registries. In an increasingly electronic and international legal environment for aircraft finance, most recently bolstered by the adoption and implementation of the Cape Town Convention in many key jurisdictions, the time has come to reassess the legal and practical benefits of using chattel paper in aircraft financing.

BOEING 747-8F
Creative Commons 2.0SA Boeing Dreamscape

The Uniform Commercial Code (the "UCC")[1] affords a super-priority to purchasers in the ordinary course who give new value and take possession of tangible chattel paper in good faith, without knowledge that the purchase violates the rights of a secured party.[2] In this article, we argue that the Cape Town Convention on Interests in Mobile Equipment preempts this UCC rule and that the proper registration of an assignment of associated rights (together with its related international interest) in accordance with the Convention is sufficient, as a matter of U.S. law, to protect secured creditors from the risks that parties have historically sought to mitigate through the creation and delivery of chattel paper as a means of perfecting security.

While there is no case law on point (and almost no case law involving the Convention) at this time, we believe the relevant courts should—and will—apply the well-established doctrine of pre-emption developed under the Federal Aviation Act to the Convention. The Convention by its terms overrides the otherwise applicable law (in this case the UCC) to the extent, but only to the extent, that it applies to a particular topic. Furthermore, the Convention clearly applies to and regulates the priority of interests in aircraft lease chattel paper (which interests comprise "associated rights and their related international interest", in the parlance of the Convention) because aircraft lease chattel paper is intended by definition to create an interest in an "aircraft object." Therefore, transaction parties should consider dispensing with aircraft lease chattel paper once and for all.

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Did you know that in 2012…

Pillsbury was involved in the delivery financings for more than half of all 747-8F aircraft delivered? Acting for key airline clients Atlas Air and Cargolux, and representing lenders to Korean Air and Cathay Pacific, we have the most experience of any law firm with this asset.

PILLSBURY CASE DIGEST

Title to Leased Parts Can Become Imperiled

Wells Fargo Bank Northwest, N.A. v. RPK Capital XVI, L.L.C. and RPK Capital Management, L.L.C., 360 S.W.3d 691 (Tex. App. Dallas 2012).
Digest by Michael Berens, SENIOR ASSOCIATE

A recent court decision highlights the need for lessors of major aircraft parts to take precautions to ensure that lessees do not transfer title of their leased parts to a buyer of the aircraft on which the part is installed. Under the Uniform Commercial Code (the "UCC"), lessors are generally protected by the rule that lessees of goods can transfer the leasehold interest in leased goods but not title to such goods. For every rule there is an exception and aircraft part lessors need to be mindful of the "Buyer in Ordinary Course Exception," which protects a good faith buyer of goods from a seller who routinely deals in such goods even if there is an existing perfected security interest in the goods. For aircraft part lessors, this means that a third party may in fact acquire title to leased goods that have become accessions when a good faith buyer acquires title to the whole goods to which the accessions were affixed or installed.

The facts of *Wells Fargo Bank Northwest, N.A. v. RPK Capital XVI, L.L.C. et al.* present a scenario familiar to most aircraft parts lessors. RPK Capital XVI, L.L.C. ("RPK") leased equipment, including a thrust reverser, to ATA Airlines, Inc. ("ATA"). ATA installed the leased thrust reverser onto an aircraft leased from FINOVA Capital Corporation ("FCC"). During the term of the RPK equipment lease and the FCC aircraft lease, ATA filed for bankruptcy and elected to assume the RPK equipment lease and reject the FCC aircraft lease. ATA returned the aircraft to FCC with RPK's leased thrust reverser installed on wing. Shortly thereafter, FCC sold the aircraft to a third party who conveyed title to Wells Fargo Bank Northwest, N.A. ("WFB"). Predictably, RFK sued WFB for conversion of the thrust reverser.

On appeal, the appellate court ruled that the Buyer in Ordinary Course Exception did not apply and ordered WFB to return the thrust reverser to RPK. The decision rested on the fact that FCC did not sell or lease aircraft in the ordinary course of its business. Therefore, the appellate court did not address whether the thrust reverser was an accession to the sold aircraft in this case. However, the case is useful reminder to lessors of the importance of monitoring their lessees and the specific location of valuable parts.

Q&A

Pillsbury Finance partners Michael Schumaecker and Charlotta Otterbeck discuss ECA Finance with Mara Abols, Senior Associate.

MA: The OECD Aircraft Sector Understanding, governing the use of export credit for civil aircraft, was revised in 2011. Can you remind our readers of the main changes to the export credit regime?

CO: The 2011 ASU, which came into force January 1, 2013, nearly doubles the premiums applicable to export credit agency financing. The revised ASU aims to ensure that ECA financing does not displace available private-sector financing by offering unduly competitive rates. Instead, airlines are encouraged to use ECA financing as a last resort when the private sector is unable to offer acceptable rates due to perceived risks or capacity constraints. In addition, the 2011 ASU treats all commercial aircraft alike (rather than distinguishing between large and small commercial aircraft), allows for market-based adjustments to premium rates, harmonizes the risk classification process for all borrowers, and caps the Cape Town discount on ASU premiums at 10%.

MA: The last few years have been the busiest on record for ECA financing of aircraft. Do you think that the higher premiums will reduce demand for ECA support?

MS: We have seen a rush to finance aircraft at lower premiums before the 2011 ASU became fully effective. This rush was partly responsible for the increase in ECA activity over the last year. When the 2011 ASU raised premiums, it was widely predicted that ECA volume would decline significantly in favor of operating leases and other funding sources. There are two reasons why a decline in ECA activity may not be as significant as commentators predicted.

First, while the higher fees charged by the ECAs are a factor in the airlines' financing decisions, they are only one factor in a matrix of strategic and financial choices. Even if lower cost financing is available in the private sector, an airline might choose to use higher-cost ECA financing because of its views on the right mix of owned versus leased aircraft or because ECA financing provides access to an alternative source of financing that can only be used for exports. An airline may wish to preserve its private sector borrowing capacity for other capital needs or for strategic investments.

Second, ASU commentators may have underestimated Ex-Im Bank's capacity for innovative thinking in developing new products. For example, as a result of the current attractiveness of capital markets interest rates, higher ASU premiums may be more than offset by substantially reduced capital markets pricing that is available now through an Ex-Im Bank bond. So long as the capital markets offer highly competitive pricing, the ASU premium is just the cost of admission.

MA: A number of new and interesting products have been developed for Ex-Im Bank covered debt these last few years, most notably the Ex-Im Bond and now the prefunded Ex-Im Bond. How are airlines taking advantage of these structures?

CO: Although the Ex-Im Bond is only a few years old as a product, it has matured quickly as the product of choice in Ex-Im Bank financing because there is something of value in it for everyone. The Ex-Im Bank guarantee gives airlines the ability to access an alternative source of capital—yield-based investors that were not accessible to them before. Bank lenders like the product because it means that banks can generate fee income by originating transactions that do not have to remain on their balance sheets. And, investors who were accustomed to investing in US treasuries can now obtain the same US government risk at a higher yield.

MS: A prefunded bond is essentially an interest rate play. If an airline believes that interest rates will increase prior to aircraft delivery, the airline can issue bonds at current interest rates and escrow the proceeds until delivery. Accrued interest needs to be escrowed by the airline, so there is some additional cost in selecting the prefunding route that needs to be considered. Another important factor in selecting the prefunded option is the comfort level an airline has with the manufacturer's ability to deliver the aircraft on or close to schedule.

MA: What do you see as possible changes in Ex-Im Bank financing?

MS: As mentioned, Ex-Im Bank has proven itself to be very resourceful and innovative in creating products that address the changing needs of the marketplace and we would expect that to continue. Up until now, risk management in a transaction has been essentially binary—either Ex-Im Bank takes all of the risk or the private sector takes it. Although banks take certain uncovered risk for indemnities in an Ex-Im Bank transaction, everyone—possibly including the banks—would agree that these risks are not significant. All of the material risks are assumed by Ex-Im Bank. We think that risk management will become more heavily nuanced and shared, with risks being assigned to the party best able to evaluate and price them. Risk sharing arrangements are not uncommon in other public-private financing arrangements and we think they might work very well in Ex-Im Bank financings.

CO: It is also possible that we might see some changes to the so-called "home country rule" which is under pressure from a number of vocal industry groups and airlines who have been excluded from ECA financings because of this rule. However, whether any changes might be made to this rule is a question best left to cable news political commentators rather than lawyers.

Did you know that in 2012…

Pillsbury was named Export Credit Law Firm of the Year by Trade Finance magazine and acted for airlines, lenders and underwriters in export-credit transactions aggregating over $6 billion? From fixed and floating eximbonds to structured equity participations, Pillsbury is at the forefront of export credit.

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BACKGROUND

What Is Chattel Paper?

"Chattel paper" is often referred to as a quasi-negotiable instrument, which affords its holder certain presumptive rights and priorities. It is defined by the Uniform Commercial Code as a record that evidences both a monetary obligation and a security interest in specific goods (in the case of mortgage chattel paper) or a lease of specific goods (in the case of lease chattel paper).[3] Practically speaking, it is a specially marked original copy of a security agreement or lease that contains the right to debt service, rental or other payments. The UCC does not distinguish between finance leases and operating leases for this purpose.

Why Does Chattel Paper Exist?

The rules surrounding chattel paper emerged to reflect common commercial practice when the original UCC Article 9 was conceived in the 1940s and 50s.[4] The key rule creates a super-priority for a purchaser or secured creditor in possession of tangible chattel paper.[5] Even though a sale or security interest in chattel paper can be perfected by filing a UCC-1 financing statement,[6] the UCC provides that a good faith purchaser in the ordinary course, who provides new value and has no actual knowledge[7] of a secured creditor's priority, takes the chattel paper and associated rights free and clear of the secured creditor's prior interest.

How Is Chattel Paper Used in Aircraft Finance?

Lease chattel paper is still commonly used in connection with the back-leveraging of aircraft operating and finance leases. In the typical case, a lender that is looking to a lease as additional collateral for a loan made in respect of an aircraft will require delivery to it of a single chattel paper counterpart that bears a "legend" indicating that it has been assigned to such lender as security. The secured lenders are effectively seeking to protect against the fraudulent creation and sale of the lease chattel paper (and the underlying receivable) to a good faith purchaser for value. Under the UCC, such a purchaser has priority not only in respect of monetary obligations under the lease, but also in respect of the lease itself.[8] This generally implies the right to step into the shoes of the lessor and recover possession of the leased goods in the event of a default by the lessee, but only to the extent that the goods constitute proceeds of the chattel paper.[9] In the case of an operating lease, therefore, chattel paper rights do not extend to the residual value of the goods absent an independent security interest in the goods themselves. But this is of little solace to a secured lender when the lessee has quiet enjoyment rights and the cash flow from its collateral is diverted to a subsequent purchase in good faith.

Did you know that in 2012…

Pillsbury represented indenture trustees in the American Airlines bankruptcy covering over 325 aircraft? Counseling the secured creditor on almost 1/3 of the American Airlines/American Eagle fleet has allowed us to gain a unique understanding of American's overall fleet restructuring.

PILLSBURY CASE DIGEST

It's Not Fraud If Both Parties Had Eyes Wide Open

GE Capital Aviation Services, Inc. v. Pemco World Air Service, Inc., — So. 3d —, 2012 WL 1071500, 2012 Ala. LEXIS 36, Supreme Court of Alabama, March 30, 2012. Digest by Mara Abols, SENIOR ASSOCIATE

GE Capital Aviation Services, LLC ("GECAS") and Pemco World Air Services, Inc ("Pemco") entered into negotiations in 2002 for the performance of major maintenance checks and the passenger-to-freight conversion of a number of Boeing 737 aircraft. Two of such aircraft were to be leased to TNT, the Belgian freight-delivery company.

Pemco alleged that the GECAS employee supervising the work was overly demanding, which drove up the repair costs and caused significant delays beyond those estimated by Pemco. In addition, the aircraft delivered to Pemco at the outset were in worse condition than Pemco had anticipated, which contributed to higher than anticipated maintenance and conversion costs. Pemco filed a suit for fraudulent misrepresentation, fraudulent suppression, breach of an express contract and breach of an implied contract. A three-week jury trial culminated in a December 2011 verdict in favor Pemco to the tune of $2,147,129 in compensatory damages and $6,500,000 in punitive damages.

On application for rehearing, the Supreme Court of Alabama reversed the trial court's order and directed the trial court to enter a judgment in favor of GECAS as to Pemco's fraudulent misrepresentation, fraudulent suppression and implied contract claims and to enter an order granting a new trial as to Pemco's breach of contract claim. The court noted that both corporations were sophisticated parties represented by competent counsel and that the contract adequately described the scope of Pemco's work and that there was no evidence of false representation on the part of GECAS. Furthermore, had the state of repair of the TNT aircraft at the outset been material to Pemco, the court reasoned that it could have insisted on an inspection of the aircraft prior to submitting its bid for the repair work. If a demanding employee required the maintenance provider to perform work outside the scope of the agreement, there may have been a breach of contract, but given that the claim for an implied breach was incompatible with the claim for an express breach of contract and since the jury verdict did not differentiate between the valid and invalid claims, the judgment was reversed and remanded for a new trial on the express breach claim.

Mortgage chattel paper typically is not used in the context of aircraft and other large ticket secured transactions. Where desired by the parties in these transactions, payment obligations are set forth in a promissory note. The promissory note incorporates the terms of a loan or other financing agreement by reference, which itself contains relevant terms and conditions, including restrictions on transfer. Unlike mortgage chattel paper, however, the promissory note embodies a payment obligation only and not a security interest in specific goods. As will be discussed below, the fact that chattel paper embodies an interest in specific aircraft objects is precisely the reason why we believe the Convention preempts the super-priority rule under the UCC.

What's the Problem with Lease Chattel Paper?

The main issues transaction parties have with using chattel paper is that it adds to transaction costs, is cumbersome to administer and by its very existence creates some of the risks it is trying to mitigate.

- While the cost of generating a chattel paper original bearing a security legend for a single aircraft financing may not be prohibitive, the numbers add up when multiplied over the hundreds and thousands of aircraft that are financed and re-financed every year.
- Similarly, the administrative costs to lenders of storing and tracking these quasi-negotiable instruments—and of returning them upon release of the collateral—are not immaterial when considered industry or portfolio-wide. Some lenders even appoint custodians, at a cost of several thousand dollars for the life of the transaction, for the sole purpose of holding these instruments.
- Finally, where a secured party misplaces chattel paper (something not altogether unusual in the context of long-term financings), a party coming into possession of it could cause problems; moreover, the secured party will be required to provide a lost instrument indemnity to the lessor/borrower at the end of term, so the tail on this exposure is at least theoretically indefinite.[10]

Secured lenders are not in the business of taking any legal risks with respect to their collateral and so understandably will require chattel paper where it serves its intended function. Rating agencies have also been known to require chattel paper originals in connection with rated transactions. However, the implementation of the Convention in the United States calls into question the effectiveness of chattel paper as a risk mitigant.

Did you know that in 2012…

Pillsbury acted for long-time client Ethiopian Airlines, the launch customer for the Boeing 787 in Africa, in a first-of-its-kind transaction delivery financing involving junior loans by African Development Bank? Partner Michael Schumaecker and his team had the privilege of joining the airline on the 787 maiden flight from Washington D.C. to Addis Ababa.

PILLSBURY CASE DIGEST

Corporate Veil May Not Shield Lessor's Shareholders

TradeWinds Airlines, Inc. v. Soros, Nos. 08 Civ. 5901 (JFK), 10 Civ. 8175 (JFK), 2012 WL 983575, S.D.N.Y (Mar. 22, 2012). Digest by Jessica Berenyi, ASSOCIATE

In a recent court case before the U.S. District Court for the Southern District of New York, plaintiffs TradeWinds Airlines, Inc. and related entities sought to pierce the corporate veil of an aircraft lessor, C-S Aviation, Inc., on an alter ego theory. Plaintiffs sought to hold CS-Aviation shareholders George Soros and Purnendu Chatterjee liable on a default judgment previously entered against C-S Aviation in a fraudulent inducement case in North Carolina Superior Court. The New York court denied defendants' motion to dismiss the veil-piercing claim. If this case is not settled out of court, it should ultimately proceed to trial and yield important jurisprudence on the issue of when a lessor's shareholders might be liable for the actions of a lessor. In the meantime, this case is a useful reminder of the required elements for an alter ego claim.

This is the latest of a series of ongoing and hotly contested cases between the parties arising from leases of seven A300s entered into in 1999-2000. C-S Aviation, as lessor, negotiated the leases; legal title to the aircraft, however, was vested in Wells Fargo, as trustee for the benefit of various foreign LLCs which were controlled by Soros and Chatterjee. The North Carolina court determined that CS-Aviation made false representations about the maintenance status of the aircraft and issued judgments of over $27 million against CS-Aviation, which judgments are subject to trebling under Delaware law. Plaintiffs are seeking to recover under an alter ego claim because CS-Aviation cannot satisfy the judgment.

Here, the plaintiffs alleged in part that (1) the multi-tiered structure of CS-Aviation's aircraft leasing operation was established to conceal Soros' participation in the business and to ensure that C-S Aviation was judgment-proof, (2) profits made by C-S Aviation were funneled to defendants through the trust beneficiaries, (3) C-S Aviation was at all times grossly undercapitalized and (4) those operating C-S Aviation regularly disregarded its status as a separate entity from one controlled by the defendants.

To prevail on an alter ego veil-piercing claim under Delaware law, however, a plaintiff (1) must establish that the company and its shareholder operated as a single economic entity and (2) must show an element of fraud or injustice. The issue before the court was really a technical one, as to whether the complaint was properly formulated

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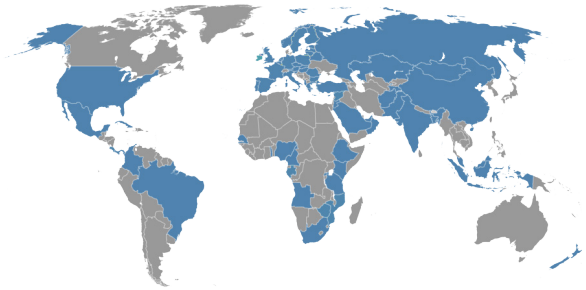
APPLICATION OF THE CAPE TOWN CONVENTION

What Is the Cape Town Convention?

The Cape Town Convention on Interests in Mobile Equipment ("CTC") is an international treaty designed to facilitate the efficient financing and leasing of mobile equipment. The CTC applies to airframes, aircraft engines and helicopters ("aircraft objects") by virtue of the Aircraft Protocol (together with the CTC, the "Convention"). The Convention by its terms overrides the otherwise applicable law (including the UCC) to the extent, but only to the extent, that it applies to a particular topic.[11]



Does the Cape Town Convention Cover Chattel Paper?

The Convention does not employ the legal nomenclature of any particular legal system and therefore does not specifically mention chattel paper. Rather, it creates a jurisdictionally neutral legal regime centered on "international interests" and "associated rights."

- International interests are essentially interests granted by the chargor under a security agreement, or vested in a person who is the conditional seller under a title reservation agreement or a lessor under a leasing agreement.
- Associated rights are essentially rights to payment or other performance by a debtor under an agreement, which rights are secured by or associated with the object. Purely personal contractual rights not secured by an aircraft object are outside the scope of the Convention.

Under the Convention, a security assignment of associated rights (i.e., of rights to receive rentals under a lease) transfers the related international interest (i.e., grants security in the lessor's legal interest under the related lease) so long as the security instrument (1) is in writing, (2) enables the associated rights to be identified and (3) enables the obligations secured to be identified.[12]

Importantly, the Convention does not apply to an assignment of associated rights which is not effective to transfer the related international interest.[13] In the case of a lease, then, the Convention does not apply to an assignment of payment intangibles separate and apart from an assignment of lessor's interest under the lease. Nor does it apply to a pure receivables financing or repackaging, even if the receivables constitute aircraft lease or loan income. This is because the Convention regulates only the priority of interests in aircraft objects and associated rights that bear a sufficient connection to the underlying aircraft object.

Did you know that in 2012…

Pillsbury Transportation Finance team leader Mark Lessard was appointed as a member of the esteemed Legal Advisory Panel for the Aviation Working Group? He continues the work of long-time Pillsbury partner Payson Coleman in advancing the international regime for aviation finance.

[continued]

to state a plausible claim for relief under this alter ego theory. The court found the plaintiffs had sufficiently met their burden of pleading and thus denied the defendants' motion to dismiss.

In doing so, the court rejected the argument by the plaintiff that the existence of the multi-tiered ownership structure was in and of itself legally sufficient to make a claim for fraud. The court highlighted, however, that plaintiffs "are not required to show that they were defrauded in order to state a veil-piercing claim under Delaware law. Plaintiffs need only show an element of injustice distinct from the underlying wrong which gave rise to the cause of action against C-S Aviation." The allegation in the complaint that defendants siphoned funds from CS-Aviation and thus left it improperly capitalized was sufficient to meet the burden of pleading injustice.

PILLSBURY CASE DIGEST

Choose Legal Forum Wisely to Stay Out of Foreign Courts

Best Aviation Ltd., v. Ronni Chowdry; and Atlas Aviation, LLC. Nos. 2:12-cv-05852-ODW(VBKx), 2:12-cv-05853-ODW(VBKx), 2012 WL 5457439 (C.D.Cal. Nov. 7, 2012). Digest by Melissa Jones-Prus, ASSOCIATE

On November 8, 2012, the U.S. District Court for the Central District of California dismissed an action brought by Bangladeshi corporation Best Aviation Ltd. against the Washington D.C. LLC Atlas Aviation for failure to state a claim on the grounds of forum non conveniens.

The parties entered into a letter of intent for the lease of three aircraft located in China by defendants (no relation to Atlas Air) to Best Aviation. This letter of intent stated that California was the appropriate jurisdiction for legal disputes, but was subsequently rescinded in favor a new arrangement for the lease of a different set of aircraft located in Spain. However, that lease was never signed. Best alleged that it made deposits of $2,500,000 under this new, undocumented arrangement that were never fully returned or accounted for.

The court found that California law did not govern, even though the initial letter of intent identified California as the forum for dispute settlement, because the lease agreement was not executed and there was no valid choice of law clause. The court further found that Bangladesh was an adequate alternative forum. This case is a reminder to purchasers of aircraft to always include appropriate choice of law clauses and to always have a signed, binding agreement before transferring funds.

Unlike the transfer of general payment intangibles or promissory notes, the delivery of "aircraft object" chattel paper is a legal act that purports to transfer associated rights for the aircraft object and their related international interest. Such legal act is governed by the Convention and the Convention's rules governing the priority of competing interests in associated rights should preempt the super-priority rule applying to chattel paper under the UCC.

What Is the Preemption Doctrine?

Article 9-109(c) of the UCC expressly provides that UCC Article 9 does not apply to the extent that a statute, treaty or regulation of the United States preempts its provisions. While there is no case law on point involving the Convention at this time, there is a well-developed string of jurisprudence involving the Federal Aviation Act (the "Act")[14] that should give precedence to the priority rules set forth in the Convention where they apply and conflict with the UCC.

The seminal case on preemption is the Supreme Court case of *Philko Aviation, Inc. v. Shacket*,[15] which held that all state laws (including the UCC) permitting unrecorded transfers to effect the interests of third parties in aircraft conflict with, and are preempted by, the Act.

> [Section] § 503(c) [of the Act] means that every aircraft transfer must be evidenced by an instrument, and every such instrument must be recorded, before the rights of innocent third parties can be affected. Furthermore, because of these federal requirements, state laws permitting undocumented or unrecorded transfers are preempted, for there is a direct conflict between § 503(c) and such state laws, and the federal law must prevail.[16]

In coming to its decision, the Court relied on the legislative history of the Act, in particular Congress' intention to create a "central clearing house" for recordation of title and other interests in aircraft. The Court noted that if state laws permitting a valid transfer to be effected without recording with the FAA were not preempted by the federal law, then there would be no need or incentive for a buyer in possession to record its interest with the FAA.[17] Subsequent cases have affirmed the approach in Philko.[18]

Did you know that in 2012…

Pillsbury was present in virtually every US airline EETC transaction, having represented liquidity providers in each of those transactions? Partner Bill Bowers was involved in one of the first ever EETC transactions, closed in 1994 for Northwest Airlines.

PILLSBURY TRANSPORTATION FINANCE | DEAL OF THE YEAR

Innovative Structure Solves Multiple Issues in Engine Re-Securitization

William C. Bowers, PARTNER

During 2012, we assisted our long-time client Willis Lease Finance Corporation ("Willis") in the refinancing of $436 million of notes issued by its subsidiary Willis Engine Securitization Trust ("Old WEST") from 2005 to 2008. Willis is a major independent lessor of aircraft engines, owning a portfolio of more than 200 engines with a value in excess of $1 billion, 113 of which were held by Old WEST.

As part of the refinancing, Willis wished to replace one of the rating agencies that had rated the Old WEST notes with a new agency, which insisted on the creation of a new special purpose subsidiary, Willis Engine Trust Securitization II ("New WEST"), as the issuer of the refinancing notes. The refinancing was funded in part with $390 million of notes issued by New WEST, which acquired a portfolio of 79 engines from both Old WEST and Willis, and in part with cash held by Old WEST. The remaining engines in Old WEST were transferred to Willis.

The transaction presented two difficult issues, both of which we were able to solve with an innovative structure. First, in order for substantially all of the proceeds of the New WEST notes to be available to repay the Old WEST notes at closing, New WEST needed to acquire substantially all of the 79 engines in its initial portfolio from Old WEST and Willis at or before the closing. Second, the cash held by Old WEST was restricted and couldn't be used to redeem the Od WEST notes as it could be released only after the Old WEST notes had been redeemed.

The engines owned by Old WEST and Willis couldn't be transferred to New WEST in advance of closing as they had to continue to serve as collateral for the Old WEST notes and the Willis corporate debt facility. To complicate matters, all 79 engines had to be transferred by their old owners, Utah common law trusts owned by Old WEST or Willis, to new Connecticut common law trusts. We solved this by having newly formed Delaware limited liability companies owned by WEST and Willis form the new trusts, which acquired 66 of the 79 engines and the related leases by closing, when the two limited liability companies were transferred to New WEST.

To bridge the shortfall in funding until the Old WEST notes could be redeemed and the restricted cash freed up, we negotiated and documented a "daylight loan" (i.e., funds advanced at the beginning of the closing and repaid at the end of the closing on the same day) from Crédit Agricole – Corporate and Investment Bank. Given the blanket lien over Willis' assets under its corporate debt facility, we also needed to negotiate significant amendments and consents under that facility. Once the Old WEST notes were redeemed in full, we liquidated Old WEST, making the cash and the remaining engines available to Willis.

The transaction involved a team of more than 25 lawyers in New York and San Francisco who handled the transfers of the engines and their leases and the documentation of the daylight loan, the debt facility amendments and the issuance and sale of the notes in a Rule 144A offering.

Do the Priority Rules Under the Convention Preempt State Law?

In order for the preemption doctrine to apply in this case, the Convention must specifically address and conflict with the super-priority rule set out at 9-330 of the UCC. In other words, the Convention must govern the priority of interests in "aircraft object" chattel paper.

We strongly believe that chattel paper created in respect of an "aircraft object" creates an interest in that "aircraft object" and is therefore governed by the Convention. We have explained how the delivery of such chattel paper constitutes an assignment of an international interest and associated rights under the Convention where all of the Convention's formalities have been respected. We will now examine the general priority rule under the Convention, and how it applies to associated rights.

How Does the Convention Establish Priority?

Unlike the Act, which does not address the priority of interests in aircraft but leaves it to state law to determine, one of the Convention's main purposes is to establish an international system for regulating the priority of interests in aircraft objects. Article 29 of the Convention sets out the main thrust of the Convention on priority: the "first in time" rule. It states that a registered interest has priority over any other interest subsequently registered and over an unregistered interest.[19] This priority applies even if the first-registered interest is acquired with actual knowledge of another interest. There can be exceptions to this priority rule resulting from the creation of "non-consensual" interests under applicable national law, such as mechanic's liens or other rights of detention,[20] but the UCC chattel paper super-priority rule relates only to the consensual interests and cannot be saved by this exception.

How Does the Convention Resolve Competing Interests in Associated Rights?

The priority of competing assignments is addressed in Articles 35 and 36 of the Convention. They provide that the "first in time" priority rule of Article 29 applies to an assignment of associated rights that is coupled with an assignment of the related international interest where there is a sufficient connection between the associated rights and the aircraft object. The key to our argument in this article is that aircraft lease chattel paper (1) creates an international interest in an aircraft object and (2) constitutes associated rights that are "object-related," in the parlance of the Convention. Accordingly, any transfer or pledge of aircraft lease chattel paper necessarily constitutes an assignment of an international interest coupled with associated rights that is registrable under the Convention, so long as the formalities of the Convention are met.[21]

Because the Convention is specifically designed to impact only the priority of interests in aircraft objects, Article 36 strictly limits the ability of an assignee of associated rights to claim the priority afforded by the

PILLSBURY CASE DIGEST

No Coverage for Intentional Damage by Insured

Highland Capital Management, L.P. v. Global Aerospace Underwriting Managers Ltd. 2012 U.S. App. LEXIS 13421 1, No. 11-3318-cv (2d Cir. 2012).
Digest by Paul Sass, ASSOCIATE

This Second Circuit decision from July 2, 2012, affirmed the district court's ruling that parties named as additional insureds under a Hull Insurance policy could not recover for physical damage that resulted from intentional misconduct by the named insured. In this case, Tower Air, Inc. ("Tower"), a now defunct airline, leased an aircraft from Fleet Business Credit, L.L.C. ("Fleet"), and financed the aircraft with a loan from Highland Capital Management, L.P. ("Highland"), which was secured by the aircraft. As its fortunes decreased, Tower began to take parts from the aircraft, which was grounded, and "cannibalize" them, that is, use them to maintain other aircraft that were not grounded. Fleet and Highland sued the insurer, claiming that the losses they incurred as a result of Tower's conduct were covered under the policy. The court found that, because these losses were not accidental, but rather were caused by the intentional misconduct of Tower, they were not covered under the policy. Further, because the policy specifically stated that for the purposes of this type of damage each of the insureds should be treated jointly rather than separately, the insurer had no liability.

Did you know that in 2012…

Four of Pillsbury's Transportation Finance partners were named leading lawyers in the Aviation-Finance category of the prestigious *Chambers USA* guide?

Convention to those associated rights that are "object-related," i.e., that bear a sufficient connection to the underlying aircraft object.[22] More specifically, an assignment of associated rights will benefit from the "first in time" priority rule where:

1. The contract under which the associated rights arise states that they are secured by (in the case of a mortgage) or associated with (in the case of a lease) the aircraft object; and
2. The associated rights are "object-related," i.e., they consist of rights to payment or performance that relate to, among other items, the price payable for the aircraft object or the rentals payable in respect of the aircraft object (together with all ancillary obligations).

Meeting these requirements contained in Article 36 should bring the priority rules of the Convention to bear and preempt the UCC super-priority rule on chattel paper. And they are not that difficult to meet in the case of lease chattel paper.

- The requirement in (b) above should automatically be met in the standard case of aircraft lease chattel paper, because—once again—lease chattel paper by definition relates to the rentals payable in respect of the aircraft.
- However, the requirement in (a) above appears to require that parties include specific wording in their chattel paper lease in order to "opt in" to the priority rules of the Convention. This may seem like a formalistic requirement,[23] but it should be followed, as it will determine whether the priority rules of the Convention or the national law apply to object-related associated rights.

CONCLUSION

The Convention addresses the perfection and priority of competing interests in associated rights (and their related international interests) to the extent that (1) the contract under which the associated rights arise states that they are secured by or associated with the relevant aircraft object and (2) the associated rights are object-related. Assuming that the relevant connecting factors are present and that the requirements of the Convention are met, including the proper registration of an international interest and assignment thereof at the international registry, a pledgee of aircraft lease chattel paper derives no additional benefit from holding the chattel paper. In fact, such a secured party would be well advised to not rely on its possession of tangible chattel paper to ensure the priority of its interest and to register an assignment of international interest (covering the assignment of associated rights) with the international registry established under the Convention.

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PILLSBURY CASE DIGEST

Once You Take it Back, It's Yours As-Is

Wells Fargo Bank Northwest, N.A. v. US Airways, Inc., 2012 NY Slip Op 05949. Digest by Maria Cho, ASSOCIATE

US Airways sold three Boeing 737-3G7 aircraft to Wells Fargo, as trustee, as part of a sale-leaseback transaction. Each aircraft had a maximum takeoff weight (MTOW) of 124,000 pounds but, at the time of the sale, US Airways was operating them at an increased MTOW of 138,500 pounds pursuant to a non-transferrable agreement with Boeing. The leases specified that upon redelivery, the MTOW will be "as at delivery and will be freely transferrable."

After termination of the leases, the aircraft were redelivered to Wells Fargo with an MTOW of 124,000. Unaware that the aircraft had been operated at an increased MTOW during the lease term, Wells Fargo accepted redelivery and signed the redelivery certificates without noting any discrepancies in the MTOW.

After becoming aware of the discrepancies months after redelivery, Wells Fargo brought a breach of contract claim against US Airways. Although a lower court granted Wells Fargo's motion for summary judgment, the New York Appellate Court, First Department, reversed. It found instead that by executing the redelivery certificates, Wells Fargo had effectively waived any claim that the aircraft were not in compliance with the redelivery conditions specified in the leases. As such, the First Department found that Wells Fargo was precluded from belatedly claiming a breach of the terminated leases. This is a helpful reminder to lessors to exercise caution in conducting redelivery inspections and executing redelivery certificates.

Did you know that in 2012…

Pillsbury senior associate Michael Berens was named a rising star in the *Airfinance Journal*'s annual Guide to Aviation Lawyers?

NOTES

1. *All references to the New York Uniform Commercial Code as in effect on January 1, 2013.*
2. *UCC 9-330.*
3. *UCC 9-102(a)(11).*
4. *Electronic Chattel Paper: Invitation Accepted, 46, Gonz. L. Rev. 407 (2010-2011) at 412. At the time, commercial lenders and financing agencies typically purchased or perfected security in loan and lease receivables by taking possession of the underlying loan or lease agreement. This practice fell short of creating a "negotiable instrument," such as a promissory note, which provides the holder (or bearer) of the paper with an ownership interest in the rights described therein. In order to preserve the chattel paper financing market, the drafters created a lower evidential threshold for chattel paper financiers to meet.*
5. *UCC 9-330.*
6. *UCC 9-312.*
7. *It is important to emphasize that under UCC 9-330, the good faith purchaser in possession takes chattel paper free and clear of registered interests unless it has actual knowledge of that registered interest. UCC rule 9-330 does not impute knowledge or create a duty to search any registry or make any inquiry, whether or not such a search or inquiry would be prudent or otherwise commercially reasonable. Therefore, the existence of a public registration made in accordance with the Convention would not by itself, in the application of UCC 9-330, alter the outcome.*
8. *UCC 9-330(c)(2), Official Commentary No. 9.*
9. *UCC 9-330(c), Official Commentary No. 11. Any lender exercising remedies in this case would only be entitled to recover the discounted present value of the right to use the aircraft during the term of the lease, with an obligation to account to the owner of the equipment or the party with a separate security interest in the equipment, as applicable.*
10. *In 1999, the UCC was revised to contemplate a system for electronic chattel paper. 13 years later, the markets have yet to adopt a common platform and market practice surrounding electronic chattel paper. Electronic Chattel Paper: Invitation Accepted, 46, Gonz. L. Rev. 407 (2010-2011)*
11. *See Sir Roy Goode, Official Commentary (Unidroit rev. ed. 2008) at paragraphs 2.7 and 2.15.*
12. *Article 31(1) and Article 32(1) of the Convention.*
13. *Article 32(2) of the Convention.*
14. *49 U.S.C.*
15. *462 U.S. 406, 103 S.Ct. 2476, 76 L.Ed.2d 678 (1983). The facts of this case are as follows: A corporation operated by Roger Smith sold a plane to the Shackets. The Shackets paid the sale price and took possession of the plane. Smith gave the Shackets only photocopies of the original bills of sale reflecting the chain of title to the plane, and assured them that he would take care of the paperwork, which the Shackets understood to include the FAA registrations. Smith did not file the title documents with the FAA, but purported to sell the same plane to Philko Aviation and provided Philko Aviation with the original title documents. Philko Aviation subsequently recorded the original title documents with the FAA. After the fraud became apparent, the Shackets filed a declaratory judgment action to determine title to the plane. The Supreme Court found in favor of Philko Aviation and clearly stated that the recordation of an interest with the FAA is required for perfection of a security interest and that the failure to register the interest with the FAA invalidates the conveyance as to innocent third parties.*
16. *Ibid. at para. 8.*
17. *In a typical US law financing, financiers will still file a UCC-1 financing statement because it is not clear to what extent the definition of "aircraft" in the Act preempts interests in related items, such as spare parts, engines, records and proceeds. While it could be beneficial to further limit the number of overlapping security filings, the issue has not been clarified in the courts probably due to the diligence of financing parties in filing with the UCC.*
18. *See Aircraft Trading and Services, Inc. v. Braniff, Inc. 819 F.2d 1227, 1987 U.S. App. LEXIS 6730, 3 U.C.C. Rep. Serv. 2d (Callaghan) 1297; see also In re: Air Vermont, Inc. and North Atlantic Airlines, Inc.; Comair, Inc. v. Air Vermont, Inc. 45 B.R. 820; 1984 U.S. Dist. LEXIS 21660; 39 U.C.C. Rep. Serv. (Callaghan) 1452; see also Southern Air Transport, Inc. v. Northwings Accessories Corp. 255 B.R. 715; 2000 Bankr. LEXIS 1422; see also Triad International Maintenance Corp. v. Southern Air Transport, Inc. 2005 U.S. Dist. LEXIS 33691; see also In re: AE Liquidation, Inc. v. Eclipse Aerospace, Inc. 44 B.R. 509; 2011 Bankr. LEXIS 599; 54 Bankr. LEXIS 599; 54 Bankr. Ct. Dec. 105.*
19. *Article 29(1) of the Convention. See also Goode, at paragraph 2.103. In particular, a registered international interest has priority over (a) a domestic interest which is neither registered under the Convention (either because it is of a kind not capable of registration or is given by a debtor not situated in a Contracting State at the time of the agreement and it does not relate to an airframe or helicopter registered in a Contracting State—see Goode, paragraphs 2.18(s)—2.20) nor covered by a declaration under Article 39 and (b) a national interest notice of which is not so registered.*
20. *See Goode, at paragraph 2.114.*
21. *As discussed above, this is not the case for a promissory note, which does not create an interest in an aircraft object.*
22. *Article 36(1) and (2) of the Convention.*
23. *See Goode, at paragraph 2.143. "This is to deal with the situation where, for example, an agreement secures not only the obligations for which it provides but obligations arising under a later agreement and the later agreement does not refer to the security, so that a subsequent assignee of the associated rights under the later agreement has no way of knowing that the obligations under the later agreement are secured on or in any way connected with the equipment and ought not, therefore, to be subject to the Convention priority rules."*

PILLSBURY CASE DIGEST

Liquidated Damages Can Be Construed as Unreasonable Penalty

GC Air, LLC v. Rancharrah Management, LLC, et al., No. 3:11-cv-00647-RCJ-VPC (U.S.D.C.N. Dec. 3, 2012). Digest by Jenny Arvidsson STAFF ATTORNEY

In this case before the U.S District Court of Nevada, plaintiff, GC Air, LLC ("GC Air"), leased an aircraft to Rancharrah Management, LLC ("Rancharrah") in 2005 under a lease governed by Connecticut law. In 2011, Rancharrah defaulted on the lease by failing to pay rent and other amounts due. Subsequently, Rancharrah entered into a voluntary surrender agreement and returned the aircraft to GC Air. The aircraft was sold by GC Air for $925,000.

GC Air sought a summary judgment awarding contractual liquidated damages in the amount of $2,357,708.33, which was the stipulated loss value for the aircraft at the date of breach. The terms of the lease in fact allowed GC Air to claim such liquidated damages. Rancharrah argued that the liquidated damages clause constituted a penalty, as it required the lessee to pay the full value of the aircraft in the event of default, without receiving any credit for previous lease payments already made or the mitigation value of the returned aircraft.

The court granted GC Air summary judgment on the issue of liability, but denied it on the issue of damages and remanded the case for a hearing on actual damages suffered by GC Air. In doing so, the court found that the liquidated damages clause was indeed a penalty because it shifted the risk of any depreciation in value in the asset to the lessee in the event of a default, while the lessor retained all upside opportunity in connection with a sale of the aircraft. As such, the damages were unreasonable and constituted an unenforceable penalty.