

Structuring Aircraft Financing Transactions

PRACTICAL LAW FINANCE WITH RICHARD FUREY, HOLLAND & KNIGHT LLP, BASED ON AN ORIGINAL ARTICLE BY MARA ABOLS, DARCY BINDER, JAMES HAYDEN AND CHRISTIAN HANSEN OF WHITE & CASE LLP

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This Note discusses the structures typically used in aircraft financing transactions including secured loans, sale leasebacks, finance leases, Japanese operating leases, enhanced equipment trust certificates, and export credit agency transactions. This Note also discusses the advantages and disadvantages of these structures and the factors that may cause an airline to consider one structure over another.

The purchase and operation of aircraft and related assets by an airline, aircraft lessor or other entity may be financed using many different structures. This Note discusses the most common aircraft financing structures. For an introduction to aircraft financing generally, see Practice Note, Aircraft Financing Overview (US).

Aircraft finance transactions are based principally on one or a combination of three basic structural concepts:

- A secured loan whereby a borrower incurs from a bank or other financial institution a loan secured by a mortgage over the aircraft.
- The ownership and lease of the asset (involving either an operating lease or a finance lease).
- A capital markets transaction whereby an entity issues bonds or notes secured by a mortgage on the aircraft.

Many transaction structures combine more than one of these concepts.

COMMERCIAL BANK FINANCE SECURED LOANS

In a basic secured loan structure, a lender makes a loan to an airline or leasing company to purchase an aircraft from a manufacturer (if new) or seller (if used). The loan is secured by a mortgage or other

security interest over the aircraft. The airline or leasing company owns the aircraft from the outset. The airline or leasing company may operate the aircraft or lease it to another party.

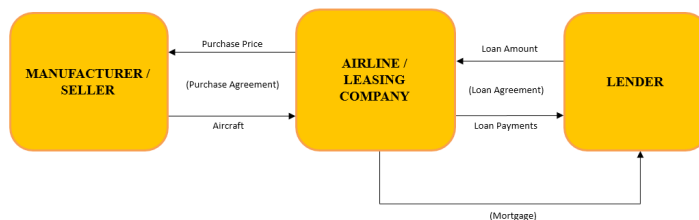
Disadvantages of the Secured Loan Structure

This structure raises several issues that may make it an unattractive option for some airlines. These issues include:

- The loan is a balance sheet transaction and is full recourse to the airline or the leasing company.
- The loan documents include typical events of default and other provisions customary to secured loan transactions which may unduly restrict the leasing company's or the airline's ability to operate its business. For a discussion of some of these restrictions, see Practice Note, Loan Agreement: Negative Covenants (5-383-3077) and Standard Clause, Loan Agreement: Negative Covenants (7-383-5792).
- The leasing company or airline may not be investment grade, resulting in a more expensive loan.
- The airline or leasing company may not be able to incur the amounts needed to purchase the aircraft under the terms of its existing loan documents. Loan agreements typically include provisions that restrict the amount of debt a company can incur or financial covenants that would be breached if additional loans are incurred (see Standard Clause, Loan Agreement: Limitation on Debt Negative Covenant (1-501-7207)).

Secured Loan Structure

A diagram of a typical secured loan structure used in aircraft financing is set out below:



LEASING STRUCTURES

There are many leasing structures that may be used to finance aircraft, including:

- Operating leases (see Operating or True Lease).
- Finance leases (see Finance or Capital Lease).
- Leveraged leases (see Leveraged Leases).
- Japanese operating leases (see Japanese Operating Leases (JOLs)).
- Sale and leaseback transactions (see Sale Leaseback).

While there are many differences among these leasing structures, they have many characteristics in common. These include:

- The airline or leasing company does not own the aircraft.
- At the end of the lease term, the airline or leasing company returns the aircraft to the lessor (although in certain structures the leasing company has the right to purchase the aircraft).

OPERATING OR TRUE LEASE

In an operating or true lease structure, an owner or lessor:

- Acquires or owns aircraft that it leases to an airline or other lessee.
- Retains substantially all the risks and rewards incident to the ownership of the aircraft.
- Regains possession of the aircraft at the end of the lease term.
- Re-leases or sells the aircraft once it is returned by the previous lessee.

The owner or lessor is frequently an owner trust owned by an equity investor, a leasing company or other airline. For more information on these parties, see Practice Note, Aircraft Financing (US): Overview: Leasing Companies or Operating Lessors and Owner Trusts and Owner Trustees.

Types of Operating Leases

There are two types of operating leases:

- A “dry lease” in which the owner or lessor only provides the aircraft and the lessee is responsible for operating, maintaining, insuring, and providing a crew for the aircraft. This is typically the case where the owner or lessor is an owner trust and neither it nor the equity investor is in the business of (or has any interest in) operating aircraft.
- A “wet lease” in which the owner or lessor:
 - retains operational control of the aircraft;
 - operates flights for the airline;
 - maintains and insures the aircraft; and
 - provides a crew for the flights.

The costs of providing these services are paid by the lessee under the lease. A wet lease is typically used when the owner or lessor is an airline or a leasing company that has some expertise operating aircraft.

Whether a lease is a dry lease or a wet lease has different implications for purposes of Federal Aviation Regulations (FARs) (14 C.F.R. §119.53) and the Internal Revenue Code. For example, rent payable under a wet lease may be subject to US federal excise tax

because a wet lease is generally classified as a transportation service agreement for US federal income tax purposes (26 U.S. C. § 4261 or 26 U.S.C. § 4271).

Advantages of Operating Leases

The advantages of the operating lease structure to an airline or other lessee include giving lessees greater flexibility in managing their fleet because they can contract for increased capacity only as and when needed. Until recently, lessees were not required to record these leases on their balance sheets. However, to address concerns that this approach did not always provide an accurate reflection of an entity's leasing transactions (or its liabilities), lessees are required starting in 2018 to:

- Recognize a right-of-use for the leased asset and a lease liability on their balance sheet.
- Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis.
- Classify all cash payments as operating activities in the statement of cash flows.

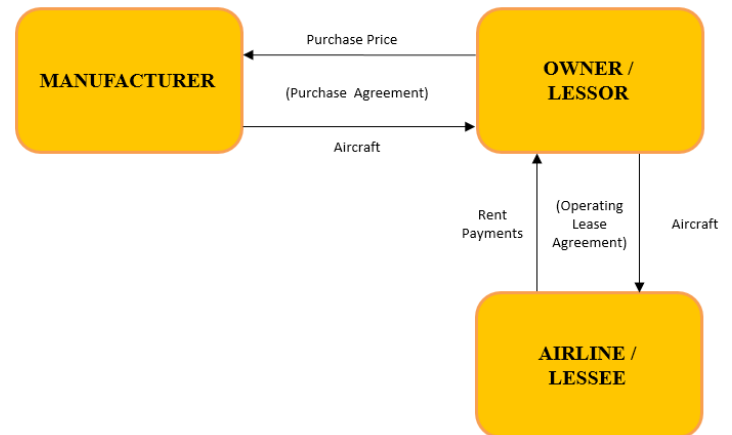
For more information on operating leases, see Article, New FASB Accounting Standard for Operating Leases ([W-012-8240](#)).

Disadvantages of Operating Leases

While operating leases enable airlines to manage their fleets, this can be a more expensive structure relative to other forms of financing. For example, in wet leases, the owner's or lessor's costs of providing all the services are passed to the airline lessee in the form of higher lease payments.

Operating Lease Structure

A diagram of a typical operating lease structure is set out below:



For more information on operating leases, see Practice Notes:

- Equipment Lease: Types of Leases: Operating Lease ([7-508-7749](#)).
- Equipment Lease: Categorization of Common Equipment Leases Under the UCC: Operating Lease ([9-519-6257](#)).
- Financial Reporting in the US: Key Topics for Corporate Counsel ([7-523-9535](#)).

FINANCE OR CAPITAL LEASE

In a finance or capital lease structure, an owner or lessor:

- Buys an aircraft from a manufacturer which it leases to an airline or other lessee.
- Provides the aircraft's purchase price.
- Structures the lease so that:
 - rent payments return all or substantially all of the purchase price; and
 - the lessee is required (or at least expected) to purchase aircraft at the end of the term.

The owner or lessor in these transactions is typically an owner trust established by an equity investor and through which it makes the investment needed to acquire the aircraft. For more information on owner trusts and owner trustees, see Practice Note, Aircraft Financing (US): Overview: Owner Trusts and Owner Trustees.

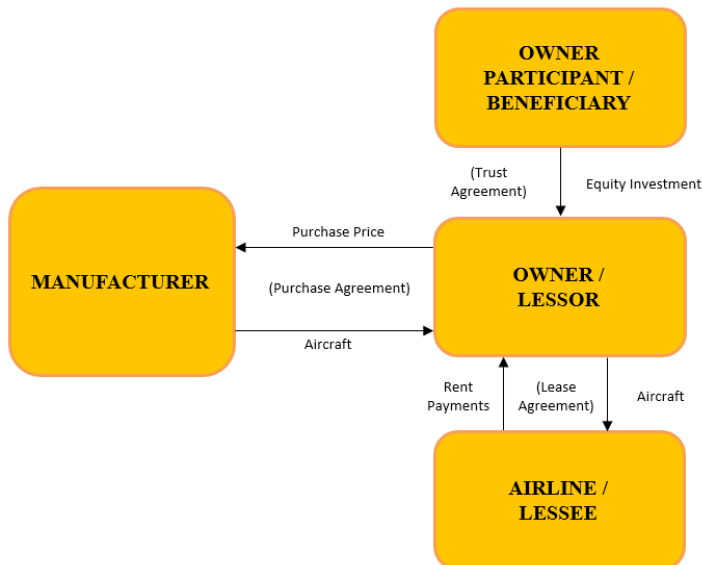
Advantages of Finance Leases

In these transactions:

- The risks and rewards incident to the ownership of the aircraft are transferred to the airline or lessee.
- The lessee has either a right or an obligation to purchase the aircraft at the end of the lease term.
- The equity investor (the owner participant) earns a return on its investment (see Practice Note, Aircraft Financing (US): Overview: Owner Participants).

Finance Lease Structure

A diagram of a typical aircraft finance lease is set out below:



For more information on finance leases, see Practice Note, Equipment Lease: Types of Leases: Capital Lease (7-508-7749) and Equipment Lease: Categorization of Common Equipment Leases Under the UCC: UCC Finance Lease (9-519-6257).

LEVERAGED LEASES

A leveraged lease is similar to a finance lease except that in these transactions, lenders provide the owner or lessor (typically an owner trust owned by equity investors, also known as owner participants) with loans to cover a portion (typically 70% to 85%) of the acquisition cost of the aircraft being purchased from the manufacturer. The balance of the aircraft's acquisition cost is provided by the owner participants. The owner trustee uses the lease payments it receives to repay the loans.

The obligations of the owner or the lessor under the loan agreement are secured by:

- A first priority lien on the aircraft and related assets.
- Its rights to receive payment from the lessee under the lease.

For more information on creating, attaching, and perfecting a security interest in aircraft, see Practice Notes, Aircraft Financing: US and International Laws, Regulations and Registration Requirements (W-001-6310) and Security Interests: Aircraft, Vessels and Rolling Stock (2-519-3295).

Advantages of Leveraged Leases

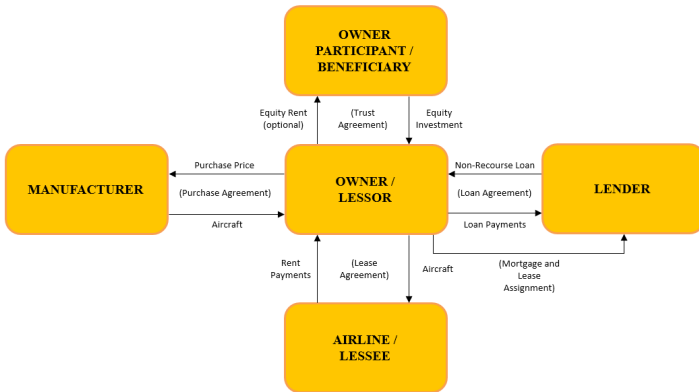
In a typical aircraft leveraged lease:

- The equity investor (also known as the owner participant), as the beneficial owner of the aircraft, can claim all of the tax benefits associated with ownership of the asset.
- The loan is non-recourse to the owner trust and owner participant. These parties are, therefore, not responsible for a shortfall in loan payments if the lessee defaults on its lease payments. The lender can only look to the aircraft and related collateral for repayment. Ensuring that the lenders' interest in the collateral are properly attached and perfected is critical part of deal planning (see Practice Note, Security Interests: Aircraft, Vessels and Rolling Stock (2-519-3295)).
- The owner participant retains 100% of the asset's residual value, while providing only a portion of the aircraft's acquisition cost.
- The airline or lessee can claim the full amount of lease payment as expenses.
- The lenders have a security interest in the aircraft and in the equity interests of the owner participant. In the case of a default, the lenders can step-in and foreclose on the aircraft or exercise its rights under the share pledge agreement and foreclose on the owner equity interests and remove the owner participant from the transaction while keeping the lease in place (this is known as an equity squeeze).
- Once the loan is repaid, the owner trustee owns the aircraft for the benefit of the equity investors free and clear of any debt, liens, or encumbrances.

While historically the leveraged lease structure was a common way to finance aircraft purchases, it has become less popular in recent years, especially in the US since the 2000s following certain tax law changes as well as a long period of low interest rates. Equity contributions are now more likely to be made by orphan trusts (see Practice Note, Aircraft Financing (US): Overview: Orphan SPVs).

Leveraged Lease Structure

A diagram of a leveraged lease structure is set out below:



For more information on leveraged leases, see Practice Note, Equipment Lease: Types of Leases: Leveraged Lease (7-508-7749) and Equipment Lease: Categorization of Common Equipment Leases Under the UCC: Leveraged Lease (9-519-6257).

JAPANESE OPERATING LEASES (JOLS)

A JOL is an operating lease fully or partly funded by a Japanese investor or equity sourced from Japan. In a JOL:

- A special purpose owner or lessor purchases an aircraft either from a manufacturer (typically by way of an assignment of a purchase contract) or an airline.
- The owner or lessor leases the aircraft to an airline or lessee.
- The owner or lessor obtains the funds to purchase the aircraft in part from:
 - commercial lenders or export credit agencies (ECAs).
 - investors in the capital markets (typically 70% to 80% of the purchase price); and
 - equity investors (typically 20% to 30% of the purchase price) under “tokumei kumiai” or “nin’i kumiai” agreements. “Tokumei kumiai” and “Nin-i kumiai” refer to two different types of associations. The former is a contractual arrangement under Japan’s Commercial Code pursuant to which participants provide capital to a business to be carried on by the company managing the “tokumei kumiai” on its own account and the latter is an entity resembling a “general partnership” formed under Japan’s Civil Code. For more information on these associations, see Country Q&A, Joint Ventures in Japan: Overview (5-617-3006).

Advantages of a JOL

- If the lease from the owner or lessor to the airline is considered an operating lease for Japanese tax purposes (which requires that the owner or lessor take at least some residual value risk):
- The owner or lessor can claim depreciation allowances on its cost of purchasing the aircraft and deduct various expenses incurred in connection with the acquisition of the aircraft. As a result, it typically generates losses for the first six to seven years following the acquisition.

- The equity investors can claim their proportionate share of these losses to set off against income and, as a result, get the benefit of tax deferrals (until the time the owner or lessor begins to generate profits). A portion of the benefit of these tax deferrals can be passed on to the airline or lessee in the form of:
 - lower lease rentals;
 - a higher purchase prices; or
 - a combination of the two.

Types of JOLs

There are two types of JOLs:

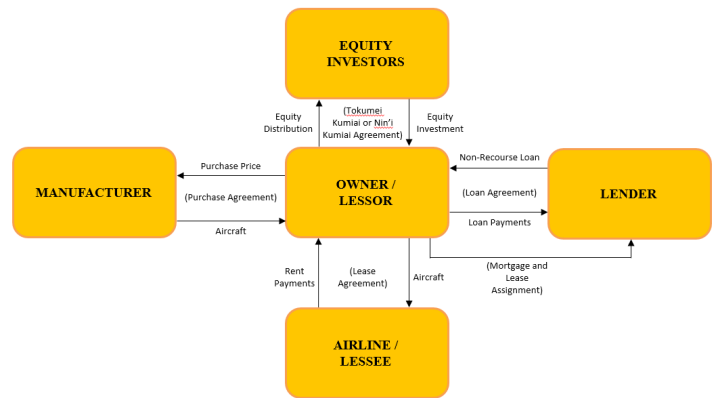
- A straightforward lease structure.
- JOLs with call options (JOLCOs). In a JOLCO, the lease agreement qualifies as an operating lease for Japanese tax purposes but contains strong incentives (such as restrictive return conditions) for the airline or lessee to purchase the aircraft at either the expiry of the lease term or at a specified early buy-out date.

There are some disadvantages associated with the JOLCO structure. These include:

- It is a long-term commitment (typically about 10 years’ duration).
- The structure is inflexible and difficult to modify or amend.
- The airline or lessee is not dealing with an operating lessor but Japanese investors which may complicate the consent and waiver process.

JOLs and JOLCOs Structures

A diagram of a typical JOL or JOLCO structure is set out below:



SALE LEASEBACK

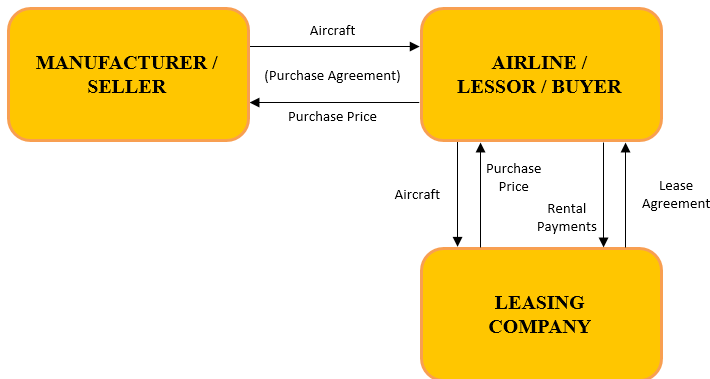
In a sale leaseback transaction, an airline sells either a used aircraft or its right to purchase a new aircraft from a manufacturer to either a leasing company or an SPV lessor. The airline then leases the aircraft back from that entity. Sale leasebacks are often used when an airline:

- Desires flexibility to manage its fleet (which shorter-term leases can provide, unlike ownership of the aircraft).
- Needs to raise capital.

For more information on sale leasebacks, see Article, New FASB Accounting Standard for Operating Leases: Sale-Leaseback Transactions (W-012-8240).

Sale Leaseback Structure

A diagram of a typical sale leaseback transaction is set out below:



EXPORT CREDIT AGENCY (ECA) FINANCING AND PRE-DELIVERY PAYMENT FINANCING

Aircraft are expensive and take time to manufacture. Manufacturers face many challenges finding purchasers for their products, including:

- Ensuring the buyers have sufficient funds to buy the aircraft.
- Cross-border payment risk if the purchaser are international purchasers, which is often the case.
- Ensuring they have access to funds during the manufacturing phase to manage their operations.

Many structures have been developed over the years to address these challenges.

ECA LOANS

ECAs promote the export of aircraft by directly financing or guaranteeing the purchase of aircraft by foreign buyers. In an ECA financing transaction, the ECA can either make direct loans or guarantee loans made by other lenders (ECA lenders) to an owner or lessor to finance the purchase by that owner or lessor of one or more aircraft from a manufacturer under their jurisdictional purview. For more information, see Practice Note, Aircraft Financing (US): Overview: Export Credit Agencies.

ECA Financing Structures

An ECA financing transaction may be structured either as an:

- Airline leasing transaction. In this structure:
 - a foreign owner or lessor buys an aircraft from a manufacturer with the proceeds of an ECA direct loan or an ECA guaranteed loan;
 - the foreign owner or lessor leases the aircraft to an airline or lessee pursuant to a finance lease (see Finance or Capital Lease); and
 - the rent payments the airline or lessee makes under the finance lease are used to repay the ECA direct loan or the ECA guaranteed loan.
- Leasing company transaction. In this structure:
 - a foreign leasing company buys an aircraft from a manufacturer with the proceeds of an ECA direct loan or an ECA guaranteed loan;

- the foreign leasing company often leases the aircraft to another entity (the lessee or sublessor), typically an affiliate or subsidiary of the leasing company which further leases the aircraft to the airline or sublessee under an operating lease (see Operating or True Lease); and
- the rent payments the airline or sublessee makes under the operating lease are used to repay the ECA direct loan or the ECA guaranteed loan.

ECAs generally can provide financing only for a maximum of 85% of the cost of an aircraft as required under the 2011 Aircraft Sector Understanding (ASU), formal guidelines on export credit support for aircraft published by the Organization for Economic Cooperation and Development (OECD). The remainder of the aircraft purchase price is generally funded by equity investors, leasing company, airline, or lessee (see ECA Loan Structure with Owner Trust). However, in many cases the contribution is made by an orphan trust (see ECA Loan Structure with Orphan Trust).

The 15% of the aircraft cost may also be financed. In this case:

- These loans are subordinated to the ECA direct loan or the ECA guaranteed loan.
- The junior lenders are precluded from taking certain action against the collateral.

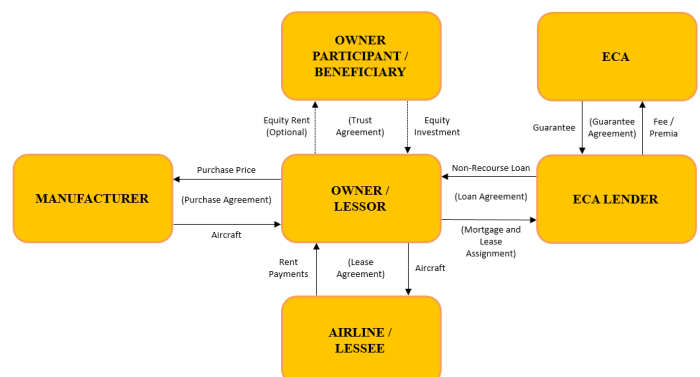
In deals involving Airbus, one of the three European ECAs active in the aircraft financing space (COFACE, Euler Hermes or UK Export Finance) is typically the guarantor of record, but all three ECAs share the risk in reinsurance arrangements. The percentage of risk attributable to each ECA is typically based on an estimate of the percentage of the aircraft that was manufactured in their respective countries. This arrangement is likely to be effected by Brexit, although how and the extent of this effect are still unclear.

Whether an airline structure or a leasing company structure, the ECA financing may be done through an owner trust or an orphan trust.

ECA Loan Structure with an Owner Trust

A diagram of a typical ECA loan structure transaction in which equity investors provide a portion of the aircraft purchase price by means of investment in an owner trust is set out below:

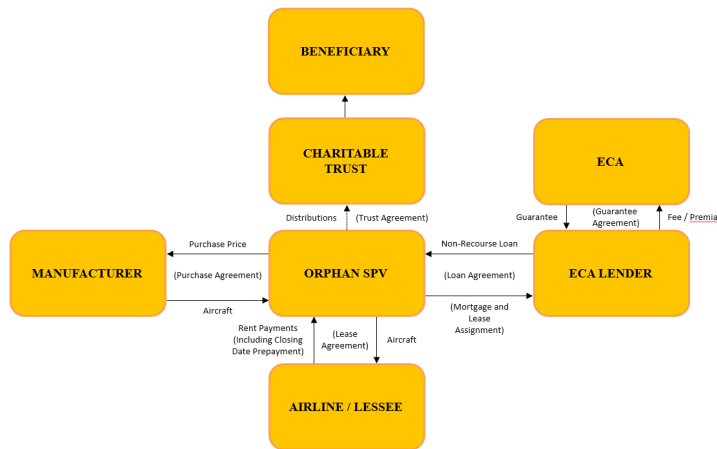
A diagram of a typical owner trust ECA loan structure is set out below:



ECA Loan Structure with an Orphan Trust

In many cases an orphan company or trust is established to act as the aircraft owner, lessor, and borrower. The owner (or if it is a trust, the beneficiary) of the orphan vehicle is a charitable trust (see Practice Note, Aircraft Financing (US): Overview: Orphan SPVs). The orphan trust, using the proceeds of the contribution of 15% to 20% made by the lessee (via a rent prepayment) and the ECA loans pays the manufacturer for the aircraft.

A diagram of a typical orphan trust ECA loan structure is set out below:



ECA CAPITAL MARKETS

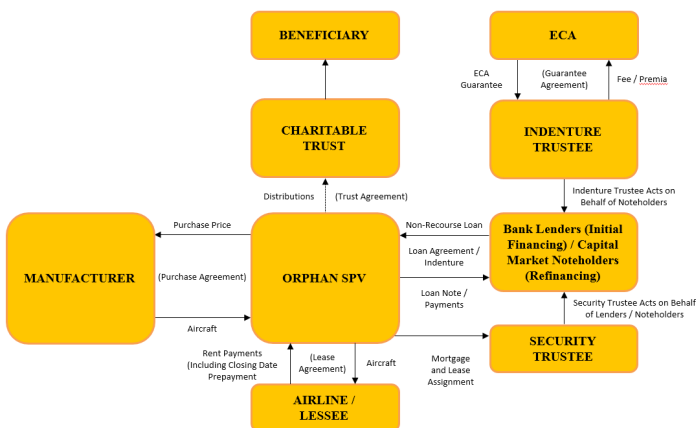
An ECA financing may also be combined with a capital markets issuance supported by an ECA guarantee. This transaction is typically structured in two steps:

- First, an initial loan financing by bank lenders under a structure similar to other typical ECA lending arrangements.
- Second, the loans are refinanced in the capital markets with the SPV issuing secured notes guaranteed by the ECA.

The notes are exempt from the registration requirements of the US Securities Act of 1933 (as amended) under Section 3(a)(2) of the Securities Act which exempts securities issued or guaranteed by the US or any person controlled by or statutorily authorized to act on behalf of the US (see Section 3 Registration Exemptions: Chart (8-383-4155)).

ECA Capital Markets Structure

A diagram of typical ECA loan structure is set out below:



AIRCRAFT FINANCE INSURANCE CONSORTIUM (AFIC): AIRCRAFT NON-PAYMENT INSURANCE

There has been an absence of financings of Airbus and Boeing aircraft supported by ECAs over the past few years. This is due to several reasons, including in the case of:

- Airbus: Britain, France, and Germany stopped supporting these payments over the disclosure of misleading paperwork that led to a UK and French bribery probe.
- Boeing: criticism from members of Congress that financing provided by the US Export-Import Bank was “corporate welfare” which led to the deauthorization of this entity at the end of 2015 for several months. Although the bank has been re-authorized through September 30, 2019, its board lacks a quorum to approve transactions exceeding \$10 million (see Practice Note, Aircraft Financing (US): Overview: US Ex-Im Bank).

New financial products have been launched to fill this void. AFIC developed a non-payment insurance product for financiers providing financing to lessors and airlines acquiring Boeing-manufactured aircraft. The AFIC product is intended to replicate, in large part, the credit support provided by the Ex-Im Bank in its traditional support arrangements for Boeing-manufactured aircraft, with an insurance policy being provided rather than an ECA guarantee. In this structure, lenders enter into a loan agreement and advance funds to financing an aircraft in reliance on an insurance policy that covers the risk of payment default by the borrower. The insurance policy is issued by a consortium of insurers.

Although intended to replicate a traditional ECA financing, there are important differences. These include:

- The insurers, although highly rated, are not sovereign entities. The credit and underwriting analysis the lenders undertake under these transactions is therefore different. They must, in addition to other factors, consider the corporate rating of the insurers and their ability to pay under the policy in the event of a default. By contrast, the Ex-Im Bank is backed by the full faith and credit of the US.
- The insurers in the consortium have several liability and not joint liability. This means that each insurer is responsible to the lenders for that insurer’s share of the liabilities and is not responsible for the liabilities of the other insurers. The lenders must, therefore, be comfortable with the credit analysis performed on four separate entities and not only the Ex-Im Bank.
- The foreign buyer’s obligations are backed by an insurance policy and not a guarantee. While the terms of the policy can be modified to make it as guarantee-like as possible, there are differences that lenders and their counsel need to consider when entering into this transaction, including a different regulatory regime.
- AFIC financing is not limited to financing aircraft that will be exported.
- ECA financings are subject to OECD regulations and the 2011 ASU requirements.
- The parties involved in AFIC transactions do not need to comply with the restrictions that often come with government support including national content requirements.

In an AFIC transaction:

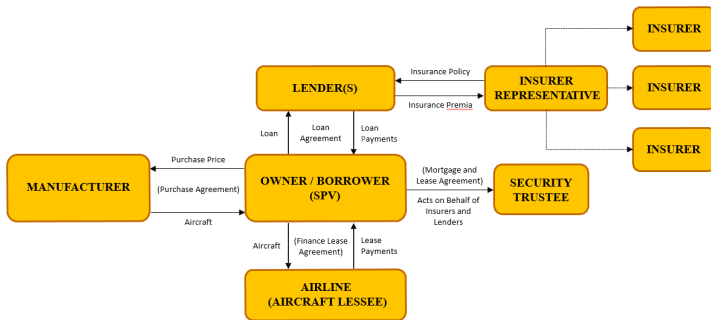
- The insurers make payments to the lenders if the borrower fails to make payments when due.

- The insurers' rights under the transaction are secured under a variety of security documents including aircraft mortgage and security assignments, an SPV share pledge agreement, and warranty and insurance documents. A security trustee holds the security for the insurers and for the lenders.
- The insurers are represented by an insurer representative (one of the insurers) who is a party to the transaction documentation, and is entitled to give or withhold consents or waivers.

In 2018, Airbus launched a non-payment insurance product dubbed Balthazar to support the financing of Airbus-manufactured aircraft.

AFIC Structure

A diagram of a typical AFIC structure is set out below:



PDP FINANCINGS

In a PDP financing, lenders finance all or a portion of the payments the airline or leasing company must make to the manufacturer during the period when the aircraft is being manufactured. These payments may amount to as much as 30% of the price of the aircraft being purchased. There is no completed aircraft existing during this period over which the lenders can take a mortgage. Instead, the lenders:

- Take a collateral assignment of the purchaser's rights under the aircraft purchase agreement entered into by the manufacturer and the purchaser as it relates to the aircraft subject of the PDP financing only. For information on collateral assignments, see Standard Document, Collateral Assignment of Acquisition Agreements ([W-006-7145](#)) and Standard Document, Acknowledgment and Agreement for Collateral Assignment of Acquisition Agreements ([W-007-0663](#)).
- Enter into a tri-party agreement (referred to as a manufacturer's consent or step-in agreement) with the purchaser and the manufacturer to set out the lenders' and the manufacturer's rights if the purchaser defaults under that agreement. This agreement allows the lender to step in and take delivery of the aircraft.

Advantages and Disadvantages of PDP Financing

Airlines or leasing companies often enter into these transactions because it takes a long time for an airplane to be built. This may be as long as 18 months. Manufacturers typically require buyers to make milestones to offset the manufacturing costs, which can be significant. Financing these payments give buyers more cash flow flexibility.

PDP financing raises several issues that must be considered, including:

- If the lender exercises its rights under the step-in agreement what price does it pay for the aircraft? Airlines or leasing companies often purchase aircraft at a discount that is not normally available to the lenders or in the open market. Purchasing the aircraft under the same terms as the airline under the purchase agreement would enable the lender to sell the aircraft at a higher price than it purchased the aircraft and recover an amount beyond what the lender is entitled to under the PDP financing documents. Manufacturers do not sell aircraft to lenders at the airline or leasing company discounted price.
- The lender does not typically fund 100% of the milestone payments due under the purchase agreement.

CAPITAL MARKETS FINANCING STRUCTURES PRIVATE PLACEMENTS AND 144A OFFERINGS

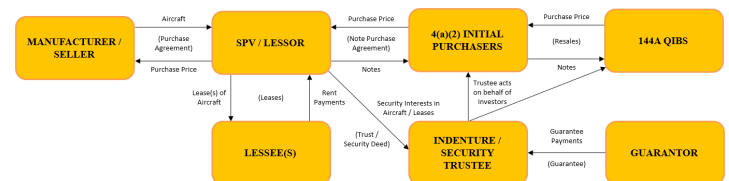
Airlines can also raise funds in the debt capital markets by issuing securities in secured or unsecured private placement transactions. In the US, these transactions are effected under Section 4(a)(2) of the Securities Act (Section 4(a)(2)) or Regulation D and Rule 144A promulgated by SEC. In these types of transactions, investment banks or broker dealers generally act as initial purchasers of the securities under Section 4(a)(2) or Regulation D and then resell those securities under Rule 144A, which allows resale without registration to qualified institutional buyers (QIBs).

In the US, the US Ex-Im Bank guarantees securities offerings of this type under a different exemption to the otherwise applicable registration requirements, namely Section 3(a)(2) of the Securities Act. These securities may be freely resold to the public without registration. The debt in these types of offerings is typically secured by the aircraft being purchased and their related leases.

For more information, see Practice Note, Section 4(a)(2) and Regulation D Private Placements.

Private Placement Structure

A diagram of a typical private placement offering is set out below:



ENHANCED EQUIPMENT TRUST CERTIFICATES (EETCS)

An EETC is a rated security issued by a special purpose vehicle created to own the aircraft and secured by aircraft. EETC transactions involve a single airline and multiple aircraft which are purchased either by the airline or by an owner trustee and then leased to the airline. These transactions are structured in one of two ways:

- **Airline structure.** In this case, the airline issues equipment notes in tranches for each aircraft it purchases. Equipment notes issued for each tranche of debt are aggregated and held by a pass-through trustee for each tranche (means, all tranche "A" equipment notes are held by the tranche "A" pass-through trustee) and the pass-through trustee in turn issues pass-through certificates to investors.

- **Owner trustee structure.** In this case, the owner trustee issues the equipment notes, also in tranches.

Advantages of EETCs

EETCs benefit from an “enhanced” credit rating due to two main structural features:

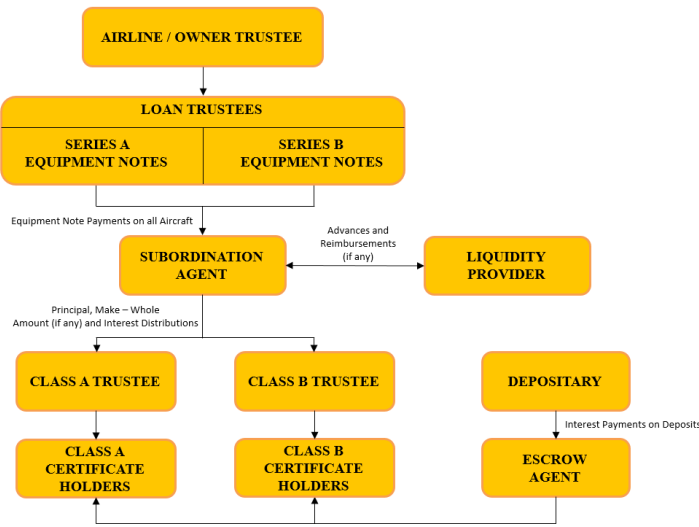
- Liquidity facilities that protect against payment defaults over a specified period (Practice Note, Aircraft Financing (US): Overview: Liquidity Providers).
- Debt tranching which creates different classes or tranches of securities with different payment priorities and pushes first loss risk down to more junior tranches of debt. For more information, see Practice Note, Subordination: Overview (3-618-8259).

The EETC debt is typically:

- **Overcollateralized.** The debt is secured by mortgages over the aircraft and, in the owner trustee structure case, also by an assignment of the owner trustee’s rights under the lease agreements. The value of the collateral typically exceeds the amount of the debt.
- **Cross-defaulted.** A default under one set of loan documents cross-defaults under other documents.

EETC Structure

A diagram of a typical EETC structure is set out below:



ASSET-BACKED SECURITIES TRANSACTIONS

Asset-backed securities (ABS) are debt securities under which payments of principal and interest are made to the holders from revenue generated by an underlying pool of assets, such as mortgages, credit card receivables, commercial loans or other loans. In an aircraft ABS transaction:

- An SPV purchases income earning assets, such as aircraft or engines, with the proceeds of the issuance of asset-backed securities to investors.

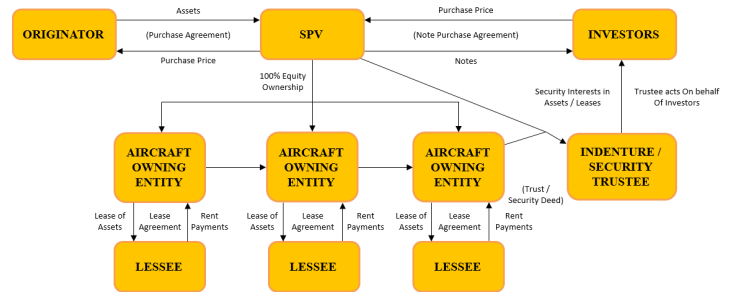
- The SPV typically holds these assets in wholly owned subsidiaries, which in turn enter into operating leases for those assets with lessees.
- The investors are repaid from the revenue generated by those assets (namely, rent payments under the leases).

The equity interests in the SPV are sometimes retained by the originating sponsor or its affiliates, or may be sold to one or more third-party investors. The credit risk in an ABS transaction, unlike in an EETC transaction, is spread among all the different lessees and is not limited to one counterparty.

For more information on these transactions, see Practice Notes, Securitization: US Overview, Securitization: The SPV (5-501-7050) and The Securities Issued in a US Securitization (3-501-4905).

ABS Structure

A diagram of a typical ABS aircraft financing is set out below:



ISLAMIC FINANCE

Two of the Islamic financing structures most commonly used in the aviation sector are ijara and sukuk and, in particular, sukuk al ijara. In an ijara transaction, a lender purchases an aircraft from the manufacturer or seller and pays the entire purchase price up front and then leases the aircraft to the airline or lessee, which makes rental payments for the life of the lease equal to the price paid by the lender for the aircraft plus a profit. For a typical ijara structure, see Checklist, Islamic Finance Deal Structure: Ijara (6-501-1260).

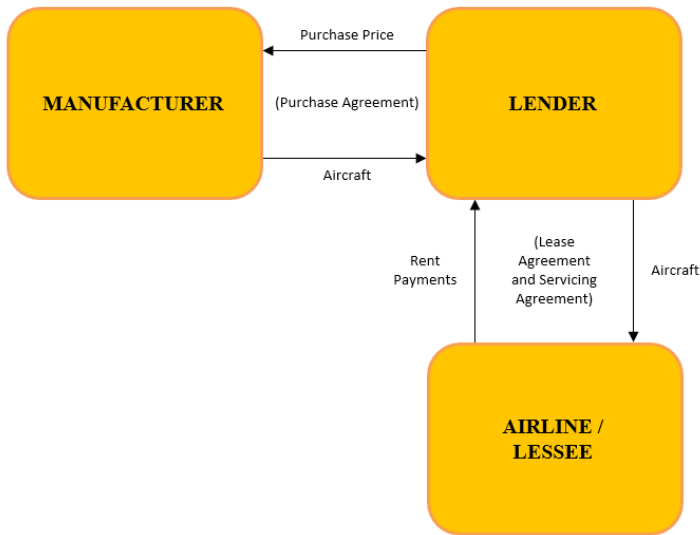
A sukuk is similar to a bond, but consists of ownership interests in a pool of assets rather than debt securities. In a sukuk al ijara:

- A pool of assets is sold by an originator to an SPV which issues sukuk certificates to investors. The proceeds of the sale are then used by the SPV to pay for those assets.
- The SPV then leases the assets to a lessee (typically the originator or an affiliate of the originator).
- Rent payments made under that lease are used to make periodic distributions to the sukuk investors.

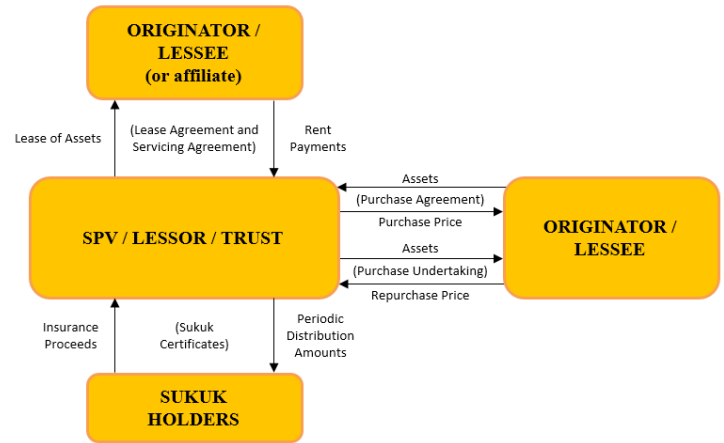
The originator or lessee often enters into a purchase undertaking where it then agrees to repurchase the assets from the SPV on the occurrence of certain events, such as events of default under the sukuk documents. For more information on this structure, see Islamic Finance Deal Structure: Sukuk al-ijara (1-500-9556).

IJARA

A diagram of an aircraft ijara structure is set out below:

**SUKUK AL IJARA**

A diagram of an aircraft sukuk al ijara is set out below:

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