Legal issues arising in the financing of Pre-Delivery Payments

CONOR KEAVENY and KATE CURNEEN overview some of the problematic issues that can arise with PDPs, particularly in the event of purchaser default or insolvency, as well as the steps that can be taken to minimise risk.

The legal nature of PDPs
Depending on the circumstances of a particular transaction, the legal construction of PDPs can vary. A significant issue that arises is how PDPs ought to be viewed in circumstances where a purchaser subsequently fails to complete the purchase of the aircraft. For example:

- A failure to complete could be viewed as a conventional breach of contract (in essence, a total failure of consideration), in which case the remedy for the manufacturer would lie, in the ordinary course, in the form of compensatory damages as opposed to retention by the manufacturer of the PDPs already made; Retention of the PDPs may be possible, if they amount to a genuine pre-estimate of loss on the manufacturer’s part. The difficulty with this is that a purchaser may argue that it constitutes an unenforceable penalty clause; or

- It might be argued that PDPs are a form of security deposit. If this is the case, then the manufacturer should calculate its loss and return any surplus to the purchaser. For example, it may be the case that the manufacturer subsequently sells the aircraft to a third party and therefore incurs either minimal or no loss. In that case, the manufacturer would find it difficult to justify the view that it is entitled to simply profit from the PDPs.

The potential legal uncertainties associated with this form of aircraft finance can make the negotiation of the financing of such payments a far from straightforward process.

The nature of security in PDPs
In PDP financings, lenders cannot take security over the asset, being the aircraft itself, as this has not been built, nor has title to the aircraft passed to the purchaser. It is usual in PDP financings for the lender to take security over the purchase agreement (the “PA”) in place between the manufacturer and the purchaser. The purpose of taking security over the PA is to ensure that the lender can step into the position of the purchaser should there be an event of default. This is usually done by way of purchase agreement assignment (the “PAA”). A key feature of a PAA is that consent is obtained from the manufacturer in respect of the PAA which sets out the terms upon which the lender can rely on its security and complete the purchase of the aircraft.

It is important that a number of key terms of the PA are assigned to the lender, such as the right to take delivery on payment of the purchase price (net of any PDPs made), the right to be reimbursed any PDPs should the lender opt not to purchase the aircraft upon a borrower event of default, and the right to certain warranties and indemnities provided by the manufacturer. Certain other aspects of the PA may remain confidential as between the purchaser and the manufacturer; for example, the purchase price is typically redacted from the assigned contract, and an enforcing lender will usually expect to pay in excess of the price originally negotiated between the purchaser and the manufacturer for the aircraft.

Lenders will want to have control over any amendments made to the PA, insofar as this impacts on the value of the aircraft or the availability and effectiveness of their security. On the other hand, the
purchaser and the manufacturer will want to ensure that there is not on-going, unnecessary interference by the lender with the performance of the PA. As with other aspects of the PAA, the degree of lender control will depend on the bargaining powers of the parties in the particular transaction.

Standstill period
Upon default by the purchaser under the PA, it is commonplace for a standstill period to the provided for before the manufacturer can terminate the PA. During this period, the lender can decide if they wish to avail of their assigned rights under the PAA. Lenders have to take into account a number of considerations when deciding whether to exercise their PAA rights, including whether the market value of the aircraft will exceed the indebtedness of the purchaser, the amount of further investment required, any modification needed before the aircraft is complete, the likely timeframe for delivery and the appetite in the market for the aircraft.

When stepping in to enforce its security, a lender will want the manufacturer to deduct from the purchase price any PDPs already made, whether such PDPs were funded by the lender or paid directly by the original purchaser.

Purchaser default under the PA
Upon purchaser default, a lender may seek to realise its security by assigning its rights under the PA on to a third party. It is important for lenders to be able to do this freely, and without the need for manufacturer consent, provided certain conditions are met. Equally, manufacturers may wish to exercise some degree of control over such onward assignments, to maintain influence over the market for their aircraft, and to prevent the interference of lenders in their marketing programme.

In addition, often it is the case that a manufacturer will reserve an option in the PA to repay the lender and take back the delivery positions (i.e. to have the PAA discharged) upon a purchaser event of default. Clearly, how these competing concerns are resolved constitutes a major negotiating point between the parties. Generally, the manufacturer’s buy back option will not amount to an open-ended commitment by the manufacturer to pay all sums due under the loan agreement between the lender and the purchaser. Payments are usually limited to such items as the financed PDPs actually made, the interest accrued for a specified period and certain other specified costs, and usually do not amount to full recovery for the lender.

Another important point for lenders and manufacturers to consider in a default situation is their right to “cherry-pick” particular aircraft. Frequently purchasers enter into a single PA for several aircraft. Different lenders may finance different aircraft and each lender will want the aircraft in respect of which it has assigned rights ring-fenced so that it is not prejudiced in respect of any matters relating to the other aircraft in the purchase agreement, and to ensure that the manufacturer cannot exercise a right of set-off against aircraft which have been financed by another lender. Each lender will want to ensure that, in an event of default, it will have the ability to exercise its buy-out rights in respect of the aircraft for which it has provided financing, and that it is not

### Refresher: PDPs
Pre-Delivery Payments (PDPs) are payments that are made by the purchaser of an aircraft to the manufacturer under an aircraft purchase agreement. PDPs are usually paid over a period of months or years prior to delivery, while the aircraft is being built. Such payments can amount to a substantial expense for the purchaser as they usually account for a considerable percentage (up to 30%) of the total gross purchase price of the aircraft. Purchasers now frequently avail of PDP financing to fund these payments, which can be beneficial for all of the parties involved in the transaction. However, such financing is not without its risks. Typically, lenders will insist that at least a portion (usually 5%) of the PDPs are funded out of the purchaser’s own resources, and 100% debt financing is usually reserved for those borrowers with higher credit ratings. The purchaser will be required to repay to the lender the amounts of PDPs advanced on or prior to delivery. This repayment obligation is usually then fulfilled out of the financing obtained to pay for the aircraft on delivery. Frequently, the same lender provides both the PDP financing and the financing of the overall purchase price on delivery.
under an obligation to exercise that right in respect of all the aircraft covered by the PA.

Similarly, where manufacturers have buy-back options, lenders will naturally want to restrict the opportunity for manufacturers to exercise their rights under the PA selectively by choosing only the most valuable aircraft positions.

**Purchaser insolvency**

One major concern for lenders and manufacturers in PDP financings is the possible insolvency of the purchaser. The insolvency of the purchaser in a PDP scenario will have the effect of triggering the manufacturer’s entitlement to terminate the PA and will, in turn, entitle the lender to accelerate its loan and enforce its security.

Manufacturers will be concerned that, if a lender ultimately purchases the aircraft under the PAA following the insolvency of a purchaser, that an insolvency practitioner (such as a liquidator, receiver, examiner or administrator) appointed to the purchaser may make a claim, sometimes known as “claw-back”, against the manufacturer for the amount of the PDPs paid over on the basis that these amount to a fraudulent preference or disposition, or because of some defect in the underlying contractual position.

As a result, manufacturers commonly seek to protect themselves against such claims by means of an indemnity from lenders. Naturally, this is something that lenders resist, as it creates potential financial exposure for them, and this point is a further key area of negotiation.

As a precautionary measure to reduce the risks involved with purchaser insolvency, lenders frequently seek to ensure, when structuring a transaction, that the purchaser is a bankruptcy-remote special purpose vehicle (an SPV). The PDP financing will be provided on a limited recourse and non-petition basis to the newly-incorporated SPV. The SPV will also enter into certain covenants, for example, not to conduct any other business, save for the PDP financing.

PDP financing is a popular option in aircraft acquisition transactions. However, there are a number of key factors involved in the negotiation of the PDP financing arrangement from the perspective of each of the parties involved. In this regard, there is a balance to be struck between (i) the lender’s exposure and the ease with which it can exercise its security in a default situation; (ii) the purchaser’s ability to manage its assets, and to negotiate freely with the manufacturer; and (iii) the manufacturer’s ability to retain payments for work done, and the comfort that such payments will not be subject to claw-back, as well as visibility as to the identity of the ultimate purchaser of its aircraft. The allocation of risks in each transaction is a matter of commercial negotiation, and is dependent upon the bargaining power of the particular parties involved. It is clear that best practice in PDP financings is for the allocation of commercial risk between the parties to be clearly mapped out at the outset, and for sound legal advice to be taken on the particular jurisdictional risks involved.

*Conor Keaveny is a partner and Kate Curneen is a senior associate in the banking and capital markets group of Dillon Eustace’s Dublin office. They provide Irish law advice on aircraft operating, finance and leasing transactions.*

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