

# GLOBAL: COVID-19 : AIRCRAFT LEASING IN THE CONTEXT OF COVID-19 – PRACTICAL CONSIDERATIONS ON COMPROMISE, RELATIONSHIPS AND MITIGATION

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BRYAN  
CAVE  
LEIGHTON  
PAISNER **BCLP**

*Dear Aircraft Lessor*

***Re: COVID 19: Aircraft Lease Agreements relating to Relevant Aircraft***

*I am writing to inform you that our business has been materially and adversely affected by the COVID 19 pandemic. My CFO has informed me that in a few months, we anticipate difficulties meeting our rental payment obligations under aircraft lease agreements entered into with your company.*

*We are hoping that we can arrange a time to speak via video conference to consider and discuss steps that we may take and agree to mitigate these circumstances.*

*Our respective companies have a long history of working together, but if there is a time that we need your co-operation, support and assistance, it would be now.*

*I look forward to hearing from you to confirm a time to discuss.*

*Yours sincerely*

*Airline CEO*

## INTRODUCTION

The above paints the scene of a typical request which most (if not all) international aircraft lessors are currently facing (and a similar scenario could also apply to financial institutions who have lent money to airlines). If you were the relationship manager of the subject aircraft leasing company, what would you do?

This paper is intended to provide some practical suggestions and considerations that commercial parties could consider when preparing for those “hard conversations” and is intended to encourage aircraft lessors, financial institutions and airlines to be innovative, creative and practical whilst balancing and prudently managing associated risks during the COVID 19 crisis.

## A. THE AIRCRAFT LEASE AGREEMENT

### 1. COVID 19 Context and the Global Aviation Market

Aircraft lease agreements (whether it be a finance or operating lease) will customarily include a “hell or highwater” clause which requires an airline lessee to pay rent and other payments when due and payable, irrespective of circumstances. An aircraft lessor is therefore not contractually obliged to entertain any request for deferral of rent or compromise any payment obligation owed to it. So why would an aircraft lessor wish to entertain such requests in the context of COVID 19?

If an airline lessee fails to pay rent under an aircraft lease, it would usually lead to an event of default. The remedies available to an aircraft lessor following an event of default are expressly set out in the underlying lease which would include, among others rights, the right to repossess the aircraft or sue to recover outstanding payments. The impact of COVID 19, however, has in a short period of time created such uncertainty in the ability of aircraft lessors to remarket aircraft that a key consideration for all aircraft lessors (before exercising its enforcement rights) is to take into account the absence of a robust aircraft leasing market.

Matching a willing lessor with a willing lessee (or if the aircraft lessor wished to sell the aircraft asset following repossession to a willing buyer) is likely to be fraught with difficulty without material compromise and reduction on pricing. If a Lessor did exercise its rights to repossess the aircraft then it would potentially also have the added responsibility of maintaining and managing that aircraft during any off-lease period. While a sophisticated aircraft lessor may be equipped with the necessary experience to manage and maintain an aircraft during an off-lease period, it will also bear the added risk associated with the cost, expense and responsibility of maintaining such aircraft asset. Since an aircraft lessor is not ordinarily in the business of operating and maintaining aircraft for any extended period, a prudent aircraft lessor should therefore take into account such risks, weighing them against any benefit of enforcing its rights and in some circumstances, it may be more appropriate to find a commercial compromise with its existing airline customer than to enforce. Maintaining that customer and ensuring that the airline continues to maintain the aircraft, even while the aircraft remains grounded, could form part of an aircraft lessor’s strategy to reduce and mitigate its own exposure and risk.

On the assumption that there are commercial considerations not to initiate proceedings to terminate the lease and to repossess the aircraft, the following provides for some practical considerations that could be considered and applied as alternatives (or collectively, a combination of one or more alternatives) that can be discussed, used and applied.

### 2. Rent Deferral and Lease Amendments

Any request for rent deferral under an aircraft lease agreement would need to be carefully drafted. Such arrangement is likely to amend or supplement an existing lease agreement. The following is a checklist of relevant considerations:

1. drafting of any rent deferral arrangements must be precise. As there are many rent instalments under an aircraft lease, a prudent approach is to specify accurately the relevant rent instalment being deferred and designating when that deferred rent instalment is due for payment. Agreeing to defer one or more rent instalments may be commercially acceptable for an interim period, but inadvertently deferring more rent instalments than commercially bargained, may leave the aircraft lessor in a deeper hole than when negotiations first started;
2. whether interest will apply to the deferred rent? Interest can be characterized as default interest or other appropriate interest component as a *quid pro quo* to the forbearance of deferring rent;

3. airline lessees may request a waiver or deferral to any pre-existing payment default. Aircraft lease agreements will usually contain cross default provisions (whether in respect of other aircraft leased by a common lessor (or its related affiliates) or by reference to monetary thresholds relating to any other commercial agreements entered into by an airline. Airlines should be conscious to make a request to waive or defer any such default when entering into rent deferral arrangements so as to avoid triggering any cross default provisions with any other applicable creditors.
4. are there any associated credit support agreements or guarantees which provide credit support to the obligations of the airline lessee under the underlying lease agreement? If so, it may be necessary for the credit support provider to grant its consent to the amendments under the aircraft lease so as to avoid any argument that the credit support provider was not aware of the amendments to the underlying lease agreement, performance or payment obligations to which it is providing creditor support for. Any alteration to the underlying "guaranteed documents" may run the risk of releasing the credit support provider of its obligations under the credit support agreement if prior consent was not given. Given the risks associated with potentially voiding the credit support agreement, it would be prudent for an aircraft lessor / creditor to obtain the consent of any credit support provider to any variation of an aircraft lease.
5. aircraft lessors may have financed its acquisition of an aircraft with secured financing provided by banks and other financial institutions. It would not be uncommon in secured financing arrangements that prior consent from financiers be obtained before agreeing a lessor is able to agree to any rent deferral or lease amendment. Careful consideration of an aircraft lessor's existing financing terms will be necessary to ensure that an aircraft lessor is compliant with its contractual obligations (particularly where lease rental obligations payable by an airline lessee is specifically structured to match loan repayment obligations of an aircraft lessor).
6. Other conditions to the deferral arrangements could include:
  - a. enhanced or additional information covenants, which may include an obligation to provide details of any government subsidies or cash support which the airline may receive, and for all or part of those proceeds be directed to repay any deferred rent or other amounts owed;
  - b. the addition of subordination or restrictive covenants relating to the payment by the airline lessee of any dividend distributions or payments under any intercompany loan agreements;
  - c. "non-discrimination" or "most favoured nations" clauses so that the aircraft lessor would not be treated less favourably than another aircraft lessor or creditor that has entered into any such similar rent deferral or other arrangement;
  - d. consideration of any additional security/collateral that the airline could grant as pre-conditions to the grant of any rent deferral e.g. a letter of credit to cover any deferred payment amount; or
  - e. enshrining consultation rights to the extent the COVID 19 crisis continues which will allow direction and continued dialogue between commercial parties.

### 3. Security Deposits and Standby Letters of Credit

Aircraft lease agreements will almost always include an obligation on the airlines to pay a security deposit as security for payment and other breaches under the lease agreement. Usually, security deposits are paid in cash, or in lieu of paying cash security deposits, standby letters of credit (SBLs) may be deposited with the aircraft lessor (or creditor).

The amount of the security deposit will range from one month through to four months, or more (such amount will usually be dependent on the credit of the airline at the time of signing the aircraft lease). In lieu of deferring rent, commercial parties could consider reducing the security deposit amount (whether permanently or for an interim period) so that all or part of those funds could be applied towards payment of outstanding or prospective rent, rather than deferring the payment of rent. Airlines can also be tactful to request a release of all or part of any cash security deposits which can be immediately injected to its cash flow, but any aircraft lessor agreeing to this arrangement may leave it without security and without rent being paid when due.

For those aircraft lessors or creditors which are the beneficiary of any SBLC, an immediate recourse for non-payment of the rent could be to draw on such letters of credit. Usually SBLCs will allow a beneficiary to be paid out an amount up to the face value of the SBLC against a compliant demand, without investigation into the position under the underlying contract that entitles the beneficiary to draw under such letter of credit. Once the issuing/confirming bank (as the case may be) pays the beneficiary under a SBLC (and provided a proper drawing request is made in accordance with the terms of that letter of credit) the applicant airline that applied for the SBLC must reimburse (within a prescribed time) in full to the issuing or confirming bank, the amount paid out. The consequence is that airlines, who have already been subject to cash flow limitations and restrictions, will be subject to further additional cash flow limitations, potentially perpetuating its inability to maintain its solvency or to meet its payment obligations<sup>1</sup>. An aircraft lessor making a drawing under a SBLC could potentially contribute to an airline's downward spiral, triggering other defaults being borne by the defaulting airline.

SBLCs deposited in lieu of cash security deposits will have specified maturity/expiry dates. Some SBLCs maintain a validity period for the entire lease term but more commonly, SBLCs have shorter maturities, such as one year and in such circumstances, would require renewal annually. In the COVID 19 environment, SBLC providers may consider such renewal requests with enhanced scrutiny, renewed credit assessment or an increase in fees reflecting any change to credit or other risks associated. If such SBLCs are not renewed, Aircraft lessors may be further exposed, leaving them only with a contractual claim to request from the already cash strapped airline lessee, cash security deposit. In circumstances where an aircraft lessor is entitled to draw under an SBLC, it may be subject to the difficult decision of deciding whether or not it should exercise such rights.

While this paper is not intended to encourage or discourage commercial parties in exercising its rights under contract or under applicable law, commercial parties should be conscious of the context and the consequences that could arise from taking and also omitting to take such action. But in the context of the COVID 19, a prevalent consideration is addressing the question, that if an airline were to become insolvent and the aircraft lessor repossessed its aircraft assets, what would it do with those assets in the current COVID 19 commercial aircraft market?

#### 4. Maintenance Reserves

Under aircraft operating leases, airline lessee's will usually be required to make incremental cash maintenance reserve contributions and payments to an aircraft lessor, which will be held as security or as reserves to be applied and/or released by the aircraft lessor when regular maintenance obligations on the aircraft have been performed. Maintenance reserve payments

<sup>1</sup> BCLP's thought leadership team has also prepared a paper entitled "U.S. COVID-19: Applying Security Deposits under Leases as Tenant Defaults Mount" which provides for relevant considerations concerning security deposits and letters of credit in respect of tenancy agreements. Those insights can also be taken into account when considering security deposits and letters of credits under aircraft lease agreements. That paper can be accessed through the following link: <https://www.bclplaw.com/en-US/thought-leadership/us-covid-19-applying-security-deposits-under-leases-as-tenant-defaults-mount.html>

are usually retained by the aircraft lessor and accumulate over time, before being reduced or released following application to pay MRO's for maintenance performed. Similar to security deposits, lessees may, in lieu of paying cash to the lessor, deposit SBLCs with the lessor as security for the performance of maintaining (and repairing) an aircraft. Under the COVID 19 environment, lessees and lessors may enter discussions to free up cash maintenance reserves by temporarily reducing the amount of reserves required to be deposited. Maintenance reserve deposits can ratchet up to millions of dollar and freeing up liquid cash for return to an airline lessee would no doubt assist in its cash flow. Alternatively, a more "permanent" deferral could also apply so that lessors will only rely on end of lease maintenance reconciliations so that no maintenance reserves are required to be paid during the lease term until redelivery. These commercial compromises will of course have an economic impact to commercial arrangements under existing aircraft leases and an increase in risk being borne by an aircraft lessor. Lessors may run the risk that they have freed up cash maintenance reserves, only to find that scheduled maintenance requirements have not been performed on its owned aircraft, potentially reducing the value of its asset if repossession ultimately occurs. Any compromise will need to be carefully assessed, but in the context of COVID 19, a departure from traditional risks assessments applied by aircraft lessors may need to be afforded.

## 5. MAE/MAC Clauses

It would not be uncommon for aircraft lease agreements to include "material adverse change" ("MAC") or "material adverse effect" ("MAE") clauses . A breach of such provisions could trigger mandatory prepayment, default, a draw-stop or prevent closing. MAC/MAE provisions are usually carefully negotiated and require some sort of determination from the party benefiting from the clause. That determination can be drafted as being "subjective" where determination of an MAC/MAE trigger could be at the sole discretion of the relevant aircraft lessor/creditor or could be characterized by applying an objective test, requiring satisfaction (under English law) of a "reasonableness" threshold. The circumstances arising as a direct consequence of the COVID 19 crisis, whether imposed by government regulation in the form of restrictive or qualified travel restrictions, the consequential effects adversely impacting the international money and capital markets, the adverse changes affecting the political and economic situation of a region or country, or more simply, the "prospects" affecting an airline lessee may all potentially trigger a breach of a MAC/MAE clause. Any aircraft lessor relying on a MAC/MAE trigger to declare an event of default under an underlying contract should exercise such rights with careful consideration, armed with factual evidence to substantiate and support its claim. A tactful airline lessee may request a waiver to such triggers in the context of COVID 19, so as to preclude such triggers leading to any accelerated termination of any pre-existing transaction.

## 6. Reservation of Rights

Assuming negotiations have commenced between the aircraft lessor and the defaulting airline to address the hard conversation of deferring rent (whether outstanding or not), an aircraft lessor should be careful during such processes, that it does not inadvertently agree to waive any pre-existing defaults. Implicit waiver of such defaults could take the form of the aircraft lessor "sitting on its hands" whilst they had actual knowledge of such continuing default. To avoid this risk, prudent aircraft lessors may wish to enter into reservation of rights letters (or include such provisions in relevant contracts) as a condition to the commencement of negotiations or agreement to any rent deferral or other compromise struck between the parties. Such reservation of rights letters / clauses may include express terms providing that:

1. aircraft lessors / creditors do not relinquish the benefit of any remedies which may be available to them, particularly if negotiations with the airline lessee are ongoing in an aim to mitigate COVID 19 circumstances and particularly if a default is continuing; and
2. if negotiations do not result in an agreement between parties, it would make clear that the aircraft lessor / creditor is entitled to pursue any remedies available to it under contract or under applicable law as if those negotiations or delays had not occurred.

## B. BUY LOW, SELL HIGH, BUYING TIME AND BUILDING RELATIONSHIPS

Some aircraft lessors with available cash, liquid assets or access to capital could seize the opportunity of purchasing aircraft assets at low prices from airlines (or from OEMs<sup>2</sup>), and subsequently leasing such aircraft assets back to the airline.

BOC Aviation and Cathay Pacific recently announced their sale and leaseback transaction of six (6) Boeing 777-300ER aircraft to BOCA for a total consideration of US\$703.8 million. As of 12 March 2020, the net asset value of the relevant aircraft assets was priced at approximately HK\$5,338,000,000 (being the currency equivalent of approximately US\$686,949,000). In an environment where “cash is king” it comes as no surprise that Cathay Pacific has announced that the proceeds from the transaction will be applied towards its general working capital<sup>3</sup> as much needed injection to its cash flow.

Robert Martin, Managing Director and Chief Executive Officer of BOC Aviation was quoted as follows:

*“We are pleased to be supporting Cathay once again, building on a long-term relationship that dates back to 2009. This transaction highlights the way we can bring financing solutions to our customers, on the strength of our balance sheet, our A- credit ratings and our available liquidity.”<sup>4</sup>*

The importance of relationships will play an important function in finding solutions to “keep the ship afloat” and would also present an opportunity for less mature or new entrant leasing companies to build, develop and nurture such relationships (and possibly taking added risk) with selected airlines by supporting them during the COVID 19 crisis.

## C. TIMING IS EVERYTHING

Global commercial aircraft travel was at its highest in history immediately prior to the COVID 19 crisis, so there is little doubt that the commercial aviation industry will make a resounding comeback – sooner or later. The key question of course is timing. Will it be three months, six months, nine months or years before commercial airlines return to flying their scheduled routes? How long could aircraft financing and leasing participants sustain the long term cash flow hemorrhage?

Economists speculate with uncertainty whether applicable global economic recessions (whether globally, regionally or nationally) arising from COVID 19 will be characterized as V shaped, U shaped, W shaped or L shaped, drawing on alphabet descriptions to characterize the pace of

<sup>2</sup> Airfinance Journal has reported that Airbus is intending to sell six Airbus A320neos with AirAsia's aircraft configuration by auction – see article entitled “**COVID: Airbus brings A320neos to auction: sources**” dated 14 April 2020 - [https://www.airfinancejournal.com/Articles/3578772?from=daily&utm\\_campaign=Daily%20-%20%2814-04-2020%2016%3A00%3A29%29&utm\\_source=Daily&utm\\_medium=email+editorial&utm\\_term=COVID%3A%20Airbus%20brings%20A320neos%20to%20auction%3A%20sources&utm\\_content=Editorial](https://www.airfinancejournal.com/Articles/3578772?from=daily&utm_campaign=Daily%20-%20%2814-04-2020%2016%3A00%3A29%29&utm_source=Daily&utm_medium=email+editorial&utm_term=COVID%3A%20Airbus%20brings%20A320neos%20to%20auction%3A%20sources&utm_content=Editorial)

<sup>3</sup> See Cathay Pacific Airways Limited Hong Kong Stock Exchange “Disclosable Transaction” announcement entitled “**Sale and Leaseback Transaction of Six Boeing 777-300ER Aircraft**” dated 16 March 2020 - [https://www.cathaypacific.com/dam/cx/about-us/investor-relations/announcements/en/20200316-sale-and-leaseback-transaction\\_en.pdf](https://www.cathaypacific.com/dam/cx/about-us/investor-relations/announcements/en/20200316-sale-and-leaseback-transaction_en.pdf)

<sup>4</sup> See BOC Press Release – 12 March 2020 <https://www.bocaviation.com/en/boc-aviation/press-releases/2020/3/boc-aviation-signs-plb-agreement-with-cathay-for-6-b777-300er-aircraft>

recovery<sup>5</sup>. V shaped being a sharp and quick recovery from recession or downturn and L shaped reflecting a long and perpetual recovery time. In the context of the aviation industry, the recovery cycle may be further exacerbated by new regulatory requirements that would be applicable to the new aviation world as a consequence of COVID 19. Following September 11, additional security screening requirements had impacted the culture and nature to flying which flight passengers have now accepted to be the customary norm. As and when commercial air travel returns to normalcy, will there be restrictions to air travel, such as medical threshold formalities that would need to be passed before being qualified to travel by air? Will "immunity passports"<sup>6</sup> be a pre-condition for certain passengers? Will testing for COVID 19 become "standard" upon arrival at airports<sup>7</sup>? Any such regulatory changes may further impact the timing for recovery of the commercial air travel market.

It goes without saying that social distancing policies imposed by government entities go directly against international air travel, however, approximately four months since the first COVID 19 case was detected and publicly announced in Wuhan (China), the social distancing policies in China are now being relaxed. Some bullish travel agents have already sought to resume commercial activities, particularly in China (hoping for a V shaped recovery), as cities come out of lockdown and local quarantine restrictions expiring<sup>8</sup>.

The expected speed and the nature of economic recovery following the aftermath of the COVID 19 crisis will have a direct impact to assessing and agreeing any commercial bargain that may be entertained or agreed between aircraft lessors and lessees. A betting person (being open to risk) may take the view that aviation travel will recover promptly by taking the opportunity to buy aircraft at a low cost and being optimistic of selling the asset for substantial gain when markets recover, but only to be stuck with aircraft asset which continues to be inoperable / unsaleable if the crisis continues. When negotiating and agreeing commercial arrangements and compromises during this environment, it would be prudent to build in flexibility to allow for risks to be incrementally and carefully managed, to take into account economic, legal and political changes.

## CONCLUSION

The considerations and suggestions presented in this paper are intended to provide insight to some options that may be available to allow airline lessee's an opportunity to "weather the storm" in an economic and political environment which is ever changing. Aircraft lessors considering to provide support, maintain and build relationships with their airline customers, will need to carefully manage and assess the risks of any concessions it may agree to ensure that such actions do not consequently, prejudice (without knowledge and assessment of risk) its own rights and interests that could potentially lead itself to an economic downward spiral that they themselves cannot recover. The current COVID 19 environment is difficult to manage due to many uncertainties, particularly in relation to the timing of when commercial air travel will return. We all wait eagerly with bated breath to receive notice that there is some positive conclusion to this COVID 19 saga, optimistic to see the skies, once again, painted with contrails to mark the recovery of commercial air travel.

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<sup>5</sup> See <https://www.reuters.com/article/us-health-coronavirus-economy-graphic/alphabet-soup-how-will-post-virus-economic-recovery-shape-up-idUSKCN21R242>

<sup>6</sup> For more information on "immunity passports", see commentary provided by the Guardian: <https://www.theguardian.com/world/2020/mar/30/immunity-passports-could-speed-up-return-to-work-after-covid-19>

<sup>7</sup> For more information on steps being taken by the Hong Kong Government to contain COVID 19 by applying mandatory screening (and other strategies) being applied at HK airport see: <https://www.scmp.com/news/hong-kong/transport/article/3080088/coronavirus-hong-kongs-screening-regime-airport-arrivals>

<sup>8</sup> See <https://www.scmp.com/news/hong-kong/health-environment/article/3079671/coronavirus-hong-kong-travel-agencies-open>

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### Getting in touch

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

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