

A large commercial airplane is shown from a low-angle, front-facing perspective, flying over a runway. The sun is low on the horizon, creating a bright, golden glow that illuminates the scene. The sky is a mix of blue and orange, with some clouds. The runway has yellow lines and lights, leading towards the horizon. The airplane's engines and landing gear are clearly visible.

Lending to Business Aviation: Don't Wing It

BY SHELLEY SVOREN

As with any industry, lending to the business aviation sector comes with its own set of risks. Shelley Svoren of First Republic Bank gives readers the insider's tips on this industry.



The world of private aviation splashed across all media forms evokes images of the glamorous life. Comparatively *The New York Times*' "The History of Private Planes Is Less High Life and More Daily Grind — The 41,000-foot Commute is Still a Commute," by Jennifer Harlan, illustrates that most private aircraft are instead used for business. For business owners, a private aircraft enables executives to efficiently meet with employees, clients, prospective clients, and suppliers. Holding meaningful face-to-face meetings will unlikely ever be supplanted by emails, texts, phone calls, or video chat. Fundamentally, one should consider the purchase and use of private or "business" aircraft as a part of an investment in one's brand that is essentially a business tool, which increases the effectiveness of the teams employed to fulfill the organization's goals.

Business aviation is a global industry with countries providing a coordinated regulatory framework for the use, safety, and registration of ownership and legal issues through their registries. Original Equipment Manufacturers ("OEMs") such as Bombardier, Dassault Falcon Jet, Embraer, Gulfstream, and Textron (Cessna and Beechcraft), located throughout the world, work with the international regulatory agencies to mandate required maintenance and operations for owners of the 21,000-plus business aircraft. The demand for business aviation ebbs and flows with the global economy; however, the U.S. accounts for the largest number of business aircraft owners (nearly 66%) although representing 24% of global GDP (according to The World Bank), which is attributed to the favorable capital expenditure climate and early adoption of private aviation following World War II.

Significant opportunities exist to support clients who purchase business aircraft. In 2018, 1,063 new business jet and turbo propeller-equipped ("turbo prop") aircraft were delivered

by the OEMs and 3,628 previously-owned business jet and turbo prop aircraft were sold to new owners. Of the 4,691 transactions, only 1,709 aircraft – or 36% - obtained financing (where a lien was placed on the aircraft) within three (3) months of closing. This does not include financing where an aircraft was financed; however, another form of financing (e.g., margin lines, unsecured loans, lines of credit, other structures, etc.) not involving an aircraft mortgage occurred. (Aviation industry data graciously provided by AMSTAT, a business aviation research company.)

The reason to (or not to) finance an aircraft is complicated for many owners. Typically, a business aircraft is owned by a single-purpose entity that exists solely to own and operate the aircraft and may, depending upon the tax structure, not produce income. Not surprisingly, most financiers require repayment assurances that include credit enhancements (e.g., additional collateral, personal guaranties) or significant loan payment amortization. Due to "Know Your Customer" due diligence requirements mandated by law and acknowledged by the global financial transaction community, the detailing of corporate ownership structures can be convoluted. For aircraft owners who provide the due diligence needed, it is possible to fix their cost of capital over the taxable life of the depreciable asset and use their cash for other investments.

For financiers, much must be considered

Risks financiers should acquaint themselves with prior to entering into business aircraft transactions:

Risk is defined in a variety of ways, but the underlying issues focus on answering the question: "How will our institution be repaid?" Above and beyond the financial risks, one must understand the tax, regulatory, and legal implications of one's client's decisions regarding the operations of the aircraft. Addressing these issues at the onset of the relationship is paramount

as it will impact structuring and these issues must be reassessed over time:

- ▶ How will the aircraft be used? Knowing the number of annual hours of use is critical to determining the forecast Fair Market Value (“FMV”), which enables a financier to structure the loan accordingly. Furthermore, the use of an aircraft results in the operating costs, which can exceed the financing expense threefold.
- ▶ Will the client engage aviation counsel and tax advisors? Given the complexities of aviation tax and laws, an owner should retain aviation specialists who will work with their existing tax and legal advisors.
- ▶ How will maintenance be addressed? Enrolling an aircraft and



its components in maintenance programs does not ensure that it meets the mandated maintenance of the OEMs and Registries. Finding a qualified aircraft maintenance provider is critical to ensuring the aircraft functions properly and can be used in accordance with all laws.

- ▶ Who will operate the aircraft and will third-party charter/leasing occur? This must comply with all mandatory requirements associated with the registry where the aircraft is registered. In the case of the U.S.’s Federal Aviation Authority (“FAA”), business aircraft are flown under FAR Part 91 or Part 135; the former is used predominately by the sole owner with limited use by friends and family, while the latter is flown for a combination of sole ownership and third-party usage.

Aircraft flown under the slightly less stringent FAR Part 91 found violating those requirements face multi-million dollar fines (*Business Aviation Advisor’s: Fifteen Shades of Grey Aircraft Charter*, by John McGraw, addresses these issues.) An aircraft management company may be desirable as they offer turnkey solutions for owning and operating aircraft.

- ▶ Will insurance be sufficient? It is critical to read the entire policy (not just accept an Accord certificate) as it details the limitations of use. A financier must assert their rights as loss payee and additional insured and it is incumbent upon financiers to mandate breach of

rather than solely rely upon industry valuation guides.) The tenor of the facility typically ties to the use of the aircraft and whether it is flown under the FAR Part 91 or Part 135 as that ties to MACRS depreciation schedules. Payments amortize loan outstandings to a balloon based upon the forecast FMV because the value of the aircraft is expected to decrease over time. True-up payments are included in most structures to ensure that Loan-to-Value requirements are met. Loans may be priced at either fixed or floating rates and interest rate swaps can be offered to fix the interest rate during the loan term.

One of the frequent questions posed to financiers is “How much

financier must first file a mortgage with the FAA, which identifies the OEM, model, and serial number of the aircraft and its engines, in addition to other collateral that may include insurance proceeds, lease/charter and or management agreements, logbooks and records (which are critical to determining how the aircraft was maintained since delivered from the OEM); and aircraft maintenance contracts.

warranty coverage to ensure payment if terms of use are violated.

Types of financing for business aircraft:

Many financing options are available for those seeking to finance business aircraft, much of which focuses on the tax and legal requirements for both the purchaser and the financier.

Traditional term loans: With traditional aircraft secured loans, the user of the aircraft owns the asset and the financier provides a portion (ranging between 20-90%) of the capital needed to purchase it. Most traditional aircraft financiers structure loans with an original commitment in an amount that is based upon a percentage of purchase price or an appraised FMV (Note: Best practice is to use an accredited aircraft appraiser who will assess the current market issues,

information do you really need?”, which contains pricing, structure and tax implications. Loans are structured as recourse or non-recourse. With recourse loans, a higher percentage of the purchase price/FMV is financed if a personal guaranty is provided and lower interest rates may be offered if a substantial relationship exists between the financier and the guarantor. With non-recourse loans, interest rates may be higher and the Loan-to-Value may be lower compared to a recourse loan. Furthermore, the owner may be limited on tax deductibility due to the at-risk rules.

From a financier’s perspective, traditional loans offer tangible and intangible benefits: It is a way to enhance the relationship with one’s client and the financier earns projectable interest income. Moreover, the risk associ-

ated with the declining value of the aircraft is placed on the borrower.

Leasing:

Leasing switches the mindset from the business aircraft user being the owner to one where the financier owns the asset and user simply uses the aircraft. The financier/lessor obtains the tax benefits and structures a lease whereby the user/lessee agrees to operate and maintain the aircraft in addition to the periodic lease payment. Early termination clauses and lease buy-out dates are generally included. Additionally, explicit use, maintenance, and return conditions enforce the lessor's ability to ensure the value of the aircraft upon its return.

For lessors, one must weigh the tax benefit against the risks. While the lessors may obtain the tax benefits associated with owning an aircraft, the lessor assumes the risk associated with the declining value of the aircraft that is challenging to predict. During the last economic downturn, the values of certain business jets declined by 8-12% per quarter, which well exceeded the forecast values at inception of the leases and caused many lessors to report losses caused by marketing-to-market their portfolio. It is also possible for lessors/financiers to use their portfolio to securitize bonds and/or debentures.

Perfecting One's Interest in a Business Aircraft

Perfection of a financier's interest in an aircraft is subject to local, country, and international laws. Aviation counsel focused on the Registry where the collateral is registered is critical, particularly as local laws can impact a financier's enforcement of rights and remedies in default and foreclosure situations. A best practice is to obtain an opinion of Registry counsel to ensure that perfection and priority of the financier's liens. In some circumstances, title insurance should be obtained.

Financing (via a loan) a U.S. reg-

istered aircraft highlights these complexities, which differs with each country and their Registry:

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The International Registry ("IR") electronically records "interests" (essentially ownership and liens) in certain mobile assets and is recognized by over 88 countries. Depending upon the size of the aircraft and the engines, financiers can register their financial interests in those assets with the IR after filing the aircraft mortgage with the FAA. Interests on an aircraft and its engine(s) are also publicly viewable records.

A UCC-1 should be filed to perfect the financier's position at the state level. A UCC-1 filing on "all assets" is insufficient and should instead encompass all aircraft collateral detailed in the aircraft mortgage.

Assignments of all contracts involved in the aircraft collateral should be obtained through tri-party agreements as this enables the financier as it requires the provider to acknowledge the financier's rights and remedies. If the aircraft is chartered/leased, the assignment allows the financier to continue the revenue generating activity and obtain rights

to the proceeds. If the aircraft is managed by an aircraft manager, the assignment enables the aircraft to be maintained and managed. If the aircraft is enrolled in aircraft maintenance program agreements for its hull, engines, auxiliary power unit, or avionics, the accrued payments will ensure maintenance under the program occurs.

This example emphasizes that the world of business aviation is complex and underscores that beyond the initial glitz, much work by many occurs. Financiers must educate themselves on the intricate legal, tax, and operating issues associated with the industry. Because corporate businesses and their owners require flexibility to meet their goals, opportunities continue to exist for financiers. And much like a client's ownership of a business aircraft, financing one is truly an investment in expanding one's brand. **TSL**

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