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# HOW THE EETC STRUCTURE HAS CHANGED

Since the first enhanced equipment trust certificate (EETC) transactions in the 1990s, EETCs have become the predominant capital markets vehicle for US airlines to finance aircraft – and they have generally withstood market ups and downs. The year 2007, for example, was strong for EETCs, with more than \$4.2 billion-worth of offerings from Continental, United, Southwest, Northwest and Delta.

With conditions in the financial markets worsening in 2008 and ultimately ending in financial meltdown, EETCs disappeared for the next year and a half. During that period there was talk that the structure would never come back or would take years to return only after structural modifications. Then, in July 2009, Continental and American tested the waters with \$390 million and \$520 million EETC offerings, respectively; these were followed up with Continental's \$644 million and United's \$659 million EETC offerings in October 2009 and United's \$810 million and Delta's \$689 million offerings in November 2009.

Reports of the demise of EETCs were clearly premature. Changes to the structure were essential to get these deals done in the economic circumstances of 2009.

## Economics

In 2009 airlines were pressured to offer investors more favourable economics than the 2007 EETCs in order to entice investors back to the market. The coupons on the senior-A tranche in the 2007

EETCs ranged between 6% and 7%, while the coupons on the A tranche in the first two of the 2009 EETCs were 9% and 10.375%.

However, as the EETC market continued to improve in 2009, airlines were able to reduce the offered coupon on the A tranche in the later transactions. For example, the coupon on the A tranche in Continental's October 2009 EETC offering was 7.25%, much closer to the 2007 rates.

Also, the 2009 EETCs had shorter debt maturities than their predecessors. The A tranche maturity in the 2007 EETCs ranged between 12 years and 15 years, whereas the A tranche maturity in the 2009 EETCs ranged between six and nine years. Shorter debt maturities last year addressed both investor concerns about long-term exposure and airline reluctance to lock in higher coupon debt for a longer term.

## Liquidity providers and depositaries

In order to obtain an enhanced rating for EETCs, a liquidity facility covering interest on the applicable tranche for a number of interest periods is usually provided for the most senior tranche and may be provided for one or more junior tranches. In the course of 2008 and 2009 some of the financial institutions that previously appeared as liquidity providers for EETCs either were downgraded or left the airfinance market.

Identifying and engaging a willing liquidity provider with the minimum required short-term unsecured debt rating of P-1 by Moody's and A-1 by Standard & Poor's appeared to be more difficult than in the past. In three of the six 2009 EETC transactions liquidity facilities were provided by the institutions affiliated with one of the underwriters of the transaction and, in the other three, the same foreign bank (acting through a New York branch) was engaged as the liquidity provider.

Furthermore, all of the 2009 EETCs were structured as pre-funded deals: the proceeds from issuance of EETC certificates were placed, in whole or in part, in escrow to be used to purchase equipment notes in

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ETCs/EETCs issued in 2009						
EETC	Amount (\$millions)	Aircraft	Coupon	Rating	LTV (prospectus base)	Date
AMR 09-1	520	16 x 737-800s 4 x 777-200ERs	10.375%	Baa3 / A-	47.5%	July
AMR 09-2 *	276	9 x 737-800s 1 x 767-300ER 2 x 777-200ERs	13.000%	B-	65.0%	August
AMR 09-3 *	450	4 x 757-200s 6 x 767-300ERs 6 x MD82s 3 x MD83s	10.500%	B2 / B	37.6%	October
CAL 09-1	390	3 x 737-800s 4 x 737-700s 5 x 737-900ERs 3 x 777-200ERs 2 x 757-200s	9.000%	Baa2 / A-	51.4%	June
CAL 09-2	528 (tranche A) 117 (tranche B)	12 x 737-800s 3 x 757-200s 1 x 767-400ER 3 x 777-200ERs	7.250% 9.250%	Baa2 / A- Ba2 / BBB-	54.0% 66.0%	November
DAL 09-1	569 (tranche A) 120 (tranche B)	2 x 737-700s 10 x 737-800s 9 x 757-200s 3 x 767-300ERs 3 x 777-200LRs	7.750 % 9.750%	Baa2 / A- Ba2 / BBB-	53.3% 64.5%	November
UAUA 09-1	659	10 x A319s 6 x A320-200s 5 x 747-400s (PAX) 7 x 767-300ERs 3 x 777-200ERs	10.400%	Ba1 / BBB	56.0%	October
UAUA 09-2	698 (tranche A) 113 (tranche B)	12 x A319s 5 x A320-200s 3 x 747-400 (PAX) 4 x 757-200 (ETOPS) 3 x 777-200s 7 x 777-200ERs	9.750% 12.000%	Ba1 / BBB B1 / BB	55.4% 64.4%	November
Total	\$4.4 billion	185				

Source: Airfinance Journal research and JP Morgan \* Not EETC-secured aircraft deal

connection with subjecting one or more aircraft to the EETC transaction at a future date or dates.

In order for EETCs to preserve an enhanced credit rating during the escrow period, the offering proceeds are placed in one or more bank deposits bearing interest at the rate borne by the relevant tranche of the certificates until the future date when an aircraft is ready to be financed. Then, the airline issues equipment notes with respect to the aircraft being financed and subjects the aircraft to an indenture, and the applicable portion of proceeds is withdrawn from the escrow arrangement and used to purchase the equipment notes from the airline. The deposit arrangement is in addition to the liquidity facility described above.

While the pool of liquidity providers in 2009 was reduced, the availability of depositaries was even more constrained. Depositaries had traditionally been de facto subject to a higher minimum short-term unsecured debt rating of A-1+ in deals that used Standard & Poor's ratings (Moody's minimum short-term unsecured debt rating of P-1 is the same for both liquidity providers and depositaries). The limited availability of financial institutions with an A-1+ rating

after the financial meltdown presented a palpable challenge.

One potential avenue to explore was to have depositaries subject to the same rating threshold as liquidity providers; however, ultimately, the threshold ratings requirement for depositaries in all 2009 EETCs remained the same as in 2007. As with liquidity providers, the challenges of reduced availability were overcome. However, it is telling that only two banks, The Bank of New York Mellon and JPMorgan, neither of which we believe had previously acted in the depositary role, served as depositaries in the 2009 transactions.

### Market disruption provisions

In 2008 and 2009 the syndicated loan market was affected by lenders' concerns that Libor might not cover their cost of funding their loans. Loan agreements that did not contemplate a prime rate-based alternative to Libor led to discussions about the circumstances (characterized as "market disruption") in which a lender could charge an alternative rate to cover what it determined to be its cost of funds.



**John Curry**

Liquidity providers began raising similar issues in the 2009 EETCs. They were constrained by the principle that in rating EETCs, rating agencies model the amount of interest payable to the liquidity provider on any liquidity provider advances because this interest is payable ahead of the payments to the holders of EETCs.

Balancing the concerns of the decreased number of potential liquidity providers, on the one hand, and the rating agencies, on the other, parties generally followed an approach to market disruption similar to cases of illegality of maintaining Libor-based loans. If the liquidity provider determines that Libor will not cover its cost of funds, the interest rate is determined by an alternative index. In the majority of the 2009 EETCs, the alternative is a conversion to a prime rate-based loan with a negotiated spread over the rate usually applicable to prime rate-based loans.



**Iryna Nikolaieva**

**EETC tranching and strict subordination**

Before 2009 EETCs usually had two or three tranches with different levels of subordination. But in early 2009 EETC arrangers said that investors preferred simplicity in EETC structures. This concern likely contributed to the simplification of the tranching of EETC certificates because Continental and American in their July 2009 EETCs offered only a single-A tranche of EETC certificates. However, as the EETC market continued to improve in the second part of 2009, Continental, United and Delta offered two tranches.



**Raymond Wells**

The first EETCs generally included a strict subordination payment waterfall – payments of principal and interest on senior tranches were paid before any payments were made on junior tranches. In 2004, to increase the attractiveness of the junior tranches, the strict subordination waterfall was modified to allow the payment of interest on the junior tranches, subject to certain limitations, ahead of the principal of the more senior tranches.



**So Jaeyong**

In 2009, to simplify the EETC structure and increase the attractiveness of the senior tranche, there was some discussion about returning to the pre-2004 strict subordination waterfall. The two 2009 July offerings each only had one tranche, while the later 2009 EETCs had multiple tranches retaining the modified 2004 waterfall.

**Additional tranches**

The 2009 EETCs differed in the treatment of adjusted interest on additional tranches that may be issued in the future. In some, adjusted interest could be paid ahead of the principal distributions on the most senior tranche, while others provided for strict subordination of tranches.

Earlier deals that allowed liquidity facilities for subsequently issued tranches generally allowed payments on those liquidity facilities to rank *pari passu*

with payments on the liquidity facility for the most senior tranche. In the 2009 transactions that allowed liquidity facilities to be provided for subsequently issued junior tranches, payments with respect to those liquidity facilities were put at the bottom of the intercreditor waterfall. If the airline wanted to provide a liquidity facility for a subsequently issued tranche, it would have to provide security to the liquidity provider outside of the EETC deal, such as a lien on additional aircraft or a letter of credit.

**Equipment note buy-out**

One of the features introduced in 2007 EETCs to make junior tranches more attractive to investors was to provide that, in the event of an airline bankruptcy, holders of junior tranches of EETCs would have the right to buy out senior series of equipment notes issued under certain individual aircraft indentures.

This would divert payments on equipment notes from the intercreditor payment waterfall directly to the buyer, because this was thought potentially to increase bargaining rights of junior creditors in a restructuring or insolvency of the airline.

Given the EETC arrangers' concerns about simplification and making the senior tranche more attractive to investors, this buy-out right was eliminated in the 2009 EETCs. Junior tranches, though, retained the right to buy out in whole the tranches of EETC to which they were junior in an airline bankruptcy.

**Cross-default and selective redemption**

Until 2007 EETCs generally did not provide for cross-default among the aircraft indentures in the deal – at least theoretically, in a bankruptcy, the airline could pick and choose which of the aircraft in an EETC to keep and which aircraft to abandon. In order to impede the airline's ability in a bankruptcy to abandon aircraft selectively in an EETC, the 2007 structure included a limited cross-default among the indentures providing that an event of default under any indenture existing at the final maturity date of the notes having the latest maturity date would cross-default all of the other indentures. The 2009 transactions broadened the limited cross-default to apply to all indentures at any time.

The latest structure also deleted the right of airlines to do selective redemptions of equipment notes relating to individual aircraft that the airlines deem more desirable to pull from the collateral pool.

**Conclusion**

While airlines and arrangers re-examined the traditional EETC structure in the context of the 2009 economic environment, last year's EETCs were structurally very similar to their predecessors.

It will be interesting to see how the EETC structure continues to evolve in response to the financial environment. ■