

FOREIGN INVESTMENT IN U.S. AIRCRAFT FINANCINGS

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To Our Clients and Friends:

The recent economic downturn and constrained availability of financial resources in the United States have caused U.S. airlines to look to new foreign financing sources for aircraft. Traditionally, most of the foreign cash for U.S. aircraft financings came from Canada, Western Europe or Japan, but traditional financing partners of U.S. airlines in those jurisdictions have experienced many of the problems that U.S. financial institutions have faced in the last few years. All of this has led U.S. airlines to consider new financing sources in the Middle East and Asia.

In addition, financing parties have also been looking to bring non-traditional financing sources into existing deals. Equity players consider such new sources when seeking to sell their investments in aircraft (whether directly or beneficially through an owner trust); to attract financing secured by an aircraft, the related lease, or both; or to raise funds by packaging leases together in securitizations. Lenders consider such sources when syndicating their loans or doing one-off transfers of their positions in a syndicate. Although traditional aircraft documents usually contemplate that transferee equity players and lenders could be foreign entities, historically the foreign entities that financing parties have had in mind have been well-known institutions in countries with familiar and relatively stable legal and political systems. That has begun to change.

The introduction of non-traditional foreign financing sources into U.S. aircraft financing transactions may affect some of the standard provisions of U.S. aircraft financing documents and may drive U.S. airlines to seek adjustments of such provisions in view of U.S. or foreign law requirements or new factual circumstances. In addition, U.S. airlines may request foreign financing parties that may not be familiar to them from prior dealings to cooperate with them in their due diligence and compliance efforts as to various U.S. laws and regulations that apply to transactions with foreign parties, including OFAC, export control and anti-money laundering rules and regulations.

RE-EVALUATING “STANDARD” PROVISIONS

Having foreign lessors, owner participants or lenders in U.S. aircraft financings has always presented issues such as withholding taxes and, in the case of lessors and owner participants, issues relating to U.S. registration of an aircraft where the economic owner of the aircraft is not a “citizen of the United States” within the meaning of 49 U.S.C. §40102(a)(15). Over

the years, U.S. airlines have developed relatively standard provisions for dealing with these issues.

However, even in areas that are normally dealt with in standard U.S. aircraft financing documents, the involvement of parties located in non-traditional jurisdictions may mean that the standard provisions will require further thought. In particular:

- The involvement of foreign financing parties outside Canada, Western Europe and Japan could lead to increased cost adjustments for U.S. airlines that are out of synch with developments in the markets in the countries from which aircraft financing has traditionally been obtained. For example, China raised its bank reserve requirements twice in 2010. U.S. airlines may, therefore, wish to consider ways to limit their exposure to increased costs for changes in law in non-traditional jurisdictions to which the airline would not have been exposed if the transferee had been located in a traditional jurisdiction.
- The choice-of-forum provisions in U.S. financing documents often provide for non-exclusive jurisdiction in New York. To avoid being sued in a relatively unfamiliar foreign country, which may not have a well-developed or relatively neutral legal system, U.S. airlines may prefer to provide that the parties submit all disputes, on an exclusive basis, to a Federal or state court located in New York unless the New York-based court declines jurisdiction. If the financing parties are not willing to agree to such choice of forum, it may be worthwhile to consider inserting an arbitration clause and specifying where arbitration will take place.
- The jurisdiction in which a financing party is located may be a jurisdiction that does not have a tax treaty with the United States, and payments to the financing party may not otherwise be exempt from U.S. withholding. In new deals, the issue of withholding tax should be addressed early on. If there is to be withholding, the documents should include provisions specifying how the withholding will be made, which party bears the risk of withholding under current law and in the event of changes in law, and related issues.

In addition, recent developments may lead to a need to re-evaluate standard document provisions even where the financing parties are in traditional jurisdictions. For example:

- Under the recently enacted Hiring Incentives to Restore Employment Act (the “HIRE Act”), payments of interest, dividends, rents and certain other amounts from U.S. sources, and any gross proceeds from the sale, exchange or other disposition of property

that can produce interest or dividends from U.S. sources, after December 31, 2012¹, to a “foreign financial institution”² or a foreign entity that is not a foreign financial institution (a “non-financial foreign entity”) generally will be subject to a 30% U.S. federal withholding tax unless such foreign person complies with additional U.S. reporting requirements.

A foreign financial institution generally will be subject to the new withholding tax unless it (i) agrees with the IRS to (a) comply with information, verification, due diligence, reporting and other procedures established by the IRS with respect to “United States accounts” (generally financial accounts maintained by a financial institution, as well as non-traded debt or equity interests in such financial institution, held by one or more specified U.S. persons or foreign entities with a specified level of U.S. ownership) and (b) withhold on its account holders that fail to comply with reasonable information requests or that are foreign financial institutions that do not enter into such an agreement with the IRS or (ii) is exempted by the IRS.

A non-financial foreign entity generally will be subject to the new withholding tax unless it provides the applicable withholding agent with either (i) a certification that such entity does not have any substantial U.S. owners or (ii) information regarding the name, address and taxpayer identification number of each substantial U.S. owner of such entity. An exception generally would apply to foreign corporations whose stock is regularly traded on an established securities market (and certain of their affiliates) and to certain other specified types of entities.

- There are some indications, which will have to be monitored, that the FAA is beginning to question some of the documentary provisions that it has traditionally accepted relating

¹ The new withholding tax would not apply, however, to any obligation that is outstanding on the second anniversary of the date the HIRE Act was enacted or to amounts that are effectively connected with the conduct of a trade or business in the U.S. by the foreign person. There is substantial uncertainty at this time as to how the new rules will be applied.

² A “foreign financial institution” includes, subject to certain exceptions, a non-U.S. entity that (i) is a bank, (ii) as a substantial portion of its business holds financial assets for the account for others or (iii) is engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in securities, partnership interests or commodities.

to the U.S. registration of an aircraft in the name of an owner trustee where the economic owner of the aircraft is a non-citizen.

- In these days of sovereign wealth funds participating in deals and government bailouts of financial institutions, U.S. airlines may request the inclusion of a waiver of sovereign immunity in any deal in which a foreign financial institution is involved, whether or not it is technically a government instrumentality.

If the laws of the country where the foreign financing party is located may affect the U.S. airline's rights under the documents, it would be worthwhile to explore ways to mitigate such effects.

- The general obligation of the airline in leases and mortgages to comply with applicable law or other standard provisions, such as indemnities, may impose requirements with respect to legal requirements of the home country of the financing party to which the airline might not otherwise have been subject. For this reason, U.S. airlines may want the covenant about the use, operation and maintenance of aircraft being in compliance with law to be drafted by reference to the law of the country of registry of the aircraft and any country in which the aircraft is flown.
- In some cases, even where the documents that the airline enters into are governed by New York law, legal requirements to which the foreign participants are subject or structural elements required by the foreign participant could have an effect on the airline's operational flexibility. For example, we understand that questions have been raised from time to time about whether an airline that operated an aircraft under a lease or other transaction governed by Islamic law would be allowed to serve alcohol on the aircraft.

Finally, U.S. airlines should consider the effects of foreign laws on the overall deal structure and funds flow.

- An airline may inquire as to whether the jurisdiction in which a non-traditional financing party is located may impose taxes (VAT or otherwise), customs or stamp duties on the aircraft or the transaction. If so, the parties will need to consider how to allocate the burden of such items.
- Another issue, which arises most acutely in leases where the equity player is the legal or beneficial owner of the aircraft, is what the airline's position would be under the laws of the applicable foreign jurisdiction if the financing party became bankrupt.

- The U.S. airline will also need comfort on the question of whether a court in the applicable foreign jurisdiction would recognize the choice-of-forum provisions agreed to by the parties and that decisions of a court or an arbitral tribunal in the agreed forum would be enforced in such foreign jurisdiction.

OFAC REGULATIONS

The regulations of the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"), 31 C.F.R. § 500 *et seq.*, commonly referred to as "OFAC regulations"³, prohibit transactions with terrorists, drug traffickers and countries hostile to U.S. policies (for example, Cuba, Sudan and Iran) or otherwise considered a threat to the national security and foreign policy of the United States (for example, Belarus⁴) that are the target of broad economic sanctions. The sanction targets may be countries, including their nationals; governments, including their fronts; or non-governmental entities targeted for particular activities, such as terrorism or drug trafficking. OFAC publishes a master list of "Specially Designated Nationals and Blocked Persons" which is regularly updated on the OFAC web site (www.treas.gov/offices/enforcement/ofac).

Before entering into a new deal, most major U.S. airlines would probably investigate whether entering into an aircraft lease or mortgage with a foreign equity participant or lender that was not a traditional aircraft equity participant or mortgage lender would run afoul of the OFAC regulations. On the other hand, it may not be quite so obvious that the initial lender's syndication efforts, or a transfer by a lessor or owner participant in a lease, could also raise questions about running into the restrictions imposed by the OFAC regulations.

³ There is no single regulation issued by OFAC that would describe prohibited transactions in general. Rather, there are separate rules applicable to the sanctions against specific target countries or entities. Most OFAC regulations are issued under authority delegated by the U.S. President when declaring an emergency and invoking the International Emergency Economic Powers Act. See 50 U.S.C. § 1701, *et seq.* Embargoes imposed prior to 1977, when the IEEPA was enacted, are based on the Trading with the Enemy Act. See 50 U.S.C. *app* §§ 1-44. Some other statutes that provide authority for OFAC programs include the United Nations Participation Act, 22 U.S.C. § 287c, and the Antiterrorism and Effective Death Penalty Act, 18 U.S.C. §§ 2332d, 2339B, among others.

⁴ On June 16, 2006, the U.S. President issued Executive Order 13405 (71 FR 35485, June 20, 2006), in which he determined that the actions and policies of certain members of the Government of Belarus and other persons to undermine Belarus democratic processes or institutions, which were manifested in the fundamentally undemocratic March 2006 elections, among other things, constitute an unusual and extraordinary threat to the national security and foreign policy of the United States. New part 548 was added to 31 C.F.R. Chapter V to implement this executive order.

Many standard U.S. bank loan agreements attempt to solve the problem of a transferee's potentially being on a foreign assets control list (as well as others) by giving the borrower the right to consent to any transfer of the loan unless an Event of Default exists. This gives the borrower the right, among other things, to check into the identity of a potential transferee, ask any necessary questions and to obtain any necessary assurances to satisfy itself that the new lender's entering into the deal will not create problems under the OFAC regulations.

U.S. aircraft lease and mortgage documents have generally differed from bank loan agreements in this respect. Equity players in aircraft leases and lenders in aircraft mortgages have negotiated strenuously for the right to transfer their interests without any consent of the airline as long as the transfer meets certain requirements enumerated in the documents, most of which have been focused on specific matters, such as securities, tax, ERISA and FAA citizenship matters. Sometimes the enumerated requirements include a general requirement that the transfer not create a violation of law, which offers some comfort that the equity player or lender cannot transfer to a person who is on a foreign assets control list. On the other hand, sometimes the enumerated requirements do not include any general requirement for no violation of law in connection with a transfer, focusing only on potential securities law, tax, ERISA and FAA citizenship issues relating to the transfer and having no reference to OFAC regulations. If the airline does not have an absolute right to consent to a transfer by a financing party in the absence of an Event of Default, it may wish to ask the transferee to make a representation that its acquisition of its interest in the loan will not cause a violation of law, or at least that it will not violate OFAC and similar regulations.

Of course, neither a representation as to no violation of the OFAC regulations or no general violation of law nor, for that matter, a consent right to a transfer gives the airline many rights if, in fact, there actually is a problem – if there is a representation and there really is an OFAC problem, the airline has the right to sue for breach of representation. Like the consent right in syndicated loan agreements, the representation is primarily valuable to U.S. airlines as a diligence matter.

EXPORT ADMINISTRATION REGULATIONS

Another possible set of issues relates to the U.S. Export Administration Regulations, 15 C.F.R. §§ 730 *et seq.*, which control the export of civilian goods and technologies that have

military applications (dual-use items)⁵ and, under certain circumstances, may require a license for the export of avionics equipment and commercial aircraft and engines. Although many export controls focus on the destination country (the country segments of Part 746 provide guidance as to the relationship between the Export Administration Regulations rules and OFAC rules relating to the country), the restriction of exports to named companies, institutions and individuals is a growing part of the export control system. There is a “denied persons list” made available on the web site of the Bureau of Industry and Security (“BIS”), the division of the Department of Commerce that administers the Export Administration Regulations (www.bis.doc.gov).

In a recent case, Balli Aviation Ltd., a subsidiary of the United Kingdom-based Balli Group PLC, pleaded guilty to charges in connection with illegally exporting commercial Boeing 747 aircraft from the United States to Iran and agreed to pay \$15 million in civil fines for violating the Export Administration Regulations and the OFAC regulations in connection with the sale. According to count one of the charges, Balli Aviation Ltd. conspired to export three Boeing 747 aircraft to Iran without first having obtained a license from BIS or an OFAC authorization. Count two of the charges asserted that Balli Aviation Ltd. violated a Temporary Denial Order issued by BIS on March 17, 2008 that prohibited the company from conducting any transaction with any item subject to the Export Administration Regulations.

The Export Administration Regulations need to be taken into account in any transaction that involves a transfer of possession of aircraft equipment to foreign persons if such equipment, or any part thereof, is subject to export controls. For example:

- The Export Administration Regulations could apply to an outright sale of aircraft equipment or a sale-leaseback transaction.

⁵ *The Export Administration Regulations include controls imposed for an array of reasons – some controls still reflect the Cold War focus on denying Warsaw Pact countries and the PRC access to advanced technologies of strategic importance, but increasingly the focus has shifted to anti-proliferation and anti-terrorism efforts. The principal statutory authority for the Export Administration Regulations is the Export Administration Act, 50 U.S.C. app §§ 2401-2420, which is not permanent legislation, and Congress has let it expire on several occasions. During periods of lapse, the Export Administration Regulations have been maintained by Presidential order under the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701-1706. In addition, other statutory provisions, executive orders and Presidential documents are relevant to the Export Administration Regulations, such as Export Controls on High Performance Computers, 50 U.S.C. app. § 2404 (note), or Satellite Export Controls, 22 U.S.C. § 2778 (note).*

- The Export Administration Regulations could also apply to a sublease, or perhaps even the return of an aircraft to the lessor at the end of the lease term or an owner participant transfer close to the return date that would result in the equipment being returned to a foreign person.
- It is possible that the so-called “deemed export” rule under the Export Control Regulations could affect the airline’s ability to comply with the standard contractual requirements for technical aircraft information required to be disclosed to foreign financing parties. Lease deals, particularly operating leases, typically require extensive technical information about the aircraft to be made available to the lessor or owner participant. Unlike operating lessors, mortgage lenders usually do not request specific equipment records, but there may not be any contractual limits on the types of information they could request. Also, the “deemed export” rule could conceivably apply to information that a financing party could discover on the kind of walk-around inspection to which lenders, lessors and their respective agents are normally entitled.

MONEY LAUNDERING

The U.S. Patriot Act makes the knowing acceptance of foreign corruption proceeds a criminal money-laundering offense. In addition, the Patriot Act required a long list of U.S. financial institutions⁶ to implement anti-money laundering programs, unless explicitly exempted by the Treasury Secretary⁷. However, in 2002, the Treasury Department provided a “temporary” exemption from the statutory requirement to “seller[s] of vehicles, including automobiles, airplanes and boats.”⁸ On February 4, 2010, the Permanent Subcommittee on Investigations within the United States Senate Committee on Homeland Security and Governmental Affairs held a hearing regarding its investigations of, among other things, how politically powerful foreign officials and their relatives and associates may be circumventing or undermining anti-money laundering and anti-corruption controls to bring funds that may be the product of foreign corruption into the United States. It was the latest of several hearings examining foreign corruption and its U.S. aiders and abettors. The

⁶ *The financial institutions (as defined in 31 U.S.C. 5312(a)(2)(T)) include “a business engaged in vehicle sales, including automobile, airplane and boat sales,” which may be deemed vulnerable to money laundering abuses due to the large amounts of money involved in this kind of transactions.*

⁷ *See Section 352 of the Patriot Act, P.L. 107-56 (Oct. 26, 2001), codified as 31 U.S.C. § 5318(b).*

⁸ *See 31 CFR § 103.170, as codified by interim final rule published at 67 FR 21110 (April 29, 2002, amended at 67 FR 67547 (November 6, 2002) and corrected at 67 FR 68935 (November 14, 2002).*

Subcommittee's report, among other things, points to the Treasury's failure to propose an anti-money laundering rule for businesses engaged in aircraft sales for more than eight years.

We do not know what, if anything, any potential Treasury regulations would say about sales of aircraft, or sales of beneficial interests in trusts that own aircraft, in connection with financing transactions. We do know that, in recent months in particular, the U.S. Department of Justice has brought criminal anti-money laundering actions against foreign officials or foreign government officials; those actions have been (and in future cases will also likely include) actions seeking asset forfeitures. We also know that the general prohibition on knowingly accepting the proceeds of foreign corruption is applicable, whether or not the Treasury Department issues rules relating to anti-money laundering programs for sellers of aircraft, and that U.S. courts have held that "willful blindness" to accepting the proceeds of foreign corruption constitutes "knowing" acceptance of such proceeds.

To avoid entanglement in money-laundering proceedings, either peripherally in a proceeding against another party or as the subject of the proceeding, an airline obtaining financing from a non-traditional foreign source or facing a transfer by a financing party to a non-traditional foreign source may want to conduct appropriate due diligence and be alert to "red flags" indicating potentially unlawful activity. For example, in new deals involving parties in non-traditional jurisdictions or contemplating transfers to parties in non-traditional jurisdictions, where it is possible to negotiate representations and warranties and transfer conditions, U.S. airlines may ask for a representation from the lender, lessor or owner participant to the effect that the funds being used to make the loan or to acquire its interest in the aircraft or owner trust, as the case may be, have not been derived from any unlawful activity, including bribery or any other activity that would constitute a predicate offense for a money laundering prosecution under U.S. or any other applicable law.

In summary, even in the case of matters such as U.S. citizenship or withholding, where U.S. airlines may have standard provisions in their documents, it is always better to ask questions early in the process of doing a new deal or responding to the desire of a financing party to transfer its interest or enter into a back-leveraging transaction. It is entirely possible that the parties have not thought through the issues in structuring the deal or the transfer. Issues under the law of the country where the financing party is located, where appropriate, need to be discussed with counsel in the relevant foreign jurisdictions at an early stage in the deal. Potential compliance issues with respect to U.S. laws and regulations would also need to be addressed.

Please feel free to contact us with any questions.

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