

In this third and final article of this asset management series, Angus von Schoenberg examines the awkward questions facing aircraft owners when airlines default and the steps required to repossess aircraft if this becomes necessary.

# Asset management part 3: default & repossession

**A**part from identifying potential early warning signals, Part 2 of this series addressed the importance of contingency planning where the survival of lessees or airline borrowers is threatened. This final article will explore the execution of that contingency plan where repossession is necessary to protect not only the financial interests of owners, but also the condition of the aircraft.

First, however, lenders or lessors must determine whether it is better to recover the asset or to support a restructuring of the struggling airline. If recovery is appropriate, most would agree that formal bankruptcy proceedings are the least desirable outcome, so a voluntary repossession is usually the least painful for all concerned. The approach taken depends on whether the insolvent carrier is a relatively small operator, such as Astraus in the UK, or a large mega airline such as American, which is now in Chapter 11. Jurisdictional issues that can affect the ability to recover aircraft.

## The decision to repossess

Attitudes to repossession vary in the financing community. If payment defaults under leases or loans become regular over a period of several months, then most are likely to conclude that steps to recover their aircraft are needed. Opinions are more divided on how quickly such steps should be taken.

Most owners do not repossess aircraft from their lessees unless they believe the operator cannot survive, or formal insolvency proceedings have begun. There are examples of successful restructurings, for example at Aer Arann in 2010, where a reorganisation and recapitalisation

enabled the regional carrier to exit examinership in Ireland and emerge in a stronger position. Similarly, the more recent political indecision at Air Baltic caused short-term worries, but the recapitalisation has now secured its future. Such examples show that repossession can be avoided even when bankruptcy proceedings have begun.

In some cases, owners can assist an airline restructuring process by taking a proactive role in capacity management. Dick Forsberg, head of risk and strategy at Avolon, points to the agreements with several lessors at Air Berlin, where some have agreed to trade delivery positions with other lessees in order to trim capacity. He adds that the manufacturers have often involved the leasing community in this process, since lessors are generally much better at placing excess capacity than airlines themselves.

Any decision to repossess will also be driven by the remarkatability of the asset. At a macro level the economic climate will have an impact. If several other carriers have gone under, while others are storing surplus aircraft due to an economic downturn, lessors and lenders need to consider carefully if they want their aircraft as part of a fleet of many parked aircraft with no obvious next user. It could be more prudent to renegotiate lease terms with the defaulting operator by agreeing to reschedule rental payments, which might include a short-term grace period.

The class of asset may also have an impact. In the regional sector, ATR and Bombardier DHC8 turboprops in good condition can be placed with another carrier within a week, because demand is high, but other types such as 50-seat regional jets (RJs), especially CRJs, could

take many months to place. If the defaulting airline is an RJ operator, rescheduling becomes more attractive. If owners take an unbending approach to lessees with such aircraft during restructuring, they are unlikely to be favourably treated if the airline survives.

Age also determines whether an aircraft can be placed elsewhere. Older, less fuel-efficient aircraft tend to be in less demand. While current next generation A320 or 737 aircraft can be placed with other operators quickly, most lessors and remarketing specialists agree that older generation or classic models may take a year or more to place if there is a market at all. If such older aircraft need to be repossessed in the current market, it is now increasingly common, for example, to lease out the engines and some other high-value components with reasonable remaining lives to their next shop visits and part out the remainder of the airframe. This can obviate the need for expensive re-entry to service maintenance, and generate lease income which could even be greater than leasing a fully serviceable aircraft.

## Legal considerations

While a detailed review of the legal complexities of repossession in various jurisdictions is outside the scope of this article, this is nevertheless a key component in any decision to repossess. Aircraft recovery under the US bankruptcy code where aircraft can be accepted or rejected after 60 days under Section 1110 is also outside the scope of this article.

Within Europe and elsewhere there are a myriad legal issues to be considered before attempting a forced repossession



*Aer Arann exited examinership in 2010 after a successful restructuring.*

from a bankrupt carrier. Advance planning is critical. Keith Wilson, partner at BLP, recommended a review of critical legal documentation in the previously described contingency plan, but this also applies to law in respect of repossession.

As there are many countries in which it is notoriously difficult to repossess aircraft, including some European countries such as Spain and Italy, local lawyers must be consulted if this has not already been done as part of any contingency plan. Similarly, in countries where the Cape Town convention has been ratified, its application under local law would need to be verified. For example, in the bankruptcy of Mexicana, not all elements of the treaty were applied in Mexico so that the self-help remedies could not be exercised. In such instances, most would recommend avoiding a forced recovery and suggest supporting a restructuring or a voluntary approach.

There may also be cross-border legal issues to consider. For example, Wilson explains that some lenders have tried to secure their assets with an English law mortgage, but if the aircraft is in another jurisdiction, however, the validity of such a mortgage can be contested. In the Blue Sky case, it was confirmed that such a mortgage was not a valid way of securing an aircraft in Holland. While it may seem odd to use an English law mortgage to secure an asset elsewhere, it can be quicker than using local courts, because if an English law judgement is presented to a court in another European country, that court should recognise it under European Union (EU) reciprocal arrangements.

## Costs

Any decision to repossess should take into account the cost of doing so. As no two cases are ever the same, this will vary considerably, but Owen Geach, commercial director at the IBA Group, says the contents in the table (*see page 8*) outline a range of costs from a worst case scenario to one that is likely to be more typical. The figures relate to a 737 that has been in service since 2005, and range from \$1.5million to close to \$4.5 million.

The above example assumes a downtime of 2-4 months for remarketing a new generation aircraft to within 95% of the expected market value. This includes time for maintenance or delivery requirements, so the loss of rental revenue can be substantial. One of the largest maintenance cost risks is engine shop visits, since a defaulting airline may well have deferred engine maintenance or have unpaid overhaul bills. This may be mitigated if a lessor has accumulated sufficient reserves or the engines are in a power-by-the-hour programme. Lenders who do not collect reserves under loans or finance leases can be more exposed to this type of unplanned cost risk.

Other major cost items are registration transfer and legal expenses. Geach explains that the former includes de-registration and re-registration in the country of the new operator, and covers the airworthiness costs of inducting a recovered aircraft into a new continuing airworthiness management organisation (CAMO), and maintaining the associated aircraft records during the downtime

period. Legal costs are estimated per aircraft. Geach says the size of the aircraft makes little difference to the cost, but these exclude any liens that may need to be cleared, such as airspace control or landing fees which appear separately. Such liens can be more expensive than shown if unpaid invoices have cumulated over several months.

While these costs assume that the tasks are outsourced to third parties, most lessors have certain levels of in-house capability as part of their general overhead, and so would not necessarily allocate these to individual aircraft. For example, many have their own in-house lawyers, engineering and asset management capability. In some cases, where lessors have repossessed aircraft, their own pilots have flown the aircraft to their own storage and maintenance facility so that attributing costs to a particular aircraft becomes less relevant.

## The repossession process

Once a decision is made to repossess an aircraft, the process differs according to whether there is agreement between the owner and the carrier, or whether it is involuntary. In the case of the latter, timing and speed are critical. The main elements to be considered include security of the aircraft, records, liens, storage, insurance, ferry flights and remarketing.

## Security

It is unlikely that all aircraft and their records will be in the same place at the same time, so a single friendly location for repossession is often not possible. Wherever the aircraft are, each will need to be secured until they can be moved to a suitable storage location. If the recovery is hostile a security team may be needed, especially if local companies are owed money and might take parts as security.

## The aircraft

Prior to repossession, the aircraft should be thoroughly inspected to assess the status of its physical condition. There are numerous cases of aircraft in such poor condition that a recovery and ferry flight has proved impossible without

significant expenditure to make them airworthy. The reported condition of a number of grounded aircraft at Kingfisher is a case in point. As discussed, regular inspections under an asset management programme should minimise this risk.

While on-going inspections are important, a technical visit before repossession is also critical to determine what is required to return the aircraft to service. In a worst case scenario, the aircraft might not only require a C check, but also full engine overhauls, completion of a long list of airworthiness directives (ADs), and corrosion repairs among other items. If it is possible that the aircraft may return to the original operator, such an inspection ensures that no claim can be made against the owner for damaging the aircraft while under its control.

## Records

Assuming a good asset management programme is in place, scans and copies of records will already have been made, but it remains important to secure the original records. Wadick Chomyszyn, chief executive officer of SGI Aviation, stresses that it is vital to maintain a good relationship with key airline records staff to assist in locating and completing all the records. Chomyszyn adds that the lessor should ensure that the quality assurance

manager signs off all records, including: non-incident statements; life limited parts sheets; AD and mandatory service bulletin lists; and modification status records.

Geach adds that it is not unusual for records staff to request payment to collate and package the records prior to their release. If the repossession is hostile, Chomyszyn says that it may be necessary to apply for permission from relevant airport authorities to access the premises where records are stored, which at a minimum is likely to involve procuring any necessary security passes.

It is critical that hard-copy records are secured. If a third-party records management organisation with appropriate IT systems has managed these records on behalf of the airline in default, it may be valuable to keep this arrangement going at least until all records have been moved and inducted into a storage programme.

## Liens

In the course of normal operations before any default or bankruptcy, several debtors may have been able to impose liens on the aircraft. Eurocontrol has wide-ranging powers in Europe and may stop an aircraft being ferried to a storage location if its outstanding accounts are

not paid first. Similarly, airport operators often prevent the movement of aircraft associated with the carrier's non payment of landing charges and other support fees.

If the aircraft is undergoing a shop visit, this will need to be completed and paid for before maintenance providers will release it. In other cases, aircraft may contain parts to which others hold title: for example, if an engine is undergoing a shop visit, the aircraft may be operating with a leased engine from a third party; or engines may have been rotated around the fleet, so that engines that were originally on the lessor's aircraft may be installed on a different aircraft. Engine changes or title swaps may have to be arranged before the aircraft can be removed from the operator's facility.

## Storage facility

If a storage facility has not been arranged as part of the contingency plan, a suitable location will need to be chosen. If, for example, the process is supported by the operator, the jurisdiction is friendly to creditors, and the facilities exist to store the aircraft, then the operator's existing premises could be used. Such a location should also be suited to remarketing the aircraft so that potential new operators can easily inspect it in an appropriate environment.

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## 737-800 REPOSSESSION COSTS

Repossession costs - \$	US\$	Worst case US\$	Typical US\$
Loss of rental (330K/month)		1,320,000	660,000
Hull insurance		50,000	25,000
C-check		230,000	115,000
Engine shop visit		1,500,000	190,000
Repaint		50,000	17,000
Legal costs of new lease/sale		50,000	50,000
Initial aircraft security		20,000	4,000
Section total		3,220,000	1,061,000
Parking & storage costs			
Induction	10,100		
4 months downtime	7,200		
Reactivation	12,000		
Section total	29,300	29,300	12,000
Typical costs of repossession			
Legal fees	80,000		
Liens by authorities	20,000		
Other third party liens	20,000		
Refuelling	8,500		
Registration transfer	500,000		
Section total	628,500	628,500	314,500
Technical costs			
Records retrieval & inspection	18,000		
Section total	18,000	18,000	9,000
Ferry flight & flight planning costs			
Ferry flight	25,000		
Flight planning	20,000		
Engineers	3,000		
Crew	5,000		
Section total	53,000	53,000	26,500
Reconfiguration			
Seating reconfiguration	500,000		
Section total	500,000	500,000	125,000
Typical travel costs			
Air tickets & local travel	6,500		
Section total	6,500	6,500	3,250
Total		4,455,300	1,551,250

Otherwise a third-party facility should be selected, particularly if the operator's base is targeted by creditors, former employees or the media. Some lessors have their own facility so that this choice is obvious, but other owners need to choose an independent option. This would partly depend on whether it has the ability to induct the aircraft into a storage maintenance programme, and whether it has a CAMO capability should the aircraft need to comply with EU EASA regulations.

Mike Skinner, chief executive of AMS, recommends that in most EU cases CAMO control should be maintained. He explains that if CAMO control is allowed to lapse while the aircraft is in storage, the owner would need to reintroduce the

aircraft into a CAMO-controlled environment when a new lease or sale is on the horizon, perform all outstanding maintenance and then reapply to the applicable aviation authority for a new certificate of airworthiness. The owner would become subject to the lead time constraints of CAMO, the maintenance provider and the aviation authority.

Remarketing considerations will also be critical. If the downtime period may be considerable, aircraft owners may wish to move the aircraft to a long-term facility, or even a location where the aircraft may ultimately be parted out if it cannot be placed within a certain time frame. If the need is likely to be short-term a full-service maintenance repair and overhaul (MRO) shop may be more appropriate.

## Insurance

As insurance may be invalidated by default or repossession, the existing policy terms will need to be reviewed carefully prior to any ferry flight. Discussions should take place with the insurer to understand the implications since, for example, a limited grace period might apply. Standby cover for ground risks and ferry flights may need to be put in place.

## Ferry flight authorisation

Before any ferry flight can take place from a bankrupt carrier, a permit to fly may be required if the operator's air operator certificate (AOC) and associated CAMO airworthiness have been revoked. "If the airworthiness management of the aircraft falls out of its CAMO environment," says Skinner, "then its certificate of airworthiness will no longer be valid."

Chomyszyn advises that the need for a permit to fly will also depend on what, if any, maintenance needs to be performed and the amount of time which has elapsed since the operator's permits were revoked. He recommends that if there is any doubt, the local aviation authority should be approached for its opinion. Skinner adds that if the ferry flight takes place promptly after the operator's demise and airworthiness management has been taken over by another CAMO, then moving it should not be an issue.

## Ferry flight

The crew for a ferry flight may be sourced from the current operator where many of their pilots may be seeking work. Other sources could include crew providers such as PARC, Southern Cross and operators of the same aircraft type. Submission of flight plans as well as fuel requirements and overfly permissions is usually the responsibility of the ferry crew and their provider.

## Storage care & maintenance

The aircraft will need to be inducted into a storage maintenance programme on arrival at the storage location. The requirements for short- and long-term storage are different, but are defined in the applicable maintenance manual. For example, long-term storage typically requires engine preservation measures while a short-term programme requires periodic engine runs and avionics systems checks.

If the downtime is expected to be short, the aircraft should be assigned to a CAMO organisation so that the aircraft can maintain its airworthiness if it is in

*Astraeus ceased operations in December 2011 after nine years of operations.*

the EASA environment. This will require the CAMO to perform a records audit.

Chomyszyn says that this is the best time to develop a workscope for return to service, although this work would not start until a new operator has been secured. This is useful from a remarketing perspective, since it will determine what is required along with the associated cost, and allow a timeframe to be established. If, for instance, certain components are needed that have a long lead time this could affect remarketability. It will enable prospective new operators to see quickly what is likely to be needed and may make it more difficult for customers to request a long list of 'nice to have' maintenance or modifications. As this workscope should be based on the maintenance review board (MRB) and manufacturer's maintenance planning document (MPD), it will determine what may be needed to bridge the maintenance programme into that of any new operator.

There are several reasons for not performing this work immediately. Apart from a general unwillingness by financiers to invest in aircraft prior to knowing how such funds can be recovered, the clock on time-controlled components starts to tick as soon as any tasks are completed so that time limits could be wasted or tasks might even need to be repeated prior to delivery. It may not be cost- and time-efficient to perform maintenance only to have to complete a separate bridging check before delivery. It may be wise, however, to order any parts with long lead times that would be needed in all circumstances so that remarketing is not negatively impacted through an inability to deliver the aircraft on time. This might include parts to complete a terminating action on ADs, or replacement components whose hours or cycles have expired.

## Remarketing strategy issues

Part of any contingency plan should involve a remarketing strategy. If the owner has its own aircraft placement capability, there will be no need to appoint a standby agent unless that owner has been funded by a third-party debt provider. Typically, lenders appoint a third party, which in some cases may step in if the owner fails to secure an acceptable sale or lease within a defined period. In other cases the manufacturer



may be the remarketing agent, particularly if it has provided any support to the original financing structure, such as a residual value guarantee.

A concern that manufacturers, in particular, may have about any agent, is that if the remarketer is disposing of other aircraft of the same type, there could be conflicts of interest. If an agent markets two 737s for different owners, which aircraft would they promote? Such a conflict may exist for a lessor of more than one of the same aircraft if they are funded by unconnected third parties.

The structure of any underlying finance may affect the remarketing strategy in other ways. Lessors aim to lease repossessed aircraft, particularly if economic conditions or the demand for the class of asset in question are such that a sale is unlikely to achieve the aircraft's full value. Lenders under a loan or finance lease, whether directly to the airline or to lessors, are more likely to want to sell.

As well as strategy considerations pertaining to aircraft age and the relative demand for different types, aircraft condition at the time of repossession may also drive how to place the aircraft. Often financiers will simply want to dispose of aircraft in an 'as-is, where is' condition as they are reluctant to invest in a delinquent asset, but this is likely to reduce its attractiveness to the next user and thereby reduce the achievable sale price or lease rate. This suggests that it can make economic sense to invest in the aircraft's maintenance condition to improve remarketability. To an extent this conflicts with Chomyszyn's previous advice to develop a workscope, but not perform any maintenance until a user has been identified. Unusual configurations exemplify this dilemma. If an A320 has

some first-class seats or is configured with unusually high-density seating for a low-cost carrier, should the owner reconfigure the aircraft to a standard variant to make it more attractive to a broader spectrum of operators?

## Concluding remarks

The decision to repossess aircraft should be a last resort for aircraft owners if it is unlikely that a successful restructuring can be completed. At the same time indecision can be risky, in particular if others have already acted to recover their aircraft, as the condition and therefore ability to remarket to alternative users can be seriously impaired if the aircraft and its records start to deteriorate, as an aircraft without its records is almost worthless.

In terms of the process, critical factors include: the location and the associated legal constraints in that jurisdiction; the completeness and condition of the aircraft and its records; and the cost and time required to return the aircraft to service with another operator. Factors that are harder to quantify include the level of co-operation by the defaulting airline and its employees.

Finally, remarketing considerations should not be ignored. The likely demand for the recovered aircraft is driven by economic conditions, the relative popularity of the type in question and its age. If the aircraft can only be placed with poor quality carriers, where the risk of default is high, it may not be advisable to place it where the process may need to be repeated again shortly thereafter. **AC**

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