

# Research on the Legal Risk of Securitization Bankruptcy in Aircraft Finance Lease

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***Abstract:** Aircraft financing leasing has become an important form of aircraft trading. The use of predictable cash flow brought by financing leasing to achieve asset securitization business operations is conducive to revitalizing market resources and promoting the prosperity and development of market participants. But it is also because the asset securitization process under aircraft financing lease involves multiple parties and the legal relationship is complicated, so lessors, lessees and special purpose carriers are more likely to have bankruptcy in market competition, which affects the entire asset securitization working normally. Therefore, this paper puts forward some measures to deal with the above-mentioned legal risks from the angles of establishing the means of pre-prevention and termination of losses, perfecting the bankruptcy legislation of financial lease, and innovating the system of special purpose company, in the hope that the law can produce a marked effect in the asset securitization of aircraft finance lease.*

***Key words:** Aircraft; Financial lease; Asset securitization; Bankruptcy risk*

## Introduction

On May 5, 2017, the first flight of the COMAC C919, a civil aircraft with China's fully independent intellectual property rights, took place on May 5, 2017, marking a new step forward in China's independent production of large aircraft technology, it is conducive to improving China's independent innovation capacity and strengthening the country's core competitiveness.

According to details of the first orders issued by China's COMAC, 497 of the C919's largest aircraft have been purchased by leasing companies, accounting for about 61 percent of total orders. Because of its financial strength, the financial leasing company that signed the C919 aircraft sale contract with China's COMAC widely bought the large aircraft and gained market share through leasing, mortgage and other means in order to obtain further benefits through the capital market. It is also because of the high value of the aircraft as a special movable property, its high price makes it difficult for the average consumer to pay in a lump sum or in installments to acquire the ownership of the aircraft, for example, according to the price quoted by China's

COMAC, it is only half the price of its main rivals such as Airbus A320 and Boeing 737, but the C919 still commands a market price of RMB350M. It is for this reason that financial leasing companies, which have a strong financial base, choose financing leasing as a new type of transaction, by signing financing leasing contracts with airlines, and according to the willingness of the airlines to purchase aircraft and China's COMAC signed a C919 aircraft sales contract to acquire the ownership of the aircraft, and then leased the aircraft to the airlines, thus the financial leasing company became the lessor, and enjoy the ownership of the aircraft, as a lessee, an airline may exercise the right to use an aircraft in accordance with the law, but it must pay rent to the financial leasing company. C919 aircraft financial leasing transactions, is conducive to the acquisition of important external financing for China's civil aviation industry plays a vital role.

## Questions Raised

In aircraft finance lease, the lessee should pay the full rent to the lessor on time, which will produce the continuous and stable cash flow. At this point, Securitization's business model is the only one in the financial lease legal relationship where the lessor can cash in and get a direct benefit. A Securitization is an Originator, Transferor, Seller, that reassembles its assets (claims) that produce a predictable and stable cash flow, it is transferred to a Special Purpose Vehicle, or SPV, through a genuine sale. The SPV then carries out certain structural arrangements, separation and reorganization, through the internal and external credit enhancement of the asset, and maintains it in a certain investment grade, and then issues securities to investors on the basis of the asset (creditor's rights) , the process of paying the principal and interest of the securities to the securities investors with the cash flow income generated by the assets after the funds raised by the securities issue are paid to the originator as the consideration of the transferee's assets.

As a result, in the Securitization process, the lessor will receive a stable and predictable cash flow from the airline, which will then be sold to a special purpose vehicle through a risk isolation and true sale process. The special purpose vehicle, after having the ownership of the cash flow, issues securities through internal and external credit enhancement for the investors to choose to purchase, thus making the rental income of the leasing company become marketable securities, to achieve the reuse of the original rent.

The Securitization process of aircraft financial lease involves many parties, such as lessor, lessee, special purpose carrier, etc. , and involves many complicated legal relations in the process of financial lease contract and Securitization. Due to the instability of the aircraft industry, the carrier of the lessee, the carrier of the special purpose or the carrier of the trust, even deep-pocketed aircraft leasing companies are likely to go bankrupt in the competitive market. A bankruptcy of one of these entities would be devastating to the Securitization process of exporting large aircraft. Therefore, we should carefully analyze the possible bankruptcy risks in the Securitization business model under aircraft financial lease and put forward preventive measures to avoid the bankruptcy risks from the legal perspective, it plays an important role in promoting the commercial operation of Securitization under aircraft finance lease and promoting the sustainable development of the civil aviation industry.

## Specific Legal Risks of Bankruptcy

As mentioned above, the Securitization under an aircraft financial lease involves multiple legal entities such as lessors, lessees, special purpose vehicles, internal and external credit enhancement agencies, etc. .To ensure the continued health of the Securitization, it is essential to ensure that the assets of the core forces of substantial participation, lessors, lessees and special purpose vehicles, are well functioning. But we also see that, the phenomenon of long-term losses of some domestic airlines as charterers exists objectively, and the situation that the profits of the special purpose carrier companies are not good because the operations of the companies are limited to the Securitization business is also very serious, therefore, it is possible for these parties to develop bankruptcy risk 4 in the process of aircraft finance lease Securitization. In the event of the bankruptcy of a major legal entity, the entire Securitization would be completely paralyzed. Therefore, we need to take into account the legal characteristics of the financial lease, the Securitization, and the actual participation of all parties in the Securitization process under the aircraft financial lease, presciently raises the specific legal risks of bankruptcy that may exist.

### Risk of bankruptcy of lessor

In the legal relationship of financial lease, the lessor is an aircraft leasing company which has strong capital and can pay large amount of money to purchase the aircraft directly for the use of the lessee. However, in order to obtain greater profits, aircraft leasing companies usually choose to buy enough aircraft for the lessee to choose. Coupled with the fact that the payment of rent is made within the period agreed upon in the financial lease contract, there is also a high risk that the lessee's airline will not be able to pay the rent on time due to the poor performance of its business. This is a huge challenge for leasing companies that need to use capital to expand their business, so there are also situations where companies can not make a profit due to lack of capital, resulting in bankruptcy.

Aircraft Leasing companies are lessors in financial leasing relationships and rely on the stable and predictable rents they receive for further Securitization operations. Therefore, in case of the bankruptcy of the lessor, the ownership of the leased property belongs to the lessor as stipulated in the chapter of "financing lease" in the contract Law of China. In other words, in the event of bankruptcy of the aircraft leasing company which is the lessor, because it has the ownership of the leased aircraft, the aircraft will be included in the bankruptcy property as the lessor's property, as a result of the actual use of aircraft to obtain the corresponding operating income of the lessee airlines have operational difficulties. At this time, the original aircraft leasing company and the airline signed financial lease contract has not the original signed the expected practical effect, so the lessor will naturally no longer obtain stable and predictable cash flow income. The bond assets that were originally used in the Securitization process are no longer in existence, thus leading to the complete collapse of the business model of the Securitization under the export aircraft finance lease.

### Risk of bankruptcy of Lessee

In the process of an aircraft financial lease, the Securitization shall, as the lessee, enjoy the right to use the aircraft and shall also undertake to pay rent to the lessor at regular intervals and in full in accordance with

the financial lease contract. However, combined with the actual situation of China's airlines, there are more airlines are actually in the state of loss, so the lessee is facing a greater risk of bankruptcy. In the event of bankruptcy of the lessee, which is an important part of the Securitization under the aircraft financial lease, it will lead to the legal consequence that the lessee can not actually perform, and that in turn has a serious Securitization effect on the whole process.

There are two main reasons why the lessee's actual performance can not be performed due to the lessee's bankruptcy: First, according to Article 18 of the Enterprise Bankruptcy Law of China, when the bankruptcy administrator decides to continue to perform the financial lease contract or to cancel the relevant provisions, when the lessee starts the bankruptcy proceedings, the insolvency representative of the lessee has the right to choose performance: That is, the administrator may decide that the financial lease agreement previously concluded between the lessee and the lessor shall remain in force and that the lessee shall continue to pay rent to the lessor and to possess and use the leased property; However, if the insolvency representative decides not to recognize the validity of the financial lease contract, the financial lease agreement shall no longer be valid and the lessor shall declare as a general claim the rent that has not been paid by the lessee. Therefore, once the insolvency representative decides to reject the benefits of the financial lease agreement, the legal relationship between the lessee and the lessor of the financial lease will cease to exist, furthermore, the lessee need not fulfill the obligation of paying rent in full and on time to the lessor.

Secondly, when the lessee goes bankrupt, based on the protection of the relative rights of the lessor, the enterprise bankruptcy law of China formally determines that the lessor loses the legal possession of the leased property as determined in the financial lease contract on the basis of the lessee, and the right to request the lessee to return the leased property to itself is the lessor's right to take back 9. If the lessor immediately exercises the right of recovery in the event of the lessee's bankruptcy, the lessee can not and must not pay the lessor rent based on the rights and obligations established in the financial lease contract, result in a situation where actual performance is not possible. As a result, the cash flow used in the aircraft finance lease process can not be fully Securitization, and the smooth operation of the Securitization can not be talked about.

### Risk of SPV insolvency

In the Securitization process, the originator takes the predictable cash flow out of the business and improves the liquidity of the original creditor assets. But because the originator's debt assets will become the bond circulation market, actually also increased the liquidity risk of the assets. Therefore, in order to deal with the liquidity risk of the assets, a special purpose vehicle should be set up in the Securitization process to complete the risk isolation and real sale of the creditor's assets of the originator.

There are currently two main Securitization: the Special Purpose Trust (SPT) and the Special Purpose Company (SPC) . Because of the basic characteristics of trusts, special purpose trusts are able to isolate the risk of bankruptcy in the Securitization process. In the special purpose trust, the trust property will be separately managed and independently accounted for with the personal property of the principal and the trustee, the creditor is also unable to assert a claim for liquidation of the trust property 10. Therefore, even if the trustee or trustee in the special purpose trust goes bankrupt, the legitimate rights and interests of the

beneficiary will not be affected, the money used for risk isolation and credit enhancement in the Securitization process can still be secured.

In the SPV model, however, there needs to be a specialist firm that is limited to Securitization assets, receiving interest and principal on those assets, and distributing the proceeds from securities. Because of the limited experience and the risk of the market assets, the SPV often faces the bankruptcy risk. According to the Enterprise Bankruptcy Law of China, when an industrial or commercial enterprise is declared bankrupt because it can not operate normally, the company must use all its assets to pay off its debts. At this point, the money in the SPV's assets that would facilitate the true sale of the sponsors' cash flows will be gone, and the entire aircraft finance lease Securitization will be seriously affected.

## **Measures to Deal with Legal Risks in Bankruptcy**

### **Establishment of pre-emptive and discontinuation instruments for the insolvency of financial leases**

As the direct subject of the financial lease contract, the aircraft financial lease company and the airline company as the lessor are the subject of the financial lease contract, I, as an important source of direct cash flows into the Securitization. Therefore, in order to ensure the smooth operation of aircraft financial leasing Securitization, it is necessary to prevent the legal aspects of the lessor and lessee in the commercial operation of the Securitization bankruptcy risk.

First of all, in the process of financial leasing, it is necessary to establish a precautionary measure in advance to prevent bankruptcy from occurring at the source because one or both parties of the lessor or lessee are facing poor management, as a result, the real right of the aircraft or the creditor's rights determined in the financial lease contract shall be brought into the bankruptcy liquidation procedure. In particular, both parties to a financial lease contract may jointly contribute to the creation of a security for the rights and obligations of both parties as defined in the financial lease contract at the time of signing the contract, thus being able to comply with the provisions of the Bankruptcy Law of China, so that the portion of the secured property is not brought into the estate by reason of bankruptcy, thereby facilitating the acquisition of the necessary liquid property to ensure the sound operation of the Securitization<sup>11</sup>. At the same time, a system of publicity for financial leasing transactions should be established. That is, at the time of signing the financial lease contract, the lessor and the lessee may agree to provide each other with the operating statements of their companies on a regular basis, so that the parties to the financial lease contract can have a detailed understanding of the operating conditions of the other company. When one party's company is about to go into bankruptcy, the other party can take timely action to prevent the insolvency representative from incorporating the aircraft into the estate or to remove the lessee from the financial lease claim.

In addition, under the background of the survival of the fittest in the market economy, the market participants implement business strategies that are beneficial to themselves in order to obtain their own interests, it is therefore difficult to guarantee that the companies involved in the aircraft financing Securitization process will not go bankrupt. How to take reasonable measures not only to protect the interests of the creditors, but also to

take into account the financial leasing company as the lessor and the airline company as the lessee should be explored. For example, in the case of bankruptcy of the lessor of a financial lease contract, according to the provisions of the contract law of the People's Republic of China, since the ownership of the financial lease object belongs to the lessor, under the conditions of the aircraft financial lease Securitization, the aircraft will be returned to the lessor and placed in the insolvency estate, while the lessee's original claim for a financial lease of the aircraft can not be asserted, seriously affecting the interests of the lessee. Therefore, when the lessor is facing bankruptcy, the lessee may offer to pay the remaining rent as agreed in the original contract and increase the amount due, as the lessee has already paid a large amount of rent in order to obtain the right to use the aircraft, to take full ownership of the aircraft. This would not bring the aircraft into the insolvency estate, but would be more beneficial to the lessor's creditors, and would not affect the Securitization's access to predictable cash flow.

### Consummate the legislation on bankruptcy of financial leasing

According to the bankruptcy law of China, when the lessor and lessee of a financial lease go bankrupt, the insolvency representative has the right to choose whether the financial lease contract should be continued or not. Once the insolvency representative decides to terminate the financial lease, the lessor will no longer be able to obtain the full cash flow on schedule to put into the Securitization process. On the other hand, the ownership of the post-bankruptcy financial lease property, although China's current law is to be enjoyed by the lessor, but to a certain extent, this will damage the lessee's expected income and legitimate rights and interests, so there is also a lack of improvement at the beginning. Therefore, China's current bankruptcy provisions for financial leasing need to be further improved.

On the one hand, we need to perfect the relevant provisions of the legislation on the bankruptcy of financial lessors 14. In order to protect the interests of creditors, the bankruptcy law stipulates that the bankruptcy administrator has the right to cancel the contract. But such a right of rescission of the contract can not play a good role in protecting the interests of the lessee and the lessor, and will probably cause the insolvency representative to realize the creditor's right quickly, and regardless of the serious consequences of the termination of the contract is directly terminated. In order to prevent the financial lease contract between the parties to the extreme imbalance of interests, legislation should be the insolvency administrator to exercise the right to terminate the contract reasonable and just restrictions. On the other hand, the bankruptcy of the leased property of the financial lessee also needs to be improved on the legislative level. As the contract law clearly stipulates the contract of financial lease, the leased property belongs to the lessor. Suppose that the lessor becomes insolvent shortly before the completion of the period agreed upon in the financial lease contract, at which point the lessee has paid a substantial amount of rent for the financial lease item, therefore, the lessor's full ownership of the leased property will have a serious impact on the interests of the lessee. Therefore, it is possible to establish the Chattel Security System in legislation, that is, to allow the lessee to acquire the ownership of the financial lease item after paying the period fixed by the financial lease contract. Chattel security enables the lessor to fully enjoy ownership of the leased property if it does not receive sufficient rent as security for the lessee to pay the full price. However, with the performance of the lessee's obligations, the lessee will be able to acquire the ownership of the leased property once all the loans have been repaid, thus achieving a balance of interests between the two parties, it also better guarantees that there will be sufficient

and predictable investment in the Securitization process.

### **Innovate and re-construct the special purpose corporation system**

At present, China has not formulated clear laws and regulations to regulate the SPV, because the SPV is used as the Securitization to isolate the risk of bankruptcy, in order to prevent the bankruptcy of the SPV from causing the failure of the Securitization, it is necessary to establish an innovative SPV system.

First, the legal nature and conditions for the establishment of a special purpose company should be regulated so as to ensure that the company can carry out its business in an orderly manner within the limits prescribed by law, to ensure the long-term prosperity and stability of the special purpose company by strictly regulating the content of important decisions and daily operations of the company, such as the company sponsors, the minimum capital limit for company registration, etc. , the risk of bankruptcy was avoided at source. At the same time, there is a need to establish an organizational structure that fits the Securitization business model and enables efficient corporate governance. As the SPV is the carrier of the Securitization, in practice, the management and disposal of the assigned assets are often left to the sponsors, so the internal governance structure of the SPV should be simplified as far as possible, in order to minimize the cost of the organization, to achieve a greater likelihood of corporate profitability. The establishment of internal control mechanisms for specific purpose companies, such as the establishment of an independent director system, can achieve the purpose of risk control and help to prevent the bankruptcy of special purpose companies.

In addition, strengthening the business norms and the use of funds of special purpose companies will also play an important role in the high-quality operation of special purpose companies<sup>17</sup>. On the one hand, the SPV is an important vehicle in the Securitization process, its business scope should be limited to specific assets such as transferred real estate or financial assets, management disposition of specific assets and issuance of asset-backed securities. Other operations should be strictly limited so as to enable the operation of the special purpose company to be completely dependent on the realization rate of the accounts receivable, it does not adversely affect the financial performance of the spv because of the poor performance of other businesses. On the other hand, the SPV obtains the required funds to acquire specific assets by borrowing or issuing asset backed securities in the course of Securitization, and use the proceeds as payment or repayment of the debt associated with the asset-backed securities. Therefore, during the Securitization process, appropriate restrictions on the use of funds by SPV companies can be conducive to the normal operation of SPV companies. Specifically, by restricting the borrowing of funds by special purpose companies, such payments shall be strictly limited to the distribution of the principal and interest of the asset-backed securities to the investors and the limitation of the funds of the Special Purpose Company shall be strictly limited to low-risk investments, such as the purchase of higher credit level claims or for bank deposits and so on. It is of great importance that the risk of bankruptcy in the course of Securitization can be fundamentally prevented only by clear limits on the use of the funds of SPV.

### **Conclusion**

Owing to the high value of aircraft and the high market price, it is difficult for airlines to acquire the

ownership of aircraft through one-time purchase, so aircraft leasing has become the main form of order source. In practice, an aircraft leasing company makes it possible for an airline to use an aircraft for civil aviation within the scope of the contract by signing a financial leasing contract with the airline company, aircraft Finance leasing companies as lessors to obtain a stable and predictable cash flow. Securitization is a business model which can make the lessor get more profit from the funds, but the legal relationship in the process of aircraft finance lease is complicated and there are many legal subjects, in the event of a bankruptcy of the lessor, lessee, or SPV, the Securitization would be seriously affected. In order to prevent possible legal risks in the Securitization of aircraft financial leasing, this paper proposes to prevent the bankruptcy risk by establishing the means of preventing and stopping the loss in advance, perfecting the legislation of the bankruptcy of the financial lease and innovating the system of the special purpose company, it is hoped that the Securitization business model under the aircraft finance lease will further stimulate the market vitality, which is of great significance to promote the development of China's market economy.

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