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Financial and Economic Crisis – Law Firms

Buying Aircraft From Distressed Sellers

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When buying an aircraft from a seller under financial stress, the first thing a potential buyer usually thinks is, “I’ve got the leverage and I’m going to get an amazing deal.” The buyer may get a bargain, but there are some unusual risks involved when buying from a distressed seller. If a buyer is not careful, a distressed seller can back out of a deal without cost, put the deal into limbo or undo a completed aircraft sale. In order to secure a good deal from a distressed seller, here are some protective measures.

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The Problem With Financially Shaky Sellers

The main problem with distressed sellers is that they may declare bankruptcy, which can affect the buyer in a number of ways. Bankruptcy gives the seller three critical weapons that can impact the buyer: (1) the ability to hold the buyer to the contract terms while delaying a transaction beyond contractual deadlines, (2) the ability to reject an otherwise binding contract and (3) the ability to treat funds on hand as assets of the bankruptcy estate. These weapons have different impacts depending upon the stage of the transaction.

If the seller files for bankruptcy protection before closing on the sale, the seller/debtor can use the bankruptcy process to reject the Purchase Agreement to enhance its position. The ability to reject the contract is tantamount to the ability to renegotiate it with you.

The bankrupt debtor/seller can hold the buyer in limbo, waiting weeks or months to reject a contract. The buyer might need to absorb the prepurchase inspection costs or pursue those costs as unsecured claims against the debtor. In the meantime, the buyer could be forced to wait – which means it will not have the aircraft it contracted to buy and cannot commit to buy-

ing a different aircraft without the risk of ending up owning two aircraft. This could be difficult for a buyer that intended to use the aircraft as replacement property in a 1031 exchange. If a seller files for bankruptcy after delivery, and the deal was “too good,” a bankruptcy court could set aside the transaction as a “preference” item or fraudulent transfer if a judge decided that the seller received less than “reasonably equivalent value” for the aircraft. The possibility of this happening goes up if there are other buyers willing to pay more than what the aircraft sold for.

The Boxer’s Mantra: Protect Yourself At All Times

The buyer has different defensive tactics available at different stages of the purchase process. In a typical used aircraft sale, the deal structure is as follows: The buyer makes a good faith, refundable deposit, visually inspects the aircraft, and then the buyer and seller sign a Letter of Intent – a nonbinding letter that establishes the purchase price, timeframe and structure of the deal. The parties then negotiate and sign a Purchase Agreement that fills in all of the details for the sale. After that, you have the inspection and you repair the squawks. Then come test flight, delivery and closing.

Pre Letter of Intent Phase

Before signing a Letter of Intent, a buyer should research the seller for signs of economic hardship and determine whether the purchase price is “too good.” If, at this point, it looks like the seller is in a tight spot, the buyer has several options. The buyer can let this deal go or move forward with the transaction, in which case the buyer will want to complete the purchase quickly, since the longer the transaction takes, the greater the risk that the seller becomes the subject of a bankruptcy peti-

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tion. Also, a buyer should make sure that it is dealing with a person from the seller that has the authority to do the deal and that the aircraft-owning company really wants to sell. The third option is to wait for the seller to file for bankruptcy. The benefits of that are discussed below.

If the buyer decides to go forward but is concerned about the seller's demise, the buyer can do several things. One option is to have an aggressively priced deal with an abbreviated pre-buy inspection that closes quickly. This works well if the aircraft is relatively new and still under manufacturer's warranty, and so the risk of airworthiness discrepancies would be low. But there is always risk, and therefore the price can and should reflect this risk. A buyer could also consider purchasing the aircraft without a pre-buy inspection for 70 percent cash and a 30 percent promissory note. After closing, the buyer would retain the right to inspect the aircraft and repair airworthiness discrepancies, and any problems found could reduce the amount owed the seller under the promissory note. The benefit of this is that it reduces the buyer's risk of getting trapped by the seller's filing for bankruptcy after the Purchase Agreement is signed but before the aircraft is delivered to the buyer. The risk, however, is that airworthiness discrepancies exceed the holdback under the promissory note. Ultimately, the seller probably will not like this structure but might be willing to avoid it with an even further-reduced purchase price.

Post Letter of Intent Phase

After the Letter of Intent is signed, but before the Purchase Agreement is executed, consider the seller's condition before signing the Purchase Agreement. Will the seller's cash "burn rate" get you through to the closing date? The buyer's due diligence on the seller should be to determine whether the seller is current on its direct operating costs, pilot salaries, maintenance costs, fuel, insurance premiums and engine maintenance programs.

Purchase Agreement Phase

In drafting and negotiating the Purchase Agreement, the buyer can build in some protections against the seller's default or bankruptcy. The main goal of the buyer is to be able to get out of the Purchase Agreement fast with no or low costs.

Typically, the buyer will make a good-faith deposit in anticipation of the purchase, which sellers normally require as evidence of the buyer's ability to buy and seriousness, and to cover costs incurred by the seller when engaging in the

process of selling the aircraft. The buyer should deposit as little money as possible, and none with the seller, since this money can become the seller's property in bankruptcy. Instead, the deposit should be held in escrow by a third party. There is, however, no guarantee that a bankruptcy judge will immediately treat this as the buyer's money, and the funds may sit frozen in the escrow account pending resolution. Part of the court's consideration will be the status of the deposit under the Purchase Agreement based upon the stage of the deal. Typically, the deposit remains refundable to the buyer prior to completion of the pre-buy inspection. After the pre-buy, if the buyer still wants to make the purchase, the deposit often "goes hard" and becomes nonrefundable to the buyer. A bankruptcy court judge will look at these matters to decide whether the deposit belongs to the buyer or the bankruptcy estate. Therefore, a Purchase Agreement should be clear as to when title to the deposit transfers to the seller. Also, the buyer should try to "stagger" when and how much of the deposit goes hard in order to mitigate the harm to the buyer both losing its full deposit and having the bankruptcy court cancel the Purchase Agreement and keep the buyer from taking delivery.

A buyer in this situation will want the seller to represent that it is paid-up with its vendors and maintenance providers to reduce the risk that liens might be filed that interfere with the closing. There are a number of contract provisions that can be thrown into a Purchase Agreement that a bankruptcy court will not respect. For example, a Purchase Agreement cannot (on its own) terminate if there is a seller's bankruptcy, since this would violate the "automatic stay" under the Bankruptcy Code. Also, the contract cannot require that the seller pay the buyer for "incidental damages" if the seller declares bankruptcy.

If it looks like things are going bad for the seller, but the seller has not yet declared bankruptcy, there are several things that a buyer can do. The best option is to quickly complete the contract and take delivery before the bankruptcy filing. Alternatively, a buyer could breach the Purchase Agreement by failing to perform its obligations prior to the bankruptcy filing, which, in conjunction with a small liquidated damages provision in the contract, would allow the buyer to get out of the contract at a relatively low cost. Keep in mind that the event of bankruptcy generally cannot be used as a default, triggering the buyer's right to take funds and walk

away. The "stay" in bankruptcy prevents creditors and counterparties from taking commercially typical steps to protect themselves based on a bankruptcy filing. You should therefore not expect to be able to cancel the deal and take your deposit back based solely on the seller's bankruptcy filing.

Buyer's Rights In Bankruptcy

If a buyer finds itself in the middle of a transaction when the seller declares bankruptcy, all is not lost. If the deal was almost done, the bankruptcy court can give approval to allow the buyer to complete the purchase. There are legitimate incentives for this, since the aircraft is probably costing the debtor/seller money to maintain and cash is being offered to the bankruptcy estate for an illiquid asset.

A Post-Bankruptcy Transaction Is Easier

If you do not foresee being able to close a transaction prior to a bankruptcy filing (and you do not want to be bound by a Purchase Agreement when that filing takes place), do not be afraid to wait for the bankruptcy filing and then pursue the purchase. In most cases, the bankrupt seller/debtor remains in control of the company, and the transaction is actually more orderly. An aircraft purchased from an entity in bankruptcy will be supported by a judicial order that offers protection from creditors.

With a little planning and foresight, a buyer can get a good deal buying an aircraft from a distressed seller and at the same time minimize the buyer's risks from the problems that can flow from such deals.

Bankrupt Aircraft Manufacturers

If the seller of the aircraft is its manufacturer most of the above analysis applies, but with some alteration. The purchaser of a new aircraft will have made progress payments (as much as 75 percent of the purchase price) and the language of the purchase agreement will determine whether that money is a part of the bankrupt estate. A buyer may end up with rights to an incomplete aircraft and an unfulfilled contract. In an extreme case, a buyer can (1) lose progress payments, (2) have its purchase agreement rejected, and (3) have "its" aircraft completed and sold to new purchaser. The recent bankruptcy of Eclipse Aviation left customers in just this position, and the "lucky" ones that took delivery before bankruptcy now have uncertain warranty and support.