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STRATEGIC ALTERNATIVES FOR AIRLINES AND THEIR SWAP COUNTERPARTIES IN RESPONSE TO RECENT PLUNGE IN OIL PRICES

As oil prices plunged from their record-breaking high in July 2008[1], airlines naturally cheered the corresponding decline in jet fuel and aviation gasoline prices. The financial impact of soaring fuel costs over the past several years resulted in airlines which had not implemented a comprehensive fuel hedging strategy suffering real financial pain. However, due to the recent sharp decline in oil prices, some airlines are now dealing with significant obligations to their swap counterparties, including the same airlines which were lauded earlier in 2008 for their prudent fuel hedging strategy.[2]

With many of their fuel hedges "out of the money", airlines are being required to post, in some cases, significant amounts of cash or cash equivalent collateral for the benefit of their swap counterparties. As these hedging contracts generally require an airline to post cash or cash equivalents as collateral to its swap counterparty quickly when the swap counterparty's exposure to the airline exceeds a certain threshold, many airlines are being forced to utilize precious cash from their balance sheets or otherwise attempt to raise capital in a challenging environment to cover their swap counterparty's exposure. Consequently, airlines are being forced to consider alternative short term strategies to provide required collateral. One such strategy which naturally makes sense is the airline pledging aircraft to the swap counterparty to cover the swap counterparty's exposure to the airline.

[1] Oil prices peaked at $147.27 per barrel on July 11, 2008. Daniel Whitten, *Congress Pursues $80 Oil With Trading Limits, Disclosure Rules*, Bloomberg.com: Worldwide, July 23, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aI3KfJ0v2akE&refer=home.

[2] Jens Flottau & Robert Wall, *Airlines Made Bad Bets in Fuel Hedging*, Aviation Week & Space Technology, Nov. 22, 2008, *available at* http://www.aviationweek.com/aw/generic/story.jsp?id=news/aw112408p3.xml&headline=Airlines%20Made%20Bad%20Bets%20in%20Fuel%20Hedging&channel=awst.

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Pledging Aircraft to Swap Counterparty

Due to the violent move downward in the price of oil (which has fallen as much as 70% from its summer 2008 highs), many swap counterparties have significant exposure to airlines under their fuel hedging agreements. The two greatest hurdles for an airline in meeting its obligations to its swap counterparties under its fuel hedging policies are (i) the significant dollar amount of the swap counterparties' exposure and (ii) the short timeframe under which the airline is required to post cash collateral for the benefit of its swap counterparties. Amending the relevant swap documentation to allow an airline to pledge aircraft to the swap counterparty in lieu of cash is an attractive alternative for the airline as it provides a reasonable, timely and effective means to clear both the collateral requirement hurdle and the timing hurdle, particularly given the challenging debt environment . However, the key issue then becomes whether swap counterparties will accept pledged aircraft in lieu of cash to cover their exposure to an airline.

If, from a value and risk perspective, the swap counterparty can be compensated through "excess" margining by posting aircraft having a value in excess of the cash posting requirement to reflect the difficulty in exercising rights against non-cash collateral, the swap counterparty should readily accept this alternative. The key to achieving this result for the swap counterparty is properly structuring the transaction which necessitates a real understanding of the aircraft being pledged and the rights a secured party would have in respect of such pledged aircraft.

We have outlined below several key issues for both the airlines and the swap counterparties to consider when structuring an amendment to the relevant swap documentation to allow for an airline to pledge aircraft in lieu of cash to cover a swap counterparty's exposure to an airline.

- *The Economics of the Deal: Advance Rate.* Based on the risk profile of the airline and the type of aircraft being pledged (including vintage of the aircraft and the relevant type of engines attached), the swap counterparty will want to consider the appropriate advance rate for the aircraft being pledged (i.e., based on the appraised value of the pledged aircraft, at what rate will the airline receive credit in the collateral structure for the pledged aircraft covering its obligations to the swap counterparty). As aircraft values can fluctuate based on market conditions, the swap counterparty will want to ensure that any reasonable risk in price fluctuations is accounted for in the advance rate such that the counterparty always has a cushion against actual exposure.

- *Properly Valuing the Pledged Aircraft.* The swap counterparty will want to ensure that the value being allocated to the pledged aircraft is accurate and as such, it will want (i) the pledged aircraft to be appraised by more than one appraiser (*Note*: Appraisals from at least three nationally recognized appraisers is recommended), (ii) the value allocated to the pledged aircraft to be based on the average of such appraisals or some other figure based on the values provided by each of the relevant appraisers and (iii) such appraisals to be dated as reasonably close to the amendment date for the swap documentation as possible. In addition, depending on the specific period that an airline may be permitted to pledge aircraft in lieu of cash, the swap counterparty will want to ensure that updated appraisals are completed at certain designated points and that upon the occurrence of certain trigger events (e.g., the downgrading of the airline below a certain threshold), updated appraisals are completed.

- *What Constitutes a "Qualified Aircraft".* As the swap counterparty is accepting pledged aircraft in lieu of cash, the swap counterparty will want to ensure that any aircraft pledged to it in lieu of cash meets certain specific criteria, including (i) the swap counterparty having a perfected first priority security interest in such aircraft, (ii) such aircraft being properly insured, (iii) such aircraft not having suffered any event of loss, (iv) no liens existing on such aircraft other than specifically negotiated permitted liens and (v) the airline satisfying all of its material covenants under the aircraft mortgage. It will be critical that the relevant aircraft mortgage and swap documentation specifically delineates that any pledged aircraft not meeting any of the agreed criteria will not constitute a "qualified aircraft" and as such, the airline will not receive any credit for such non-qualified aircraft for purposes of meeting its obligations to the swap counterparty.

The above structuring points are a few of the fundamental issues to be considered by both airlines and their swap counterparties in negotiating a pledged aircraft in lieu of cash transaction. There are, of course, additional critical issues which should be considered by the parties. Your regular Milbank contact or any of the members of our Global Transportation Finance, Global Finance or Global Project Finance Groups, whose names and contact information are provided below would be happy to discuss such additional structuring points with you. As always, we are available to assist you in developing and implementing the appropriate strategies to respond to recent market events.

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