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# Documentation and Structure: Financing Rail, Aircraft, and Marine Assets

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# Overview

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- Documenting Equipment Financing Transactions
  - Types of Financing Transactions
  - Legal and Economic Terms
    - Lease-Specific Considerations
- Rail Equipment Finance
- Aircraft Finance
- Marine Equipment Finance

# Types of Financing Transactions: Allocating Tax Benefits

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- Loans – Borrower retains title, tax benefits allocated to Borrower:
  - Fixed rate
  - Variable rate
  - Fully amortizing
  - Balloon
- Leases – Lessor retains title, tax benefits allocated to Lessor or Lessee:
  - Master v. one-off lease
  - Tax lease (UCC Article 2A “finance” lease)
  - Lease for security
  - Synthetic (TRAC or Split TRAC)



# Legal and Economic Terms

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**"I'm your attorney, Debbie, but I want to be more than that.  
I want to be your accountant, too."**

# Legal and Economic Terms

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- Documents Should Protect Four Main Elements:
  - Protect Loan/Lease Revenues
  - Protect Enforceability
  - Protect Residual Value
  - Protect Lender/Lessor from Liability
- Standard Documentation:
  - Loan: Loan Agreement, Promissory Note, Security Agreement
  - Lease: (Master) Lease Agreement, Equipment Schedule



# Legal and Economic Terms: Protecting Revenues

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- Term
- Payment Amount or Lease Rate Factor:
  - Payment Frequency: monthly, quarterly, annually
  - Payment Timing: in advance/arrears
  - Progress Payments and Interim Payments
- “Time is of the essence”: payable without prior notice or demand
- Fees & Taxes: documentation, commitment, filing/search, legal
- Late Payment Charges: amount, automatic or discretionary
- Leases Only: “Net Lease”/“Hell or High Water” – no deduction, setoff, abatement or reduction for any reason



# Legal and Economic Terms: Protecting Revenues

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- Interest Rate

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**"I'm just glad we got out before interest rates went up again."**

# Legal and Economic Terms: Protecting Revenues

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- Payment Frequency and Timing



*"Don't come home till that bag is full of money."*





# Legal and Economic Terms: Protecting Revenues

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- Progress Payments and Interim Payments

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*"I could be wrong, but you look like a man trapped in low-yielding financial instruments."*



# Legal and Economic Terms: Protecting Revenues

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- Fees



*"I'm going to get you acquitted, but I want my fee to be a lesson to you."*

# Legal and Economic Terms: Protecting Revenues

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- Fees & Taxes:
  - Allocation of responsibility to prepare and file all tax reports and returns – depends on type of transaction (Loan v. Lease)
  - Leases Only: Allocation to Lessee of liability for all fees and taxes (other than net income taxes of Lessor) incurred in connection with the acquisition, ownership and leasing of the equipment
    - Lessee's obligation to reimburse Lessor on an after-tax basis for any fees or taxes paid by Lessor
    - Authority of Lessee to contest the imposition or amount of fees and taxes
    - Ability of Lessor to pay fees and taxes which are the responsibility of Lessee and collect from Lessee such amounts as are advanced, together with interest

# Legal and Economic Terms: Protecting Enforceability

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- Representations and Warranties:
  - Corporate status and authority
  - No consents required and no violation of other agreements
  - Validity and enforceability of obligations
  - Accuracy of financial statements
  - Covenants:
    - Obligation to provide ongoing financial information
    - Financial covenants
    - “Further assurances”
- Conditions Precedent to Lender’s/Lessor’s Obligation:
  - Delivery of certified resolutions and incumbency of officers
  - Evidence of insurance
  - UCC financing statements to be filed

# Legal and Economic Terms: Protecting Residual Value

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*"Sure it has some life left in it, but you might ask yourself just what kind of life it would be."*

# Legal and Economic Terms: Protecting Residual Value

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- Delivery, Inspection and Acceptance of the Equipment:
  - Obligation to inspect, accept and execute an acceptance certificate
  - Allocation of responsibility for expenses incurred in connection with the acquisition, delivery and installation of the equipment (capitalized or expensed?)
  - Leases Only: Consequences of Lessee's failure or refusal to accept the equipment
- Use of Equipment:
  - Use in the conduct of business and in compliance with the requirements of any insurance policies
  - Geographic restrictions on use
  - Prohibition against termination of use or becoming a "fixture"

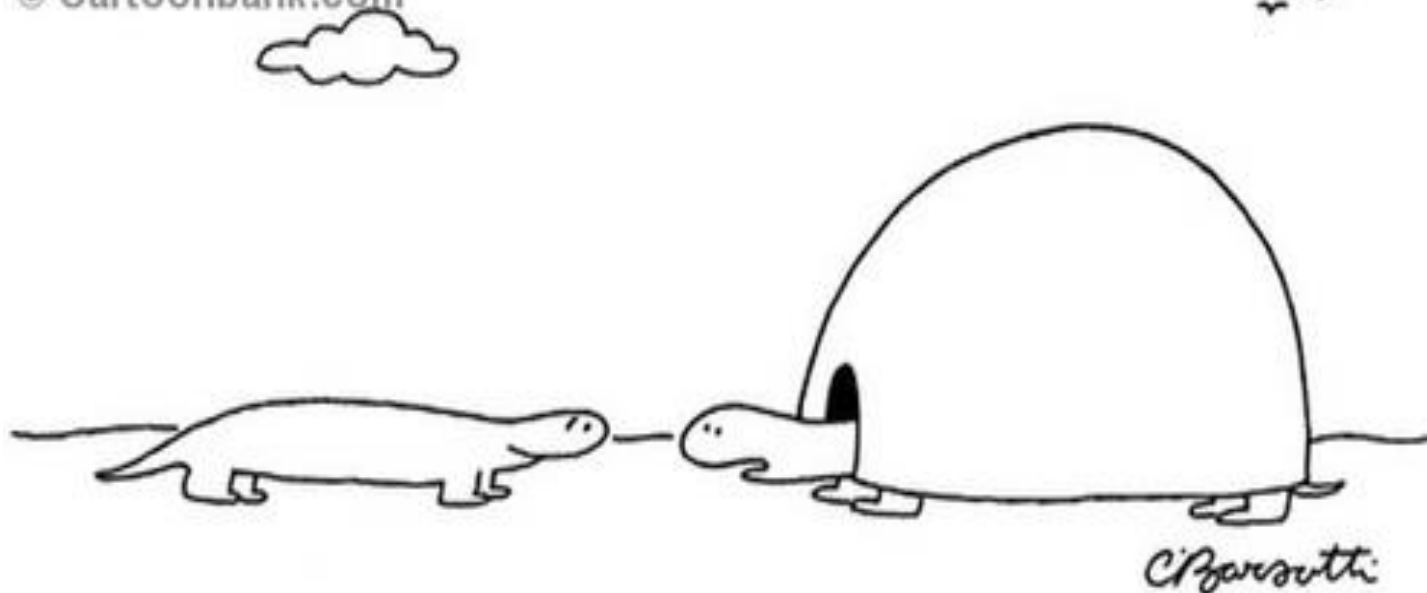


# Legal and Economic Terms: Protecting Residual Value

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- Maintenance of Equipment

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*"Yes, it's nice, but it's lost twenty per-cent  
of its value in the past year."*



# Legal and Economic Terms: Protecting Residual Value

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- Maintenance of Equipment:
  - Allocation of responsibility to Borrower/Lessee for maintenance at its expense
  - Establishment of the standard to which the equipment is to be maintained:
    - Compliance with the manufacturer's specified maintenance program
    - Maintenance so as to be in "as good operating condition as when delivered to Borrower/Lessee" (ordinary wear and tear excepted)
    - Special maintenance requirements for special types of equipment (AAR Rules and Regulations or FARs)



# Legal and Economic Terms: Protecting Residual Value

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- Maintenance of Equipment (cont'd):
  - Distinction between severable vs. non-severable improvements:
    - Income tax consequences
    - Removal without adversely affecting the value, utility and remaining useful life
    - Title to replacement parts or improvements
  - Prohibition against material alterations without prior written consent
  - Requirement to create and preserve maintenance records
  - Right to inspect maintenance records and equipment



# Legal and Economic Terms: Protecting Residual Value

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- Preserving the Equipment Free from All Liens or Encumbrances:
  - Imposition of the burden on the Borrower/Lessee to maintain the equipment free from all liens and encumbrances:
    - Exception for statutory and other liens arising by operation of law
    - Exceptions available only so long as the amounts which are the subject of the statutory lien are not yet delinquent or are being contested in good faith in proceedings which suspend collection and do not involve any substantial danger of the sale or impairment of the interest of Lender/Lessor in the equipment
    - Exceptions for liens arising out of judgments or awards against Borrower/Lessee which have been adequately bonded and/or where a stay of execution has been obtained

# Legal and Economic Terms: Protecting Residual Value

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- Insurance:
  - Property damage:
    - Not less than the greater of (i) the full replacement value or (ii) the outstanding principal amount/Stipulated Loss Value
    - Lender/Lessor added by endorsement as the loss payee
    - Lender/Lessor given power of attorney with respect to insurance proceeds
  - Liability insurance:
    - Amount required must be realistic in light of the exposure to be protected against and availability in the marketplace
    - Primary coverage vs. excess coverage
    - Lender/Lessor added by endorsement as an additional insured
  - Lender's/Lessor's satisfaction as to identity of the insurer, form and amount of policies, deductibles and self-insurance programs



# Legal and Economic Terms: Protecting Residual Value

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- Insurance (cont'd):
  - Borrower/Lessee obligated to maintain the required insurance, pay the premiums and deliver evidence of coverage (including renewals or replacements)
  - Additional required endorsements:
    - Prior written notice of any material alteration or cancellation of the policy
    - Breach of warranty by Lessee
    - Waiver of subrogation
    - Primary insurance



# Legal and Economic Terms: Protecting Lender/Lessor from Liability

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- Loss and Damage:
  - Allocation to Borrower/Lessee of all risks of loss and damage to the equipment
  - Distinction between partial and total loss or damage:
    - Borrower/Lessee is obligated to repair or replace partially damaged equipment at its own expense
    - Upon a total loss, Borrower/Lessee is obligated to pay the outstanding principal amount (plus any prepayment fee) or the Stipulated Loss Value
  - Application of insurance proceeds

# Legal and Economic Terms: Protecting Lender/Lessor from Liability

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- Indemnity:
  - Borrower/Lessee agrees to indemnify and hold harmless Lender/Lessor against all exposures resulting from Lender's/Lessor's participation in the transaction
    - Exclusion for damage resulting from Lender's/Lessor's gross negligence or willful misconduct
    - Specific reference to responsibility for claims in tort for strict liability
  - If no default, Borrower/Lessee permitted to control the defense of any claim, provided that Lender/Lessor has the right to approve defense counsel selected by Borrower/Lessee

# Legal and Economic Terms: Protecting Lender/Lessor from Liability

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- Events of Default:
  - Specification of the events which constitute a default
    - Distinction between monetary and non-monetary events
    - Provision of opportunities to cure
    - When are notices of the occurrence required?
  - Does the event require some action to be taken on the part of the Lender/Lessor or the expiration of a period of time before it becomes a default
  - Leases Only: If the lease agreement serves as a master lease pursuant to which separate schedules are executed, does the occurrence of a default with respect to one schedule constitute a default with respect to all schedules

# Legal and Economic Terms: Protecting Lender/Lessor from Liability

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- Remedies:
  - Preservation of maximum flexibility while avoiding election of remedies
  - Liquidated Damages Formula
  - Stipulated Loss/Casualty Value Formula
  - Is the Lender/Lessor required to take some specific action before it is able to exercise remedies?
    - Declaration of default and notice to Borrower/Lessee (under UCC Article 2A, no notice of default is required)





# Legal and Economic Terms: Protecting Lender/Lessor from Liability

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- Remedies (cont'd):
  - Specific essential remedies:
    - Accelerated payment of principal/rent and/or liquidated damages
      - Under UCC Article 2A, liquidated damages may include tax benefits and Lessor's residual interest
    - Ability to recover possession of the equipment
    - Enforcement Costs
  - Leases Only: Reservation of right to dispose of the equipment by sale or lease, or to retain the equipment
    - UCC Article 2A expressly recognizes Lessor's right to the residual value of the equipment
    - Under UCC Article 2A, Lessor is not obligated to mitigate damages by disposing of the equipment
    - Obligation to apply an appropriate credit to Lessee's financial exposure (e.g., "market rent" under UCC Article 2A)



# Legal and Economic Terms: Miscellaneous Provisions

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- Assignment and Subletting:
  - Prohibition against assignment or subletting by Borrower/Lessee:
    - Require Lender's/Lessor's prior written consent
    - If assignment permitted, Borrower/Lessee remains primarily liable
  - Preservation of the right of Lender/Lessor to assign any or all of its rights or interests under the loan agreement/lease
    - Obligation to provide notice of assignment to Borrower/Lessee
    - Obligation of Borrower/Lessee to acknowledge receipt of notice and to provide an estoppel certificate
    - Leases Only: “Hell or High Water” assignment – no responsibility of Lessor's assignee for performance of duties under the lease



# Legal and Economic Terms: Lease-Specific Considerations

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- End of Lease Return Provisions
  - Lessee Notice provisions
  - Automatic Renewal Provisions
  - Equipment Return Provisions
    - Return locations
      - Mile limitation
      - Specific location
    - Shipping, crating charges
    - Who bears risk of loss or damage in shipping
  - All or None Return
    - Rights of substitution and limitations thereof



# Legal and Economic Terms: Lease-Specific Considerations

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- Condition of Equipment
  - Lessee's reimbursement for repair, etc.
  - Additions/Alterations
  - Lessee to pay rent until equipment received by Lessor is in condition required
  - Certification for manufacturer's maintenance requirements
  - Inspection of returned equipment
- Data Removal

# Rail Equipment Finance: Laws that Impact Rolling Stock Finance

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- The Association of American Railroads (AAR):
  - Maintains a registry of reporting marks
  - Establishes rules by which railcars may pass from one railroad to another
  - Rules for allocation of risk and payment in respect of railcar casualty
- AAR Reporting Marks:
  - Marks are a combination of letters reflecting the name of party registering the car and numbers that uniquely identify the railcar
  - In this context, “owner” is the party registering the car with the AAR. It may not be the legal owner and usually is not
  - The registered AAR owner is the party that agrees to be bound by AAR rules for interchange



# Rail Equipment Finance: Laws that Impact Rolling Stock Finance

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- AAR Reporting Marks (cont'd):
  - Reporting marks are important because
    - Legally unique for purposes of identifying equipment with the Surface Transportation Board (STB) and Registrar General of Canada (RGC)
    - Used by Railinc for reporting information of railcar movement to UMLER (Universal Machine Language Equipment Registry)
- Interchange Rules:
  - Allocate responsibility and provide settlement for damages
  - Set specific minimal mechanical requirements
  - Rule 107 – settlement value for each unit calculated by evaluating several factors, including (a) original cost, (b) age, (c) depreciation rates and (d) salvage value



# Rail Equipment Finance: Laws that Impact Rolling Stock Finance

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## Governmental Authority

- U.S. Department of Transportation
  - Federal Railroad Administration
  - Surface Transportation Board (STB)
  
- FRA
  - Rail safety regulations
    - Hazardous materials
    - Rules unique to locomotives

# Rail Equipment Finance: U.S. and Foreign Systems for Perfecting Liens

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## STB

- 49 U.S.C. § 11,301 preempts state UCC provisions with respect to security interests in rolling stock
- Ownership and liens on rolling stock must be recorded with STB
  - In addition to filings of ownership interests and liens, assignments of such interests are also recorded at the STB
  - Customary practice includes filing of a short form “Memorandum”
- Recordations searchable online





# Rail Equipment Finance: U.S. and Foreign Systems for Perfecting Liens

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- Recognition of Foreign Filings:
  - If instrument is in recordable form acceptable to STB and is filed elsewhere, then such instrument given same effect as if filed at STB
    - Includes priority of liens
    - Intended to induce Canada and Mexico to pass similar law – but we are still waiting...
- For rolling stock located outside US, need to look to foreign laws on perfection issues:
  - CANADA:
    - A lease or loan governed by U.S. law that is filed with STB but where the equipment is used in Canada, must also be filed in Canada
    - Searching not as convenient as at the STB

# Rail Equipment Finance: U.S. and Foreign Systems for Perfecting Liens

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- MEXICO:
  - Contrary to popular belief, Mexico does have a filing system – the Mexican Railway Registry
    - Use of the system is rare:
      - Cost prohibitive - \$120 per unit (as opposed to per document)
      - Only functions as “declaration of belief” of ownership or lien – not evidence



# Rail Equipment Finance: Tax Issues

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- Foreign use of leased equipment can affect tax treatment in two ways:
  - Change method and recovery period for depreciation purposes
  - Can cause the income and loss to be foreign source, which could limit availability of foreign credits
- Leases Only: Lessor typically entitled to MACRS deductions under § 168 of the IRC
  - Predominant foreign usage could stretch out recovery period
  - One significant exemption is “within/without” rule:
    - Foreign use may not exceed a specified period per year

# Rail Equipment Finance: Documentation Issues

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- Maintenance:
  - AAR Interchange Rules establish base guidelines
  - Equipment-specific considerations:
    - Locomotives
      - HP
      - Electronic components
      - Software
    - Tank Cars
      - Linings
      - Returned empty and cleaned
      - Lessor gets inspection reports

# Rail Equipment Finance: Documentation Issues

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- Return
  - Location
    - Interchange point
    - How many locations?
  - Minimum number of units at each location
  - Storage
  - Inspection
    - Critical for locomotives
    - Hard to accomplish other than at end of term

# Rail Equipment Finance: Documentation Issues

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- Insurance:
  - Property Insurance: For freight cars, unlikely that individual accident will have meaningful impact on total transaction value
    - Set required coverage amount accordingly
    - \$2-3 MM for locomotives
  - Liability Insurance:
    - Amount varies greatly dependent on use
    - Typical endorsements
    - Clean-up and pollution coverage

# Aircraft Finance:

## Laws that Impact Aviation Finance

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- 49 U.S.C. § 44101 et seq. (Federal Aviation Act) governs all aspects of aircraft ownership and transactions in the U.S.
- Federal Aviation Administration (FAA) prescribes rules for aircraft registration and maintenance standards
- Aircraft owner must be and remain a “citizen of the United States” pursuant to the Act
  - Establishment of a trust as the nominal owner permits foreign entities and individuals to own a U.S.-registered aircraft
    - Trust structures administered by banks/financial institutions must conduct extensive due diligence into beneficial ownership to avoid violating U.S. law
      - Bank of Utah found itself in the spotlight for managing a trust that owned an aircraft on behalf of a Russian oligarch whose company was under U.S. sanctions



# Aircraft Finance:

## Laws that Impact Aviation Finance

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- Article XIII of the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment governs registration of aircraft with the International Registry:
  - Aircraft must be eligible to be registered
    - Airframes that are type certificated to transport:
      - At least eight (8) persons including crew; or
      - Goods in excess of 2750 kilograms (6050 pounds)
    - Helicopters that are type certificated to transport:
      - At least five (5) persons including crew; or
      - Goods in excess of 450 kilograms (990 pounds)
    - Jet propulsion aircraft engines with at least 1750 pounds of thrust or its equivalent, or turbine-powered aircraft engines with at least 550 rated take-off horsepower or its equivalent



# Aircraft Finance: Laws that Impact Aviation Finance

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## Governmental Authority

- Federal Aviation Administration (FAA)
  - Aircraft is identified by:
    - FAA Registration Number (N-number)
    - Serial numbers for (1) airframe, (2) engine(s), (3) rotor(s), (4) propeller(s), and (5) auxiliary power unit
- International Registry (IR)
  - Aircraft is identified by
    - Manufacturer make and model
    - Serial numbers for (1) airframe and (2) engine(s)



# Aircraft Finance: U.S. and IR Systems for Perfecting Liens

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- FAA:
  - Security interest is perfected by filing a security agreement or lease with the FAA
  - FAA assigns a Conveyance No. to recorded instrument
  - In synthetic leases, Lessor retains title while registration is in the name of Lessee
- IR:
  - Appoint Transaction User Entity (TUE) and Professional User Entity (PUE) to file security interest with the IR
  - Security interest is recorded as a lien on the underlying assets, with right of discharge in Secured Party

# Aircraft Finance: Documentation Issues

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- Maintenance:
  - FAA service bulletins
  - Manufacturer's guidelines
- Insurance:
  - Property Insurance: greater of full replacement value or outstanding principal amount/Stipulated Loss Value
  - Liability Insurance
    - Amount varies dependent on type of aircraft:
      - Small cabin jet/Turbo prop: \$1,000,000 per seat (including crew)
      - Mid- and large cabin jet: \$2,000,000 per seat (including crew)
      - Owner-pilot: \$5,000,000 per occurrence
      - Rotorcraft: \$10,000,000 per occurrence
    - Typical endorsements

# Marine Equipment Finance: Laws that Impact Marine Asset Finance

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## Trading Restrictions

- “Rivers, bays, lakes, inland or territorial waters of the United States, or offshore within the Exclusive Economic Zone of the United States”
- Vessel or other asset must be operated within areas covered by its insurance trading warranties

# Marine Equipment Finance: Laws that Impact Marine Asset Finance

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## Citizenship

- Vessel owner must be and remain a U.S. citizen - 46 U.S.C. § 50501
- Must qualify for specific trade endorsements:
  - Coastwise
  - Fishery
  - Registry



# Marine Equipment Finance: Laws that Impact Marine Asset Finance

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## Coastwise “Jones Act” Trade

- Vessel must be built in the U.S., owned and operated by U.S. citizens and manned by U.S. crews
- 75% of equity in vessel-owning company must be owned by U.S. citizens
- Coastwise qualification entitles vessel to engage in trade between U.S. ports and between U.S. ports and offshore rigs and platforms on the OCS



# Marine Equipment Finance: U.S. System for Perfecting Liens

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- Perfection procedures depend on the tonnage and/or type of asset (e.g., non-self-propelled barge v. yacht)
- Generally, U.S. Coast Guard (USCG) regulations govern perfection
  - Vessels in excess of 5 net tons and 25 feet in length (documented vessels):
    - Vessel is identified by (1) hull number, (2) official number, and (3) name
    - Security interest evidenced by First Preferred Fleet Mortgage filed with the USCG National Vessel Documentation Center



# Marine Equipment Finance: U.S. System for Perfecting Liens

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## Perfection (cont'd)

- Vessels under a state title system and certain non-self-propelled barges used in inland waters (undocumented vessels):
  - Security interest is evidenced by a Memorandum filed with the USCG National Vessel Documentation Center
- Intermodal vessels (e.g., barges):
  - Security interest is evidenced by a Memorandum filed with the STB
- Leases Only: Registration must be in the name of Lessor





# Marine Equipment Finance: Documentation Issues

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## Standard Documentation

- Loan:
  - Promissory Note
  - Loan Agreement
  - Security Agreement
  - Preferred Ship Mortgage
  - Assignment of Charter Hire and Earnings
  - Assignment of Insurance
  - Evidence of Insurance

# Marine Equipment Finance: Documentation Issues

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## Standard Documentation (cont'd)

- Lease:
  - Bareboat Charter
  - Supplement
  - Bill of Sale
  - Protocol of Delivery and Acceptance
  - Sales Tax Documentation
  - Assignment of Subcharters/Earnings
  - Assignment of Insurance
  - Evidence of Insurance



# Marine Equipment Finance: Documentation Issues

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## Marine Insurance

- Hull and Machinery
- Protection and Indemnity (P&I)
- Pollution Liability
- War Risk
- Mortgagee's Interest/ Breach of Warranty
- Builder's Risk (for construction loans)



# Marine Equipment Finance: Documentation Issues

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## Marine Insurance (cont'd)

- Liability Insurance:
  - Dependent on type of vessel/attendant risks
  - Including pollution
  - Examples:
    - Offshore Supply Vessel - \$200,000,000
    - Fast Supply Vessel - \$150,000,000
    - Tug pushing oil barge/barge - \$100,000,000
    - Passenger vessel - \$50,000,000
    - Marine construction vessel - \$21,000,000
    - Tug pushing dry cargo barge - \$10,000,000

# Marine Equipment Finance: Documentation Issues

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## Lease Only: Return Provisions

- In class without overdue requirements or recommendations
- Survey cycles up to date
- All certificates valid for at least 6 months following redelivery
- Surveyed at least 90 days prior to expiration
- Charterer obligated to correct deficiencies in condition
- Follow-up survey to confirm correction
- All inspections, overhauls, rebuilds, or certifications known to be or expected to be due within 12 months of the end term must be completed prior to redelivery
- All at Charterer's expense



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*"I'm certain I speak for the entire legal profession when  
I say that the fee is reasonable and just."*

Happy to answer any questions.



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