

# Global Transportation Finance Newsletter

April 2018

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## Aircraft Lender Not Responsible for Customer's Structuring Strategy

Most business aircraft purchasers, especially high net worth individuals, rely on advice from their various resources when acquiring such expensive assets. Those resources typically include brokers, OEMs, lawyers, accountants, pilots and, in some cases, their golfing buddies. Aside from the obvious considerations regarding the suitability of a particular aircraft for the customer's needs, customers often seek advice regarding the related economic considerations including the price, resale value, operational cost, financing terms and pertinent tax implications. Although the tax considerations for U.S. customers could include how to optimize any

unique income tax benefits available to aircraft owners, customers often seek advice on how to minimize any related taxes, duties, import or other governmental charges or impositions.

In a recent case, *1st Source Bank v. Neto*,<sup>1</sup> a guarantor of an aircraft acquisition loan argued that he should not have to pay the loan balance because he relied in part upon the lender's expertise and implied advice regarding the non-citizen ownership and tax structure, which resulted in the aircraft's seizure by the Brazilian government. As discussed below, the lender ultimately prevailed, but the case serves as an important reminder to lenders, lessors and other financing providers that they should generally

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<sup>1</sup> *1st Source Bank v. Neto*, No. 3:15-CV-261-JD, 2018 WL 571941 (N.D. Ind. Jan. 25, 2018).

## Recent Accolades

Vedder Price's Global Transportation Finance team advised the equity investors in Thunderbolt 2017-1, the [\*Airline Economics 2018 Overall Deal of the Year\*](#) presented at the **2018 Aviation 100 Global Leaders Awards** in Dublin.



Dean N. Gerber, Gavin Hill, Ronald Scheinberg and Jeffrey T. Veber are individually recognized in the *Chambers Global 2018 Aviation: Finance Guide*. As a firm, Vedder Price is ranked Band 2 in the *Chambers Global 2018 Aviation: Finance Guide*.

Francis X. Nolan, III is individually recognized in the *Chambers Global 2018 Shipping: Finance Guide*.

As a firm, Vedder Price is ranked Band 2 in the *Chambers Global 2018 Rail: Finance Guide*.

refrain from providing structural advice to their customers beyond financing.

The guarantor in this case, Joaquim Neto (a Brazilian citizen) used a non-citizen trust (“**NCT**”) to purchase a Dassault Falcon 2000 aircraft and register it with the U.S. Federal Aviation Administration (“**FAA**”),<sup>2</sup> although he planned to primarily hangar and operate the Aircraft in Brazil.<sup>3</sup> Neto entered into a grantor trust agreement in 2009 with Wells Fargo, as owner trustee (the “**Owner Trustee**”), for the purpose of establishing the NCT. As trustor Neto directed the Owner Trustee to purchase the aircraft and register it with the FAA in that capacity. In 2011, Neto sought financing for the aircraft from 1st Source Bank (the “**Bank**”), and after counter-signing a letter of intent (“**LOI**”) from the Bank offering to make a \$6 million loan, he directed the Owner Trustee to enter into a loan and security agreement and other loan documents evidencing the obligation to repay the loan and pledge of the aircraft as collateral to secure that repayment. Neto guaranteed the loan obligations by entering into a guaranty in favor of the Bank.

Unfortunately for Neto, the aircraft was confiscated in 2012 by the Brazilian government while they investigated Neto’s alleged import tax evasion. Neto asserted that he did not pay any such import taxes because he believed that no import taxes would be imposed, despite his hangaring and operating the aircraft in Brazil. Neto continued making the loan payments for several months after the confiscation, but he stopped paying in September of 2014, and the Bank accelerated the loan balance and sought to enforce its repossession, collection and other remedies under the loan documents.

The Bank was unable to foreclose on the aircraft while it remained in the custody of the Brazilian government so it pursued a casualty claim as loss payee under the insurance policy required to be maintained under the loan documents, and the insurer remitted the loss proceeds to the Bank in an amount less than the outstanding loan balance. The Bank then sued the Owner Trustee, as borrower, and Neto, as guarantor, to collect the deficiency amount. Neto and the Owner Trustee asserted affirmative defenses to the Bank’s demands, alleging that it impaired the collateral and failed to mitigate

The 2018 edition of *Euromoney’s USA Best of the Best Expert Guide* includes Dean N. Gerber, Ronald Scheinberg and Jeffrey T. Veber as three of the top aviation lawyers in the U.S.

Dean N. Gerber is also named one of the top 30 aviation law practitioners in the world in the 2018 edition of *Euromoney’s Best of the Best Global Expert Guide*.



## Recent Speaking Engagements

April 20, 2018

**3rd Annual Capital Link International Shipping Forum China, Shanghai**

Shareholder Ji Woon Kim moderated a panel, **Financial Leasing**, during which he and panelists discussed the outlook for Chinese Leasing, a dominant form of ship finance for the Chinese & International Shipping Industry.

March 19-21, 2018

**Airline Economics Growth Frontiers Korea 2018 Conference, Seoul**

Geoffrey Kass, Ji Woon Kim and Bill Gibson were lead presenters at the Commercial Aviation Legal & Technology Day, speaking on the following topics:

- **Investing in Aircraft – A Comparison of Investment Options**
- **Servicing Agreements – An Overview**
- **Intercreditor Issues**
- **The Three R’s of Leasing: Repossession, Redelivery and Remarketing**
- **Aircraft Financings – A Risk Overview**

<sup>2</sup> The use of an NCT ownership structure was necessary for FAA registration of the aircraft because Neto was not a U.S. citizen for the purposes of 14 C.F.R. §47.2.

<sup>3</sup> *Id.* at \*1. All parties including the Bank were advised as to the aircraft’s primary usage in Brazil. *Id.*

its damages. The bases for these asserted defenses were that the Bank did not adequately attempt to obtain the aircraft's release from the Brazilian government, and that it failed to mitigate its damages by accepting less than 100 percent of the loan balance due when settling its casualty policy claim. Of particular interest, Neto also counterclaimed for negligent misrepresentation by the Bank, alleging that in extending the loan the Bank had impliedly advised Neto that registering the aircraft with the FAA pursuant to the NCT would allow Neto and the Owner Trustee to avoid paying Brazilian import taxes despite hangaring and operating the aircraft in Brazil.

The court granted summary judgment in favor of the Bank for both the recovery of the loan deficiency and other related payment obligations, and against Neto's counterclaim that the Bank had negligently misrepresented the Brazilian import tax implications.

### Lender's Liability Regarding Alleged Structural Advice

This case is especially noteworthy because the customer asked the court to hold the Bank accountable for damages relating to certain

structural aspects of the related transaction. The Bank had to rebut Neto's counterclaim that it negligently misrepresented the tax avoidance benefits of the NCT registration, and he relied on the Bank's advice because it held itself out as an experienced aircraft lender. The sole basis for Neto's misrepresentation claim was the Bank's statement in the LOI which read as follows: "[w]e believe these terms meet your desires as well as fall within our agreed upon credit requirements and applicable U.S. and Brazilian laws."

The court dismissed Neto's negligent misrepresentation counterclaim by holding that despite the Bank's admitted "knowledge of aircraft financing and banking, and [its offering of] aircraft financing through its Aviation Division of its Specialty Finance Group,"<sup>4</sup> Neto and the Owner Trustee had already created the aircraft trust prior to seeking the loan and without any consultation with the Bank. Therefore, the Bank's statement in the LOI and related loan terms could not be construed as advice concerning the structure of an already-established NCT, the aircraft's FAA registration, and/or Brazilian tax implications. The court observed that Neto's counsel advised him that

March 18-20, 2018

#### NBAA 2018 Business Aircraft Finance, Registration & Legal Conference, Fort Myers

Shareholder Edward K. Gross presented **Leasing vs. Secured Lending: Differences for Financing Providers**, which addressed how, from a financing provider's perspective, aircraft leasing and secured lending present a host of differences in financing documents, the closing process and tax/regulatory issues.

March 1, 2018

#### 17th Annual German Ship Finance Forum, Hamburg

Partner Dylan Potter moderated a panel, **Credit Market Options: From Alternative to Traditional**, which focused on non-bank funding sources in the Maritime industry.

February 6, 2018

#### Strafford Webinar

Shareholders Edward K. Gross and Denise L. Blau conducted a webinar on **Structuring Equipment Financing: Developments for 2018** with Strafford, which examined important new developments in equipment financing, including the new lease accounting standards and bundled lease structures which include service components.

January 29-30, 2018

#### Corporate Jet Investor and Helicopter Investor Conferences, London

Shareholder Edward K. Gross moderated a six-member panel discussion titled **Across the Pond: Has the Trump Bump Slumped or Jumped?** He also presented on **Managing Insurance and Liabilities**.

Shareholder David M. Hernandez moderated a three-member panel discussion titled **Crime and Punishment: Common Scams Being Used Today—How Cyber Criminals Target Transactions**.

<sup>4</sup> *Id.* at \*2 n.3.

the NCT structure for the aircraft's ownership was legally compliant "prior to [the Bank]'s provision of financing services."<sup>5</sup> The court also noted that the lender was unaware of Neto's intentions regarding the cross-border and non-business operation of the aircraft,<sup>6</sup> which operation was the Brazilian government's justification for its seizure<sup>7</sup> and the Bank's resulting inability to foreclose on the aircraft.

The Bank also had to rebut the affirmative defense raised by Neto and the Owner Trustee that the Bank itself impaired the collateral by not adequately attempting to secure the release of the aircraft from Brazilian authorities.<sup>8</sup> The court rejected Neto's collateral preservation defense by noting that it was the Owner Trustee's responsibility under the terms of the loan documents to "keep the Collateral safe and secure... [to] use and operate the Collateral with care and only with qualified personnel in the ordinary course of Customer's business and in conformity with all laws and regulations ...' and [to] not 'permit [the airplane's] identity to be lost, or otherwise dispose of [the] Collateral or any interest therein ...'."<sup>9</sup> The court also noted that the defendants had not alleged

that the Bank had taken any action that influenced the seizure of the aircraft, and in any event the aircraft's preservation and reclamation was the Owner Trustee's express responsibility.<sup>10</sup> To the contrary, even though the aircraft's preservation was the Owner Trustee's responsibility, the court noted that the Bank timely notified the Brazilian government of their security interest after the aircraft's seizure, preventing the government from selling the aircraft<sup>11</sup> and further impairing its collateral remedies.

### Lender's Limited Duty to Mitigate Damages

Neto and the Owner Trustee also alleged that the Bank failed to mitigate damages because the Bank settled its insurance claim for less than the full amount of the loan balance.<sup>12</sup> The court interpreted the loan documents to mean that the Bank had no further duty to mitigate damages beyond the insurance settlement, noting "receipt of payment by [the Bank] under the Aircraft Policy did not extinguish the debt that Defendants obligated themselves to pay ... even if [the Bank] had obtained a full recovery under the [insurance policy]."<sup>13</sup> Additionally, there was no

### Airline Economics Growth Frontiers Dublin 2018 and 20th Annual Global Airfinance Conference Dublin 2018

Vedder Price hosted a cocktail reception for several hundred aircraft finance industry executives in connection with the annual commercial aviation finance **Airline Economics** and **Airfinance Journal** conferences in Dublin on January 23.



### Good, Clean Fun with Clients during the Rail Equipment Finance Conference this Spring.

Global Transportation Finance attorneys and their guests enjoyed an exhilarating afternoon of ATV driving during the 32nd Rail Equipment Finance Conference, March 4–7.



<sup>5</sup> *Id.* at \*1.

<sup>6</sup> *See Id.*

<sup>11</sup> *Id.*

<sup>6</sup> *Id.* at \*6.

<sup>9</sup> *Id.* at \*2.

<sup>12</sup> *See Id.*

<sup>7</sup> *See Id.*

<sup>10</sup> *Id.* at \*4.

<sup>13</sup> *Id.* at \*5.



contractual obligation for the Bank to collect from their insurer before invoking the terms of the guarantee.<sup>14</sup> Neto executed an unconditional guarantee of the loan obligations, prompting the court to reason that under Indiana law, there is “no dispute that the unconditional guarantee that [Neto] entered into made him responsible for payment in full of the amounts due, regardless of any settlement.” The Bank prevailed, as the court deemed the insurance settlement to be commercially reasonable, and in any event, the settlement had no impact on Neto’s unconditional guarantee to pay the loan obligations.

## Conclusion

Lenders, lessors and other financing providers should avoid conveying the appearance of providing structural advice to their aircraft finance customers. Careful allocation by lenders to borrowers of collateral risks and responsibilities is both equitable and prudent, especially when financing aircraft and other expensive mobile assets. Due diligence before and during the loan term, and prompt and reasonable responses to adverse circumstances are still essential to ameliorating any resulting consequences.

Vedder Price advised [BBAM Limited Partnership](#) on an acquisition by its managed entities of 132 Airbus narrowbody aircraft, and options to purchase an additional 50 A320/321 NEO family aircraft, from AirAsia Berhad and its subsidiary, Asia Aviation Capital Limited.

The Vedder Price GTF team providing counsel on this acquisition consisted of 15 lawyers. The team was led by Geoffrey Kass, Raviv Surpin, Adam Beringer and Ji Kim, who leveraged the firm’s Singapore office throughout the highly complex, cross-border transaction.



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<sup>14</sup> See *id.*

## Slots: A Source of Coin Even After Insolvency?

The administrators of the airline Monarch Airlines Limited (**Monarch**) have won an appeal in the Court of Appeal<sup>1</sup> regarding the rights of Monarch in and to certain “slots” at Luton and Gatwick airports, after Monarch went into administration at the beginning of October 2017.

The case is of significance as it re-affirms the value ascribed to slots by airlines and their financiers as rights of the airline, and that slots can, as a result, be traded for value even after insolvency.

### Slots, and how they’re allocated in the UK

*A slot is defined as “the permission given by a coordinator in accordance with this Regulation<sup>2</sup> to use the full range of airport infrastructure necessary to operate an air service at a coordinated airport on a specific date and time for the purpose of landing or take-off as allocated by a coordinator in accordance with this Regulation.”<sup>3</sup>*

The slots in question, at Luton and Gatwick, are allocated by Airport Coordination Limited (ACL), the respondent in the case and the coordinator for a number of airports in the UK. Slots are allocated on a twice-yearly basis, and the slots for the summer 2018 scheduling period were to be allocated by ACL by 26 October 2017.

As part of the basis for determining how slots are to be allocated, an airline that has held particular slots in one scheduling period in one year may be able to claim the equivalent slots in the same season in the next year.<sup>4</sup> In determining the appropriate allocation of slots, the ACL also places other slots into a pool with the intention of distributing 50% of them to “new entrants”<sup>5</sup> – a process that was relevant to the case.

### Review of ACL’s decision

Shortly before it entered administration, Monarch applied for slots at Luton and Gatwick on the basis of its operation of the corresponding slots from the summer 2017 scheduling period. However, shortly before the 26 October 2017 deadline, ACL informed Monarch’s administrators that it would not allocate any of the relevant slots



Shareholder Ronald Scheinberg authored the [\*State of the Aircraft Finance Debt Market\*](#) published in *Law360*, in which he details developments in debt finance, particularly with respect to private markets. Mr. Scheinberg’s article follows his recent release of [\*The Commercial Aircraft Finance Handbook, 2nd Edition\*](#), a resource for aircraft finance practitioners.



Shareholder Edward K. Gross and Associate Erich P. Dylus published [\*Syndications and Capital Markets: Recent Highlights\*](#) in the *Equipment Leasing & Finance* magazine. The article details recent developments and topics considered by the ELFA Capital Markets Legal Subcommittee, which was created in 2017 to follow legal issues relating to this market segment.

<sup>1</sup> R (Monarch Airlines Ltd) v Airport Coordination Ltd [2017] EWCA Civ 1892

<sup>2</sup> Council Regulation (EEC) No. 95/93 of 18 January 1993 (the **Slots Regulation**)

<sup>3</sup> Art. 2 of the Slots Regulation

<sup>4</sup> Sometimes known as “historic precedence” or “grandfather rights”; art. 8 of the Slots Regulation

<sup>5</sup> Subject to there being enough applications from “new entrants”; art. 10 of the Slots Regulation

to Monarch but would reserve the slots pending a determination by the UK Civil Aviation Authority as to whether Monarch's operating licence should be revoked or suspended.

Monarch's administrators applied for judicial review of ACL's decision at the Divisional Court but the claim was dismissed and the administrators appealed that decision to the Court of Appeal. According to the judgement, the administrators sought the allocation of slots so that they could obtain the maximum value for Monarch's creditors:

*"Monarch does not pretend that it envisages using the slots it has requested itself. It hopes to exchange the slots for other, much less valuable ones and receive a payment reflecting the difference in worth. According to the company's administrators, this would result in a proper realisation of Monarch's assets."*<sup>6</sup>

### Was Monarch an air carrier?

The Slots Regulation provides the basis on which slots are allocated to an "air carrier" – for example Article 8(1) of the Slots Regulation provides that "slots are allocated from the slot pool to applicant carriers". Pursuant to the Slots Regulation an "air carrier" means ...an air transport undertaking a valid operating licence or equivalent at the latest on 31 January for the following summer season or on 31 August for the following winter season..."<sup>7</sup>

With Monarch's entry into administration about 1,900 of Monarch's employees were made redundant, with approximately 200 staff being retained to assist with the administration, and all aircraft operated by Monarch were being repossessed by their owners. With this background, much of the Court of Appeal's analysis of

the case centred on whether Monarch had ceased to be an "air carrier", given its capacity to operate as an air transport undertaking would seem to have been vastly reduced as a result of entering administration.

As the court perceived the issues, the questions that arose were:

- "i) *Has Monarch ceased to be an "air carrier"?*
- ii) *Should Monarch, even if still an "air carrier", be denied slots on the basis that allocating them to it would be inconsistent with the purpose of the Slots Regulation?*
- iii) *Should the Court anyway decline to grant Monarch any relief in the exercise of its discretion?"*

In the Court of Appeal, Monarch successfully argued that it was an "air carrier" within the meaning of the Slots Regulation, and that ACL had erred in its decision not to allocate slots to Monarch in line with its grandfather rights under Article 8 of the Slots Regulation. In the course of making its arguments, ACL conceded that if there was a temporary cessation of business by an airline this would not preclude the airline from claiming that it was still an air transport undertaking. The Court of Appeal held:

*"It cannot be supposed that an undertaking inevitably ceases to be an "air carrier" for the purposes of the Slots Regulation whenever, and as soon as, it becomes unable to operate air transport services... What matters most, perhaps, is that the wording of the Slots Regulation provides no guidance on where any line should be drawn. Had it been intended that there should be such a line, the Slots Regulation could be expected to have said something about it, but it does not;"*<sup>9</sup>

<sup>6</sup> R (Monarch Airlines Ltd) v Airport Coordination Ltd [2017] EWCA Civ 1892, para. 8

<sup>7</sup> Art. 2(f)(i) of the Slots Regulation

<sup>8</sup> R (Monarch Airlines Ltd) v Airport Coordination Ltd [2017] EWCA Civ 1892, para. 48

<sup>9</sup> Para. 56(i), *supra*.

The Court acknowledged that there might be an argument as to whether there was a “realistic” possibility that the air carrier was capable of resuming its operations but that this assessment was not something that fell within ACL’s remit – *“had it been intended that a coordinator should undertake such functions, the Slots Regulation could be expected to have said something about it, but it does not;”*<sup>10</sup>

The Court went on to consider the role of ACL as expressed by Mr. Justice Maurice Kay in the States of Guernsey Transport Board case,<sup>11</sup> who said that their role had a “very limited remit, consistent with the need for and flexibility...” for the purpose of arranging the allocation and coordination of slots and that it does not have any “kind of investigatory and regulatory function.”

Accordingly, the Court felt, *“there is a compelling case for saying that matters relating to an undertaking’s financial circumstances and ability to continue in business are best left to, and intended to be left to, the licensing process. Approaching matters in that way achieves certainty, avoids the need for a coordinator to undertake a potentially difficult assessment of an undertaking’s position and prospects, and avoids the danger of a coordinator’s work cutting across that of the licensing authority.”*<sup>12</sup>

## Conclusion

By overturning the Divisional Court’s decision, the Court of Appeal accepted Monarch’s administrators’ submission that, despite entering administration, Monarch retained its grandfather rights. Following the judgment, and with ACL confirming that there would be no appeal, the administrators sold a number of the slots at Luton and Gatwick to airlines including IAG<sup>13</sup> with interest from a number of carriers.

The case is important for airlines and for their creditors who see value in slots, their allocation and tradability. It might be argued that the result is perverse, that slots ought not be allocated to an entity where it is known that there is no reasonable prospect that the air carrier to whom the slots are issued will utilise those slots, but this is not a matter for ACL. Its role is to facilitate the allocation of slots and coordinate any trading of those slots – and ACL did so in this case, when the administrators sold those slots to others, recovering some coin for Monarch’s creditors.



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<sup>10</sup> Para. 56(ii), supra.

<sup>11</sup> R v Airport Coordination Limited, ex parte States of Guernsey Transport Board [1999] EU LR 745

<sup>12</sup> R (Monarch Airlines Ltd) v Airport Coordination Ltd [2017] EWCA Civ 1892, para. 56(vi)

<sup>13</sup> <https://www.ft.com/content/11eac09a-d3b4-11e7-8c9a-d9c0a5c8d5c9>



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### Global Transportation Finance

The Vedder Price Global Transportation Finance team is one of the largest, most experienced and best recognized transportation finance practices in the world. Our professionals serve a broad base of clients across all transportation sectors, including the aviation, aerospace, railroad and marine industries, and are positioned to serve both U.S.-based and international clients who execute deals worldwide.

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