Aircraft Lenders Should Provide Financing (Not Advice)

By Edward Gross and Erich Dylus

It may seem intuitively obvious that when a bank or leasing company finances a customer's acquisition of an aircraft, it is strictly engaging in the business of financing (which presumably is its area of business focus and expertise). A reasonable customer, absent representations to the contrary, would not assume that its lender or lessor will also provide business risk, tax, structural, or other advice or assurances. Yet, in a recently decided case, a lender's arguably ambiguous statements prompted a customer to sue, claiming that the lender breached a duty by failing to protect the customer from a tax liability that resulted in the aircraft's seizure by a foreign government. Although the bank prevailed against the customer in litigation, the case serves as a cautionary tale for lenders and lessors about the need to disclaim any role or duty to provide ancillary advice or assurances to their customers beyond those specifically memorialized in the loan or lease documentation.

Background

The structures and documents typically used by parties to commercial aircraft finance transactions reflect market practices developed and refined over time among air carriers, manufacturers, lessors, lenders, and investors, and their respective counsel, tax, accounting, and other advisors. Although periodic innovations reflect changes in acquisition and fleet strategies; financing trends; accounting, tax, or legal considerations; or other circumstances, the transaction structures and documents that achieve market acceptance are thereafter replicated for each new transaction of a particular type. Lenders, lessors, and investors in these replicated transactions find it comforting that the structural considerations and enforcement risk and other implications have already been scrutinized and accepted by other sophisticated market participants. This approach provides predictability regarding financing providers' enforcement of their commercial aircraft leases and loans.

Business and general aviation financing, by contrast, is much less commoditized, and the enforcement cases reflect the challenges of extending credit to the broad spectrum of customers in that market. Unlike air carriers and operating lessors, business and general aviation aircraft purchasers, especially high net worth individuals, rely on advice from their various external resources when acquiring these expensive assets. Those resources may include brokers, original equipment manufacturers, lawyers, accountants, pilots, and, in some cases, their social network. The advice sought and provided by these more or less informed sources can include the suitability of a particular aircraft for the customer's needs, balance sheet and privacy matters, liability, and regulatory compliance. However, a typical customer's primary focus tends to be the cost of acquiring, owning, maintaining, financing, and operating an aircraft.

Most of these economic considerations either are a function of prevailing market circumstances or may be managed by practical means. Among the cost variables that business and general aviation customers may find most compelling and seek to manage structurally are related tax implications. Although tax considerations for U.S. customers could include how to optimize any unique income tax benefits available to aircraft owners, both domestic and non-U.S. customers are likely to seek advice as to how they might minimize any related taxes, duties, import or other governmental charges, or impositions payable in each pertinent jurisdiction. These considerations are also meaningful in commercial aircraft transactions, but in most cases, parties to those transactions rely on precedent structures and documents that are assumed to be consistent with advice provided by sophisticated tax counsel and a common aversion to reputational risk. The soundness of the structural engineering intended to achieve the customer's tax purposes in certain business and general aviation transactions may not be as reliable as with commercial aviation due to the uniqueness of the circumstances of the spectrum of business and general aviation customers and the lack of an industry vetting process.

Unreliable tax advice in these transactions could lead to harsh economic circumstances, including fines, penalties, liens, or even seizure of aircraft. When leased or financed aircraft are seized, the lessor or lender must endure the related consequences. But these financing providers expect to be protected from and not accountable for the consequences of the customer's tax-related transaction structuring.

The *Neto* Case

In a recent case, *1st Source Bank v. Neto*,[1] a high net worth individual customer living in Brazil believed that he was exempt from import taxes because of the structural

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aspects of his acquisition and ownership of an aircraft. The structure did not achieve the customer's import tax avoidance purposes, and the Brazilian government ultimately seized the aircraft. The aircraft had been financed, and when the lender pursued the loan balance, the guarantor argued that he should not have to pay because he claimed to have relied in part on the lender's expertise and implied advice regarding the tax structure. As discussed below, the lender ultimately prevailed, but the case serves as a caution to lenders, lessors, and other financing providers to refrain from providing structural advice to their customers beyond financing.

The ultimate customer and guarantor in this case, Joaquim Neto (a Brazilian citizen), used a noncitizen trust (NCT) to purchase a Dassault Falcon 2000 aircraft and register it with the U.S. Federal Aviation Administration (FAA),[2] although he planned to primarily hangar and operate the aircraft in Brazil.[3] Neto entered into a grantor trust agreement in 2009 with Wells Fargo, as 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, and after countersigning 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 guarantee in favor of the bank.

Unfortunately for Neto, the Brazilian government confiscated the aircraft in 2012 while it investigated Neto's alleged import tax evasion. Neto asserted that he failed to pay any such 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 stopped paying in September 2014. 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 in the custody of the Brazilian government, so it pursued a casualty claim as loss payee under the insurance policy required under the loan documents. The insurer settled the bank's claim and remitted the loss proceeds to the bank in the agreed amount, which was 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 Wells Fargo asserted affirmative defenses to the bank's demands, alleging that it impaired the collateral and failed to mitigate 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, alleging that the bank, in extending the loan, 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.

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The Lender Was Not Accountable for Alleged Structural Advice

The *Neto* case is especially noteworthy because the customer asked the court to hold the bank accountable for damages relating to certain structural aspects of the 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."[4]

The court dismissed Neto's negligent misrepresentation counterclaim. It held that despite the bank's admitted "knowledge of aircraft financing and banking, and that it offers aircraft financing through its Aviation Division of its Specialty Finance Group,"[5] Neto had not relied on structural advice by the bank, as evidenced by Neto's having created the aircraft trust prior to seeking the loan or even consulting the bank. Therefore, the bank's statement in the LOI and related loan terms could not be construed as implicit advice that the aircraft's FAA registration pursuant to an already established NCT could achieve Neto's import tax avoidance purposes. The court observed that Neto's counsel advised him that the NCT structure for the aircraft's ownership was legally compliant "prior to [the bank's] provision of financing services."[6] The court also noted that the lender was unaware of Neto's intentions regarding the cross-border and nonbusiness operation of the aircraft,[7] which was the Brazilian government's justification for its seizure,[8] and the resulting seizure frustrated the bank's ability to foreclose on the aircraft.

The Customer's Other Claims and Defenses

Neto raised other defenses to the bank's deficiency claim, in each instance alleging that the bank had breached responsibilities under the loan agreements and related documents or under commercial law

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applicable to secured parties.

The bank had to rebut Neto's affirmative defense that the bank impaired the collateral by not adequately attempting to secure the release of the aircraft from Brazilian authorities.[9] The court rejected the collateral preservation defense, however, 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.'"[10] 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.[11] Further, despite this allocation of responsibility to the owner trustee, the court acknowledged the bank's undertaking to preserve its collateral rights by timely notifying the Brazilian government of the security interest after the aircraft's seizure, preventing the government from selling the aircraft[12] and further impairing the bank's collateral remedies.

Neto also alleged that the bank had a duty to mitigate its damages, and failed to satisfy that duty, because the bank settled its insurance claim for less than the full amount of the loan balance.[13] The court, however, held that the loan documents did not require the bank to mitigate its damages beyond pursuing the insurance settlement and applying the related proceeds against the loan balance, 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]."[14] Nor did the court find that the bank had any contractual obligation to collect from the insurer before demanding payment of the unpaid loan amounts from Neto pursuant to his unconditional guarantee to make those payments.[15] Instead, the court reasoned 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."[16] The bank prevailed, as the court deemed the bank's settlement with the insurer for the agreed amount to be commercially reasonable, and in any event determined that the settlement had no impact on Neto's unconditional guarantee to pay the bank upon demand all unpaid loan amounts.

Banks Provide Financing, Not Tax or Structural Advice

In the *Neto* case, the customer was unable to convince the court that the bank provided advice regarding structural devices that the customer should employ to achieve his tax avoidance purposes. Neither the LOI provisions nor the other transaction circumstances cited by the customer as proof of the bank's having provided unreliable tax advice were sufficient to persuade the court that the bank should be held accountable to the customer for the seizure of his aircraft after he failed to pay the required import taxes. The bank's deficiency claim was also supported by what the court deemed to be a commercially reasonable approach to mitigate its damages, as well as the unconditional nature of Neto's guarantee.

Nonetheless, lenders and other financing providers should take note of the arguments Neto raised, especially his argument that the bank provided structural advice and Neto suffered harm by relying on that advice. Business and general aviation financing providers compete for lending and leasing opportunities, and certain of these lenders and lessors market not only their financing products but also their experience with the various ownership, operational, and other considerations by their customers when acquiring an aircraft. That experience may be useful to the customer, especially as to the cost and time efficiencies associated with approving, documenting, and closing a lease or loan transaction. However, marketing materials, transaction documents, and discussions with customers should be accompanied by a disclaimer of any responsibility regarding tax, accounting, regulatory, or other structural matters. This would be consistent with the proposition that a proposed financing transaction is not intended to achieve any purposes other than the acquisition financing or refinancing of the customer's aircraft. All of these documents and communications should also clearly allocate to the customer the responsibility for seeking and relying on the advice of its lawyers, accountants, and other resources, and not the lender or lessor, as to these other matters.

As noted above, Neto's misrepresentation claim was based on a single statement by the bank in the LOI that it believed the proposed terms "meet your desires as well as fall within our agreed upon credit requirements and applicable U.S. and Brazilian laws."[17] The bank could have avoided any risk that this statement evidenced its having provided structural advice if it had not included this text or any similar assurance regarding the alignment of the proposed terms with the customer's "desires" or that the terms comply with "applicable U.S. and Brazilian laws." Some lessors and lenders address this risk by expressly disclaiming any structural advice, including pursuant to text provided above or near the customer's signature, to the effect that:

> BY ITS EXECUTION AND DELIVERY OF THIS PROPOSAL LETTER, CUSTOMER CONFIRMS THAT NEITHER [LESSOR/LENDER] NOR ANY OF ITS AFFILIATES, OR ANY OTHER PERSON PURPORTING TO ACT ON ITS OR THEIR BEHALF, HAS MADE ANY REPRESENTATION WARRANTY, OPINION, ADVICE, OR OTHER ASSURANCE OF THE ACCOUNTING, TAX, COMMERCIAL LAW, OR OTHER CHARACTERIZATION OF THE TRANSACTIONS CONTEMPLATED IN THIS PROPOSAL LETTER.

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Of course, it is also important for a financing provider to be aware of its customer's purposes and consider the legal and reputational implications. Aside from avoiding claims that they provided or confirmed advice regarding structural matters, lenders and lessors should also be wary of circumstances that may give rise to claims by the customer, the government, or third parties about facilitating harmful, unlawful, or other nefarious conduct. The due diligence practices of most established lessors and lenders should provide meaningful protection from these risks.

We have not identified any other similar reported cases in which a borrower argued that a lender should be held liable for advice given to the borrower. However, other cases involve claims that lenders had and breached some duty to a customer. Certain of these customers alleged that the lenders had and breached some fiduciary duty or duty of care generally related to the loan, including as to disclosures, enforcement, or diligence regarding the property being financed.[18] For example, the court in *Bank of Red Bay v. King* acknowledged the capacity for such a duty, noting:

> While the relationship between a bank and its customer has been traditionally viewed by courts as a creditor-debtor relationship which does not impose a fiduciary duty of disclosure on the bank, a fiduciary duty may nevertheless arise when the customer reposes trust in a bank and relies on the bank for financial advice, or in other special circumstances.[19]

Several of these opinions were issued by California state and federal courts applying California law. Generally, a financial institution owes no duty of care to a borrower under California law when the institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money.[20] A financial institution is generally thought to have exceeded the scope of its conventional role as a lender of money when it assumes the ability to exercise control over the enterprise to which it is providing capital.[21] A financial institution may also be deemed to have a fiduciary duty when it has a substantial interest in the success of a borrower to which it has extended a loan beyond the "immediate purpose of the contract."[22] Although the facts of these cases were dissimilar to those of the *Neto* case, they underscore that financing providers may be vulnerable to defenses and counterclaims if their involvement in the transaction extends beyond lending money.

Conclusion

Although commercial aviation lenders and lessors should avoid giving the appearance of providing structural advice to their aircraft finance customers, the risk may be greater when dealing with business and high net worth aviation customers because courts might be more sympathetic to their allegations. The favorable decisions by the court in the *Neto* case could be attributed to the bank's reasonable approach to the circumstances, the unassailable provisions of the loan documents, and the specious nature of the customer's claims, especially the attempt to blame the bank for the customer's failure to avoid the imposition of the Brazilian import tax by registering his aircraft at the FAA registry. Lenders and lessors that follow these prudent documentation, diligence, and enforcement practices are more likely to achieve their investment purposes and avoid unnecessary enforcement risks, expenses, and delays by avoiding these types of claims.

Endnotes

1. No. 3:15-CV-261-JD, 2018 WL 571941 (N.D. Ind. Jan. 25, 2018).
2. The use of an NCT ownership structure was necessary for FAA registration of the aircraft because Neto was not a U.S. citizen for purposes of 14 C.F.R. § 47.2.
3. *Neto*, 2018 WL 571941, at *1. All parties, including the bank, were advised as to the aircraft's primary usage in Brazil. *Id.*
4. *Id.*
5. *Id.* at *2 n.3.
6. *Id.* at *1.
7. *Id.* at *6.
8. *See id.*
9. *See id.*
10. *Id.* at *2.
11. *Id.* at *4.
12. *Id.*
13. *See id.*
14. *Id.* at *5.
15. *See id.*
16. *Id.*
17. *Id.* at *1.
18. *See, e.g.*, Alpine Bank v. Hubbell, 555 F.3d 1097, 1111 (10th Cir. 2009) (applying Colorado law) ("[Borrowers] must establish . . . that '(1) [they] actually reposed a special trust or confidence in the [Bank]; (2) such trust was justifiable; and (3) the [Bank] either invited or ostensibly accepted the trust imposed.'"); Bank of Red Bay v. King, 482 So. 2d 274 (Ala. 1985) (applying Alabama law); Li-Conrad v. Curran, 50 N.E.3d 573 (Ohio Ct. App. 2016) (ruling that the tort of negligent misrepresentation does not apply to a loan transaction between a bank and its customer because there is no fiduciary-like relationship in which the bank would have a professional duty to give dependable information).
19. 482 So. 2d at 285.
20. *See, e.g.*, Dougherty v. Bank of Am., N.A., 177 F. Supp. 3d 1230 (E.D. Cal. 2016); Griffin v. Green Tree Servicing, LLC, 166 F. Supp. 3d 1030, 1048–49 (C.D. Cal. 2015); Cornejo v. Ocwen Loan Servicing, LLC, 151 F. Supp. 3d 1102 (E.D. Cal. 2015).
21. *See, e.g.*, Connor v. Great W. Sav. & Loan Ass'n, 447 P.2d 609, 616 (Cal. 1968); Kinner v. World Sav. & Loan Ass'n, 57 Cal. App. 3d 724, 734 (Ct. App. 1976); Bradler v. Craig, 274 Cal. App. 2d 466, 476 (Ct. App. 1969).
22. Wagner v. Benson, 101 Cal. App. 3d 27, 34–35 (Ct. App. 1980).

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