

A guide to aircraft finance

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Introduction

Aircraft financing can be complex for the following reasons:

- The aviation industry is highly regulated and for the proposed operation of most aircraft the laws of a number of jurisdictions and conflicts between these laws will need to be considered.
- Despite the fact that attempts have been made to establish the rights of owners and financiers on an international level (e.g. with the Cape Town Convention), these have some way to go in establishing, for example, uniform laws and procedures for the recognition and enforcement of aircraft mortgages and priorities of liens. There are still a number of jurisdictions (notably certain African countries) which are distinctly lender-unfriendly.
- An aircraft is a collection of parts which need regular and extensive maintenance or replacement and unless the appropriate maintenance is undertaken and where required, replacement parts of the appropriate type, manufacture, modification status, utility and remaining life are installed, the value of the aircraft could be severely reduced.
- The major elements of an aircraft (the airframe and the engines) will be manufactured by different entities so that the benefit of any warranties and customer care arrangements in respect of them will need to be assigned to a financier separately.
- An aircraft can be the subject of various liens (i.e. rights to retain possession of the aircraft to discharge a debt) and rights of detention which will have priority over a financier's mortgage over such aircraft even though the liens arose after the date of such mortgage. Some liens or rights of detention can apply to fleets of aircraft operated by the same operator.
- If pre-delivery finance is being provided, the security available for such finance may be limited and the financier will need to consider carefully the value of any available pre-delivery security over the aircraft.

For the purposes of this guide it is convenient to categorise a typical aircraft financing transaction into the following three stages and the related issues (although clearly many issues will overlap these categories):

1. Structural: mortgage versus finance lease structures; where is the aircraft to be registered; who will be the aircraft owner and who will be the operator; the security package to be taken and any documentary filing fees which may be payable.
2. Documentary: The Purchase Agreement, the Loan Agreement, the Aircraft Mortgage and ancillary documents.
3. Completion/Post-Completion.

Structural issues

Before any documents are drafted and detailed negotiations begin, the financier should carefully consider how an aircraft financing transaction is to be structured in order to ensure that the financier obtains maximum security over the structure by a combination of mortgage and (possibly) ownership rights whilst shielding the aircraft from other creditors of the borrower and minimising the possibility of any liability to third parties.

Mortgage versus lease structures

The two basic alternatives available to a financier are (a) outright ownership of the aircraft as owner/lessor, or (b) a security interest as mortgagee. The remainder of this guide will assume that the financier is taking a security interest as mortgagee.

Aircraft registration

It is vital to know where the aircraft to be financed is to be registered and whether the financier can record its interest in the aircraft as mortgagee in the state of registration for the following reasons:

- The financier must be satisfied that the laws of the state of registration will recognise the proposed form of mortgage, particularly if it is governed by a different law. Some jurisdictions will only recognise a mortgage if it is governed by local law and is in a particular form and language. A few countries do not even recognise aircraft mortgages in any form as a valid type of security and different forms of security interest will have to be considered and the effectiveness of such

arrangements should be examined on a case by case basis. For example, Belgium and Austria do not recognise a 'mortgage' and a financier's interest needs to be protected by means of a pledge.

- Normally the priority of mortgages will be dealt with by reference to the time that an aircraft is registered on the aircraft register in the state of registration. It may be possible to arrange pre-registration protection for a potential mortgage.
- Any financier will require the co-operation of the registering authority to realise its security over the aircraft as an aircraft must be deregistered before it can be registered in a different jurisdiction or registered to a different owner. This is why it is normal to obtain a deregistration power of attorney from the borrower as part of the security package.
- Each jurisdiction prescribes what conditions need to be satisfied for an aircraft to be eligible for registration in its registry (these conditions usually relate to the nationality of the owner or operator of the aircraft depending upon whether it is an owner or operator register).

The Chicago Convention of 1944 on International Civil Aviation (the "Chicago Convention") deals with the registration of aircraft. Virtually all countries have ratified the Chicago Convention other than Taiwan. The Chicago Convention provides that aircraft may only be registered in one jurisdiction at a time. However, the registration of an aircraft may be changed from the register of one contracting state to another. The Chicago Convention also provides that an aircraft has the nationality of the state in which it is registered and all aircraft engaged in international aviation are required to bear their appropriate nationality and registration marks.

The Chicago Convention provides that the registration of aircraft in any contracting state shall be in accordance with that state's laws and regulations. Therefore, the Chicago Convention gives a wide degree of autonomy to contracting states in the establishment and maintenance of their own aircraft registers. For example, in some jurisdictions (e.g. the UK) the aircraft register is primarily an operator register where aircraft are registered in the name of the operator or charterer by demise (i.e. lessee) of the aircraft. Such registrations do not constitute any evidence as to title. In other jurisdictions, however, e.g. the USA, the aircraft register is an ownership register. Generally speaking, in order for an aircraft to qualify to be registered in a particular jurisdiction, the legal owner or the operator of such aircraft must be domiciled or incorporated in the same jurisdiction.

Whilst most countries have an aircraft register, they do not have a separate register for aircraft engines. However, some protection for owners and financiers of aircraft engines (whether separately or as part of an aircraft) is provided under the Convention on International Interests in Mobile Equipment (the "Cape Town Convention"). The Cape Town Convention 2001 has been adopted by many countries, but has only been ratified or acceded to by the following: Afghanistan; Albania; Angola; Cape Verde; Columbia; Ethiopia; India; Indonesia; Ireland; Kenya; Malaysia; Mexico; Mongolia; Nigeria; Oman; Pakistan; Panama; Senegal; South Africa; Syrian Arab Republic; United Arab Emirates; the USA and Zimbabwe. Effective registration in the International Registry (established pursuant to the Cape Town Convention) is only available to aircraft registered in these countries which have both adopted and ratified the Convention. The Cape Town Convention is discussed in more detail under the heading "Miscellaneous" below.

In some jurisdictions whilst there is a register of aircraft, there is not a separate register of mortgages. Also, as mentioned above, in some jurisdictions e.g. USA, the register of aircraft constitutes proof of ownership, although in other jurisdictions (e.g. the UK) it does not. Therefore, in any proposed transaction it will be crucial for the financier to obtain local legal advice with respect to aircraft registration.

Who is to be the owner of the aircraft?

Careful consideration should be given as to the entity that will actually own the aircraft (and be the borrower under the loan agreement). Usually, where private jets are being financed, the ultimate beneficiary will be an individual but for various tax and other reasons it is likely that a special purpose vehicle ("SPV") will be set up to be the registered owner of the aircraft and the borrower.

As mentioned above, in the USA the FAA Register is an ownership register and legal ownership of any US registered aircraft has to be vested in a US person or entity. This means that an aircraft beneficially owned by a non-US party or parties can only be registered in the US where the registration is in the name of a US trust company which holds the legal title to the aircraft on trust for non-US beneficial owner or owners or, alternatively where a US voting trustee under a separate voting powers trust agreement, holds the voting powers of non-US beneficiaries. The most commonly used US trust companies are Wells Fargo and Wilmington Trust. In these circumstances, it is necessary for the US trust company (legal owner) to be a party to the aircraft mortgage as well as the non-

US beneficial owner so that both the legal and beneficial interests in the aircraft are mortgaged to the financier by way of security.

The security package

As mentioned above, a financier needs to consider how to obtain maximum security in any aircraft financing transaction in order to put itself in the best possible position in the event of default by the borrower. The following types of security documents and other documents may be relevant in any given situation:

Aircraft Mortgage: In almost every aircraft financing the financier will be looking to take a mortgage or equivalent security over the aircraft upon delivery. The mortgage will give the financier by way of security over the aircraft a right (amongst other things) to sell the aircraft on default. As mentioned earlier, in some jurisdictions it is not possible to take a local law mortgage over an aircraft. For example, in Belgium and Austria aircraft mortgages are not recognised in any form as a valid type of security. In such countries financiers may have to consider different forms of security interest and the effectiveness of such arrangements, or simply not lend where those countries are involved.

A financier should take local legal advice in order to ensure that any aircraft mortgage is valid and enforceable in the jurisdiction where it is likely to be enforced. When addressing the question of whether a mortgage is valid and enforceable under English law the concept of *lex situs* means that the validity of a transfer of a moveable asset will be valid if it is valid under the law of the state in which the asset was situated at the time of the transfer (i.e. the execution and delivery of the mortgage). *Lex situs* leads many to the conclusion that, as a matter of prudence, an aircraft should be located in the UK at the time of transfer of title (i.e. at the time the mortgage is executed or, if conditional, then at the time all of the conditions are satisfied). However, the physical presence of the aircraft in the UK is not seen as necessary by all practitioners. Some practitioners argue that due to the moveable nature of an aircraft, the governing law to determine validity of a transfer of title should be the proper law of transfer determined in the same way as the proper law of contract, that is either by the contracting parties' choice of governing law of the mortgage or (in default) the law of the country to which the mortgage has the closest connection. Having said that, our view is that where the financier is taking an English law mortgage the financier should, as a matter of best practice, either insist that the aircraft touches down in the UK on the

date that the transaction closes (or at the very least be in international air space) or (if this is impractical) obtain a *lex situs* opinion from lawyers in the jurisdiction where the aircraft is located when the aircraft mortgage is taken, confirming that such jurisdiction recognises the validity of the English law mortgage. It should be noted that many jurisdictions do **not** recognise the validity of an English law mortgage eg. France, Switzerland and Norway.

Guarantee: In the context of an aircraft financing transaction an SPV will usually be set up to own the aircraft and, consequently, be the borrower under the loan agreement. The guarantor will usually be the beneficial owner of this SPV (or, alternatively, a parent company or other company in the same group as the borrower). The purpose of having a guarantee is to ensure that the financier has recourse against the ultimate owner of the SPV as the SPV will be a limited liability entity and also (given the issues referred to in the introduction to this Guide) to ensure maximum co-operation is obtained from the SPV should the financier need to realise its security over the aircraft.

Share Charge: It is also common for financiers to take a charge over shares in the borrower and, perhaps also to take a charge over the shares in the guarantor if, of course, the guarantor is a company. The main purpose of having a charge over the shares of the borrower SPV is to give the financier control over the SPV should there be a default. It is important to note that the person/entity giving the charge will not be the borrower itself, but instead the owner(s) of the shares in the borrower. If the owner(s) has not also given a guarantee then the charge will need to be drafted as a third party charge so that it secures the liabilities of the borrower rather than the chargor. Legal advice should be taken from lawyers in the jurisdiction of the borrower (whose law will normally govern the share charge if they are registered shares as opposed to bearer shares) and, if different, the jurisdiction of the chargor (to ensure that the chargor has, for example, necessary capacity and authority to enter into the charge).

Tri-Party Agreement: On a practical level, a tri-party agreement may also be appropriate. A tri-party agreement may not itself create a security interest, but is an agreement between the financier, the borrower and the operator of the aircraft whereby the operator agrees that if the financier wishes to enforce its security the operator will fly the aircraft to a lender-friendly jurisdiction of the financier's choice to enable the financier to enforce its security and the financier may take additional security over the aircraft in that lender-friendly jurisdiction. The tri-party agreement is particularly important where the aircraft is registered and/or operates in a lender-unfriendly jurisdiction where it would be impossible for the financier to realise its security in a quick and efficient manner

unless the aircraft were flown to a lender-friendly jurisdiction. The essential elements of the tri-party agreement are that the operator undertakes to act in accordance with the financier's instructions at the expense of the financier should an event of default occur, that it gives reasonable notice to the financier before its operating agreement with the borrower is terminated and it agrees to provide information to the financier concerning the whereabouts of the aircraft both before and after an event of default.

It is best practice for the financier to obtain a tri-party agreement on every aircraft financing transaction. The reason for this is simple: the financier can never be 100% certain where the aircraft is going to be flown and, if the aircraft were located in a jurisdiction which is unfriendly to the financier at the time of enforcement, the financier could be faced with delays, high legal costs and, at worst, security which it cannot enforce.

There are a number of problems which financiers may meet with respect to tri-party agreements. First, if the operating agreement between the borrower and the operator has already been entered into it may be difficult to convince the operator to enter into such an agreement as there will be little incentive for the operator to assume the additional obligations which a tri-party agreement would impose on him. Why should an operator agree to be bound in such a manner? For this reason, at the outset of any aircraft financing a borrower should be warned of this requirement and itself insist that the prospective operator enter into the tri-party agreement. This could be a particular problem where an aircraft is being re-financed. Also, the tri-party agreement will rely on the existence of an operating agreement. If there is a mismatch between the term of the operating agreement and the term of the loan, a financier could be left with an unenforceable tri-party agreement if (as is likely) the operator no longer has access to the particular aircraft following termination of such operating agreement. Therefore, it is vital to build into any tri-party agreement the right for a financier to be given prior notice of any cancellation or termination of the operating agreement, so that the financier has the opportunity to put suitable alternative arrangements in place.

Deregistration Power of Attorney and/or Deregistration Certificate: In order to assist in the enforcement of an aircraft mortgage the aircraft may have to be deregistered from the aircraft registry on which it is registered before it can be re-marketed and sold. Each aircraft registry has its own rules as to how deregistration in its own particular jurisdiction may be

effected. In certain countries the consent of the borrower as well as the owner may be necessary for this deregistration to be effected and accordingly the financier should consider taking an irrevocable power of attorney from the borrower that it can deregister the aircraft without the need for the co-operation of the borrower. In certain jurisdictions it may be possible to obtain a "deregistration certificate" on registration of the aircraft which would give the holder of the certificate notice if an application for deregistration of the particular aircraft was made.

It may also be possible to obtain a deregistration undertaking (or comfort letter) from an aviation authority that, on the happening of a certain event, it will deregister a particular plane. It is important to note that these are, as a matter of law, unenforceable. The aviation authority of any country is a government administration department and, as such, would be entitled to claim sovereign immunity. Basically this means that an aviation authority cannot be successfully sued if it fails to honour its undertaking.

Assignment of Insurances: Although this paragraph is under the heading "Assignment of Insurances", this is slightly misleading as it is impossible to give a detailed set of guidelines as to what protections a financier can obtain with respect to insurance of the aircraft. What is available from the insurance market will be influenced by current trading conditions and can change over time.

It is desirable for a financier to be an additional named assured rather than taking an assignment of the insurances or simply having its interest noted, joint insurance ensures that:

- there is a direct contractual relationship with the insurers;
- any claim would have to be negotiated with the financier as well as with the borrower; and
- as the interest of the financier in the insurance is original and not derivative (i.e. through the borrower), the interest is not liable to prejudice to the same extent (e.g. on a breach of warranty by the operator) as if the financier is merely noted on the policy.

In the event that the insurers refuse to include the financier as an additional insured an assignment of insurance is required in order to give binding legal effect to the "loss payee" clause in all circumstances by giving notice to the insurers. Assignment of third party liability insurances is not practicable because the

beneficiary under any liability insurance would be the third party making the claim. For a fuller discussion of the principal types of insurance that a borrower is likely to arrange in respect of an aircraft please refer to the section below entitled "Insurances".

Assignment of Airframe and Engine Warranties: If the aircraft is new or, as a general rule, less than five years old, it is likely that warranties will be available from the manufacturer of the airframe and the engines. With used aircraft, whilst the original manufacturer warranties may have expired, there may be other supplier warranties (e.g. from airframe/engine maintenance organisations) which should be assigned. This is very important as the warranties can be a significant part of the aircraft's value.

If warranties are still outstanding, it is necessary for the financier to check the original purchase agreement (or separate warranty documentation) to ensure that any warranties are freely assignable as the financier will wish to take the benefit of any warranties on enforcement and to have the ability to pass on such benefit to a purchaser.

Many manufacturers have their own forms of warranty assignment documentation so that it is important to contact the airframe and engine manufacturers well in advance of closing in order to agree the forms of warranty assignment with them. As we are currently very much in a seller's market, the manufacturer will rarely agree to negotiate with the financier on the terms of the warranties.

Charge over the Aircraft's Maintenance Reserves: A financier may insist that a borrower pays money into a specific deposit account at designated times in respect of future maintenance works to be undertaken on the aircraft. This is particularly the case with larger aircraft. The monies in this account are often charged to the financier as part of the security package. Please refer to the section below entitled "Aircraft Maintenance".

Subordination: It will be necessary to consider whether the borrower has any other loans outstanding at an early stage in the transaction as, if so, a financier would normally insist upon a subordination agreement as part of the security package as it would not want any other loan to the borrower paid off before its own loan.

To a certain extent the financier is relying upon the integrity of the borrower to disclose the existence of such loans (although the borrower's accounts should alert the financier to their existence) and it would be prudent to have a representation in the loan agreement that the borrower has disclosed the

existence of any other loans or, indeed, that there are none. If the balance of the aircraft purchase price is being made up by the subscription of equity share capital in the borrower then subordination will not be necessary.

If a financier is not providing finance for 100% of the purchase price of an aircraft, careful inquiry should be made as to how the balance of the purchase price is to be funded. If another lender is providing finance then this loan should be subordinated to the financier's loan. Any inter-company loans should also be subordinated unless the only companies involved are the borrower and a guarantor to the financier.

Exit Strategy: As part of the structuring of an aircraft financing transaction it is important that a financier has in mind a sustainable exit strategy should the borrower default. Field Fisher Waterhouse LLP has prepared a separate paper on this.

Documentary taxes or filing fees

In some jurisdictions, a mortgage structure may be unattractive because local law prescribes onerous and costly procedures for creating and perfecting the aircraft mortgage. For example, a mortgage governed by Cayman Islands law is subject to stamp duty of 1.5% of the secured amount. In other countries (for example, Portugal) there are requirements that mortgage and underlying loan documents have to be translated into the local language, notarised, legalised and filed in several central registries. The cost of registration of the aircraft mortgage may also be expensive in some jurisdictions. Therefore, it will be crucial to have an understanding of the particular costs to be encountered on a transaction at the outset as this may impact on the structure of the transaction.

Documentary issues

The purchase agreement

In the case of a new financing, it is necessary for the financier to review the aircraft purchase agreement. The following should be noted:

- The financier needs to be satisfied that the purchase agreement is freely assignable or, at least, that the right to take title of the aircraft is assignable.

- It is normally made between the airframe manufacturer and the borrower, but will nevertheless include the supply of engines.
- It will usually provide for stage payments (normally 30% before the construction of the aircraft). If the financier is providing pre-delivery finance, the aircraft purchase agreement needs to be checked to ascertain what rights the financier would have if either the manufacturer or the purchaser defaults. Ideally, the financier should have "step-in" rights (i.e. the right to step in and perform the obligations on the part of the borrower/purchaser) where there is a default on behalf of the purchaser.
- As the aircraft will not exist and title will not have passed to the borrower until delivery, the only security that the financier will be able to take over the aircraft until delivery will be an assignment of the benefit of the aircraft purchase agreement. The financier will normally also take a guarantee from the ultimate beneficial owner of the borrower and a charge over the borrower's share capital.

The loan agreement

The loan agreement is the contract between the financier and the borrower whereby the financier agrees to lend money for the financing or re-financing of the aircraft up to a specified amount. On an aircraft financing transaction the loan agreement is usually the longest and most heavily negotiated document. It contains a number of provisions designed to protect the financier's position. The following section contains a discussion of some of the types of provisions which will be relevant on an aircraft financing transaction (although this list is by no means comprehensive).

Conditions precedent: The conditions precedent ("CPs") are, as their name suggests, specific conditions which a financier requires a borrower to fulfil before part or all of a loan can be drawn down. On an aircraft financing, because there are usually numerous CPs to satisfy, the CPs are normally listed at the back of the loan agreement in a Schedule. It is important that the borrower is made aware of the CPs at the beginning of any transaction as often it will take the borrower a considerable amount of time to satisfy the CPs and it is usually fulfilment of these conditions (as opposed to negotiating the documents) which can hold up any aircraft financing, particularly where a third party is involved in the provision of the information/documents (e.g. the airframe manufacturer or the operator). The following are usually contained

within the list of CPs:

Valuation: There will always be a requirement for a valuation of the aircraft prior to drawdown to be paid for by the borrower.

Pre-Purchase Inspection Report: This is normally required by the financier where the financing relates to a used aircraft if the borrower/purchaser is having its own pre-purchase inspection report prepared by specialists acceptable to the financier and such pre-purchase inspection report is addressed to the financier as well as the borrower/purchaser, the financier will normally not insist on having an independent report as well.

Ownership: There should be an obligation on the borrower to provide evidence that the borrower has acquired good title to the aircraft. It is important for the financier to be satisfied that its borrower actually owns the aircraft as opposed to only having an interest in the aircraft under a hire purchase or lease arrangement. Proof of ownership is normally constituted by a bill of sale executed by the manufacturer/seller in favour of the purchaser. However, in the case of a used aircraft, evidence of the title chain "back to birth" may be appropriate.

Insurance: There will be a CP that the borrower should provide a certificate of insurance from the insurance brokers placing the insurances and an opinion from the financier's insurance advisers confirming that the insurances are acceptable. It is important that the borrower provides drafts of the insurance certificate to the financier as soon as possible, because any external insurance advisers may take time to review the policies and may also request changes to be made which may take time to implement. Please refer to the particular section on insurance undertakings below.

Certificate of Airworthiness: There is often a CP that the borrower should provide a "Certificate of Airworthiness" in relation to the aircraft. This is a certificate which is issued in respect of an aircraft only when the aircraft is properly registered with the relevant aviation authority and conforms to the particular safety regulations laid down by such aviation authority. The Certificate of Airworthiness is valid and the aircraft may be operated so long as it is maintained in accordance with the rules issued by the aviation authority. In practice, the certificate may only be received after completion, so is, in fact, a condition subsequent rather than a condition precedent.

Certificate of Registration of Aircraft and Mortgage: It is not unusual to have a CP that the Certificate of

Registration of the aircraft should be provided by the borrower. However, like the last discussed CP, this CP is "circular" in that in the case of a new financing the Certificate of Registration will not be issued until the financier has lent the money and the aircraft has been registered in the name of the borrower. As a CP the financier will, however, need to be satisfied that the Certificate of Registration will be issued very shortly after it has lent the money and a financier will often seek an undertaking from the entity attending to the registration on behalf of the borrower (often the operator) to this effect. If the aircraft is registered in a jurisdiction where there is a separate aircraft mortgage register (as well as an aircraft register) it will be necessary to obtain both certificates. The UK, for example, is a jurisdiction where the mortgage register is separate from the aircraft register.

Legal Opinions: The financier's lawyers will advise on what legal opinions should be obtained in any given aircraft financing and there should be a CP in relation to each opinion. Broadly speaking, legal opinions will be sought from the financier's lawyers in the borrower's jurisdiction, the jurisdiction of any guarantor or other third party providing security, the jurisdiction of registration of the aircraft and, if *lex situs* issues apply, the jurisdiction where the aircraft is located at the time the mortgage is entered into. If there is a division of the legal and beneficial ownership in the aircraft (as is often the case in the US) a legal opinion should be sought in respect of both the legal and the beneficial owner and the arrangements under which the aircraft is held on trust.

The purpose of obtaining legal opinions is to help the financier have a real understanding of any given transaction and its areas of uncertainty. As such, the "qualifications" section of the legal opinion will be the most relevant to the financier as it should list those areas of the transaction where the documents do not give the full picture and the local law may have an impact which is not in accordance with the terms of the documents.

Undertakings

Undertakings (also known as covenants) are one of the main provisions in a loan agreement which help a financier to monitor and control a borrower once the agreement is executed. In particular, the financier will be concerned that the value of the aircraft is maintained. The following are usually contained within the loan agreement as undertakings:

Aircraft Maintenance: Each aircraft must have a maintenance programme approved by the aviation authority in its state of registration based upon the manufacturer's maintenance planning document, which will set out the various checks, inspections,

maintenance and parts replacement that must be undertaken on the airframe and the engines at various intervals. The intervals are generally determined by flight hours, cycles and calendar time. The cycle is one take off and landing.

It is essential for the financier to ensure that the aircraft is properly maintained and a failure to do so will be an event of default.

Sometimes (especially in the case of larger aircraft or fleets) a financier will require the borrower to pay specific amounts calculated by reference to completed cycles and hours into a designated account in respect of future maintenance works to be undertaken on the aircraft. These maintenance reserves are then used to carry out maintenance to the aircraft. The maintenance reserve account is normally charged to the financier so that if the financier enforces its security over the aircraft it can take the benefit of the maintenance reserves to ensure that the value of its collateral is not adversely affected by the cost of forthcoming scheduled maintenance work.

Manuals and Technical Records: The manuals and technical records are part of the aircraft and if they are unavailable or have not been properly kept up-to-date this can severely reduce the value of the aircraft. For example, it can take up to two years to reconstitute such documents and during this time the aircraft could not be remarketed and sold on. The financier's documentation will include undertakings requiring that the manuals and technical records are securely kept, written up in English, properly kept up-to-date and a provision enabling the financier to take possession of the manuals and technical records if it enforces its security over the aircraft.

Insurances: The financing documentation will include detailed provisions requiring the borrower to insure the aircraft, to keep these insurances in full force and effect and not to fly the aircraft in contravention of these insurances. The main types of insurances that the borrower or its operator will need to take out are *hull all risks insurances* including war and allied perils (i.e. insurances against damage to the aircraft by anything including war risks) and aircraft *third party liability insurances* including war and allied risks (i.e. insurance against loss or injury caused to third parties arising from the operation of the aircraft).

Consideration should also be given as to whether there is a requirement for *passenger, baggage and cargo liability insurance*. The borrower/operator may also take out (and the financier may also require) political risks insurance (i.e. insurance against a change of government in the relevant jurisdiction resulting in the aircraft being e.g. confiscated or requisitioned).

Broadly speaking, a financier will wish to ensure that:

- the level of cover is satisfactory
- the insurances are on an "agreed value" basis (i.e. the underwriters agree to pay the value agreed by the insured with the underwriters on a total loss of the aircraft rather than the market value or the provision by underwriters of a replacement aircraft)
- the insurers name the financier as additional insured and sole loss payee in the event of a total loss of the aircraft
- a "breach of warranty" waiver is included in the insurance policies (contracts of insurance require the insured party to disclose all relevant information to the insurer otherwise the insurance policy may be avoided by the insurer). The financier will require the breach of warranty waiver so as to ensure that the insurance policy is not avoided due to the borrower/operator failing to disclose any information.
- where the insurances are placed with underwriters which are insufficiently robust (e.g. local insurers in the third world), that any re-insurance proceeds are paid directly to the financier (usually in aircraft finance this is dealt with by the inclusion of a "cut through clause" in the primary insurance policy).

The insurance market has developed standard endorsements including the AVN 67B which is the "aviation finance/lease contract endorsement" and AVN 52E which is the war risks endorsement. A financier will usually insist that these endorsements are made to the certificate of insurance.

Events of default

The "Events of Default" dictate the circumstances in which a financier can terminate its loan early and enforce its security. Because of this, they are often the most heavily-negotiated clauses in the whole agreement.

Typical "Events of Default" in an aircraft loan agreement will include a failure by the borrower to pay principal and interest under the loan; any breach of representation or warranty that the borrower has made; breach of covenant; a failure to maintain or insure the aircraft; the aircraft being arrested, confiscated or seized (although this may instead be contained in a separate mandatory pre-payment clause); the insolvency of the borrower or any guarantor and the borrower failing to pay any airport charges or other operational costs when due. In

addition there is normally included a "catch all" clause (also known as a material adverse change clause) whereby if any change occurs in the business, operations or financial condition of the borrower or in the value of the aircraft which constitutes an adverse change which is material to the ability of the borrower to perform its obligations under the finance documents, the financier is entitled to terminate its loan and enforce its security.

Careful consideration should be given as to whether the borrower should be given time to remedy a breach of an Event of Default. This will be appropriate in a number of circumstances, for example, if the borrower accidentally fails to pay an airport charge it would be draconian to enforce the loan and security immediately. However, grace periods will not always be appropriate and, in particular, where the insurances are not maintained in full force and effect in accordance with the provisions of the finance documents there should never be a grace period as the potential liability is so great.

One point which is sometimes raised by the borrower's lawyers is that certain Events of Default in the proposed loan agreement are beyond the borrower's direct control and can be triggered due to the action or inaction of a third party such as the operator. It is argued that these events should not be included as Events of Default as they could trigger "cross default" provisions in other documents which the borrower has entered into resulting in detriment to the borrower. If this point is raised, the normal way around the problem is to remove the events into a separate provision which, if triggered, would not result in an Event of Default but would instead oblige the borrower to make a mandatory prepayment.

Completion and post-completion

Completion (or "closing") of an aircraft financing transaction is the date on which all the finance documents are dated and the money is lent to the borrower. It is also usually the date upon which the aircraft is registered in the name of the new owner.

As there are so many documents to be executed and supplied to the financier on or prior to completion it is important for the financier or their lawyers to have a "checklist" (which may include timelines) to keep track of what has been done and by whom.

Getting the correct people to sign the correct documentation can be one of the most problematic parts to an aircraft financing, particularly where there is a tight deadline to be adhered to. Also, certain original documents may have to be sent to a number

of countries prior to completion. For example, in order to ensure that the financier's mortgage is registered with the FAA (the US aircraft authority) and the International Registry on the date that the mortgage is entered into thus securing priority for the financier, it is necessary for the original executed mortgage to be sent to the financier's US FAA legal counsel prior to the date of closing. If, for example, the individual executing the mortgage on behalf of the beneficial owner is in the Cayman Islands, the original mortgage must be executed and sent to the US FAA legal counsel in plenty of time prior to completion. This is further complicated by the fact that, as mentioned above, if the aircraft is registered in the US but beneficially owned by a non-US entity, a US trust company (e.g. Wells Fargo) must also execute an aircraft mortgage and return the executed document to US FAA legal counsel (see under heading "Miscellaneous" below for further details). In addition, the mortgage may need to be registered in a number of different jurisdictions so it is important that it is executed, at least, in triplicate.

The legal opinions of the various lawyers in each jurisdiction should also all be dated on the completion date (or as close to this date as possible).

With the exception of the situation mentioned above where certain originals have to be sent to particular places in order to be registered, it should be possible to complete an aircraft financing with PDF copies of the executed finance agreements. However, undertakings should be sought from the relevant parties' lawyers that the original documents will be couriered to the financier (or its lawyers) within, say, 7 days after completion.

Frequently the financier is faced with a 'chicken and egg' situation in that the seller will not release the bill of sale (which proves title to the aircraft) unless and until it receives the funds. Also, the aircraft will not usually be able to be registered with the relevant aviation authority without the bill of sale so the financier ends up funding and relies upon the seller's undertaking in relation to the bill of sale and the operator's undertaking in relation to the due registration of the aircraft.

Miscellaneous

The following section deals with a number of miscellaneous issues which may need to be considered on any particular aircraft financing.

Do any international conventions apply?

A number of International Conventions regulate the registration and operation of aircraft. This is a logical consequence of the fact that aircraft are fast, have an extensive multi-jurisdictional range of activity and are not physically restricted in terms of territorial boundaries. Some of those of particular relevance to financiers are mentioned below.

As previously mentioned, the Chicago Convention deals with the registration of aircraft. Please refer to the section of Aircraft Registration (above) for a fuller discussion of this topic.

The Convention of 1948 on the International Recognition of Rights in Aircraft (the "Geneva Convention") deals with the registration of security rights in aircraft. The primary purpose of the Geneva Convention is to protect secured creditors and third parties dealing in, or with, aircraft, to define and protect the rights of privileged or priority claims against aircraft and to facilitate the transfer of aircraft from one register to the other. The Geneva Convention achieves this not by any mandatory requirement that security interests be registered in national registers, but by providing that a recorded security interest validly constituted in the contracting state where the aircraft was registered at the time the interest was constituted, will be recognised by other contracting states.

The UK (among other nations) has not ratified the Geneva Convention, but the consequences of this should not be exaggerated. First, only a limited number of countries have ratified the Geneva Convention and secondly, the Geneva Convention only provides protection in a case where an aircraft is registered in one contracting state and enforcement action has to be taken in another contracting state. Accordingly, it should be assumed that, for risk-assessment purposes when evaluating the structure of an aircraft financing that this protection will not be available unless the aircraft is registered in and is flying exclusively between contracting states. The "Cape Town Convention" provides for the creation of an 'international interest' which can be registered on a paperless "International Registry" which will be recognised in all contracting states. The Cape Town

Convention also aims to provide financiers with a range of basic default and insolvency related remedies and, where there is evidence of a default, a means of obtaining speedy interim relief pending final determination of its claim. As mentioned above, only 23 countries (including the USA and Ireland) have ratified or acceded to this Convention, but if the financier is dealing with an aircraft which is registered in a contracting state or, indeed, the aircraft owner is incorporated, located or established in a contracting state then legal advice specifically on the Cape Town Convention should be sought from local counsel. For example, when financing a US registered aircraft (the USA being a contracting state to the Cape Town Convention which has ratified it) pursuant to the Cape Town Convention the entity registering an "international interest" must grant its consent through an "International Registry authorised individual" so that the registration can be made. It is important that such arrangements are in place well before the scheduled completion date of an aircraft financing transaction in order to ensure such consent is granted.

Value Added Tax (VAT)

The purchase of an aircraft in the EU or the importation of an aircraft into the EU will be subject to VAT.

Article 148 of Directive 2006/112/EC provides relief from VAT in respect of aircraft "used by airlines operating for reward chiefly on international routes". Most EU member states have implemented Article 148 literally. However, the implementation of the UK (including the Isle of Man) is more generous: zero rating applies to the importation or supply of an aircraft of a weight of not less than 8,000 Kg. (The weight is its authorised maximum take-off weight. This is specified - for civil aircraft - in the certificate of airworthiness in force for the aircraft.) For this reason, it will frequently be advantageous for an aircraft qualifying under the UK legislation to be imported into the UK or Isle of Man where it can benefit from zero rating and then be in free circulation throughout the EU.

Possessory liens and other rights of detention

Liens and rights of detention can be a problem to a financier because they may be exercised against the aircraft notwithstanding that they arise after the date of any aircraft mortgage. Whether or not a lien arises depends of course on the law of the place where the aircraft is located. A financier should take local legal advice on this issue.

There are also certain statutory provisions in various jurisdictions which permit the relevant authorities to detain and sell aircraft. Often these relate to airport and navigation charges.

Liens and rights of detention in the UK

In **the UK** the following liens and rights of detention will each have priority against a financier with a valid mortgage:

Repairman's lien: Any possessory lien in respect of charges for work done on the aircraft, whether before or after the creation or registration of the mortgage. The repairer's lien can only be exercised against the aircraft to which the charges relate and not against other aircraft, engines or parts belonging to the same owner, lessee or operator in the repairer's possession. This is a possessory lien only and will also attach to the aircraft's documents to the extent that they are in the possession of the repairers. Release of the aircraft without the documents creates a major problem as the documents are vital for a sale of the aircraft.

Airport Charges: Under the Civil Aviation Act 1982, UK airport authorities have power to detain an aircraft for unpaid airport charges (being charges payable to the airport authority for the use of the airport or for services provided by it and attributable to a particular aircraft) and, if 56 days from the date of detention after those charges are still unpaid, it can apply to the court for leave to sell the aircraft no matter to whom it belongs. The authorities may detain either:

- a. the aircraft in respect of which the charges were incurred, whether or not they were incurred by the person who is the operator of the aircraft at the time when the detention begins (meaning that the new operator of an aircraft can be required to pay charges on the aircraft incurred by a former operator); or
- b. any other aircraft of which the person in default is the operator at the time when the detention begins. This is in the nature of a fleet lien and therefore the aircraft detained may not itself have incurred any charges.

"Operator" in relation to an aircraft means the person having the management of the aircraft and therefore, on any aircraft financing transaction a financier will have to perform due diligence upon the proposed operator of the aircraft.

Notice of an application for leave to sell must be given to any persons whose interests may be affected,

which would of course include a person holding security over the aircraft.

Air Traffic Control Services: The CAA has power to detain and sell an aircraft for the non-payment of charges for air traffic control services provided by the UK National Air Traffic Services ("NATS"). In addition, the CAA has power to detain and sell an aircraft for non-payment of Eurocontrol charges or charges due to the Governments of Denmark and/or Iceland for air traffic control services. As above, in each such case, the CAA may detain either:

- a. the aircraft in respect of which the unpaid charges were incurred, whether or not they were incurred by the person who is the operator of that aircraft at the time the detention commences; or
- b. any other aircraft of which the person who is in default is the operator at the time the detention commences. The fleet lien in relation to Eurocontrol can be of serious concern to aircraft lessors and mortgagees because Eurocontrol fleet debts can be large and Eurocontrol has regularly taken advantage of its fleet lien detention rights in England.

If Eurocontrol is unable to ascertain who is the aircraft operator it may give notice to the aircraft owner. When the CAA detains an aircraft on behalf of Eurocontrol it does not need to give warning of its intention to detain to anyone (including any owner, operator or mortgagee of the aircraft) nor seek a court order prior to detaining the aircraft. However the CAA must not sell an aircraft on behalf of Eurocontrol for unpaid Eurocontrol charges without leave of the English High Court. Before applying to the court the CAA must take certain prescribed steps to bring its proposed application to sell the aircraft on behalf of Eurocontrol to the notice of interested persons and for affording them an opportunity to become a party to the proceedings.

Miscellaneous: Under English law aircraft may be detained, but not sold, for the contravention of airline licensing requirements (not likely to apply to private jets but mentioned here for the sake of completeness), contravention of certain air navigation regulations (i.e. if the nationality and registration marks are not displayed correctly on a particular aircraft), for contravention of certain aircraft noise and emission requirements, for contravention of certain patent infringement and for breaches of public health requirements.

Further, an aircraft may be detained and sold for breaches of customs legislation and for unpaid taxes

(i.e. if a person is charged with tax they may have their goods, including aircraft, seized in order to satisfy their tax bill). Also, under English law an aircraft can be detained and, in some cases, forfeited under the criminal law, for example, in connection with offences relating to terrorism, theft and drug trafficking. Finally, at any time of "hostilities, severe international tension or great national emergency", the Government may requisition aircraft (although in such a case compensation would be payable).

A key problem is that aircraft liens (and detention rights) in the UK are not registrable, and so can often occur without interested parties (such as the owner or any mortgagee) being aware of them. No provision is made for the registration of aircraft liens in either the UK Register of Civil Aircraft or the UK Register of Aircraft Mortgages. Aircraft liens are also not required to be registered in the UK Companies Register of Charges or the Bills of Sale Register. There is no UK register containing details of airport charges, although some information is available in certain publications. A financier may also contact airports directly in order to establish whether any airport charges are outstanding.

Liens and rights of detention outside the UK

It is also important to consider the laws of the countries to which a particular aircraft flies as such countries may impose their own liens, rights of detention and separate rules as to whether such liens can be registered or not. Some countries may impose even more stringent liens which financiers may not expect, for example, in Mexico and Spain employees of the owner of an aircraft have a lien relating to unpaid salaries and other benefits for the year preceding the claim.

In some countries public registers are kept of outstanding lien claims, which should be checked prior to any aircraft financing. For example, in the US, for any aircraft registered at the FAA aircraft registry the FAA has established a central system for the recording of any "conveyance" affecting an interest in such aircraft. For these purposes a "conveyance" includes any bill of sale, contract of conditional sale, mortgage, lease, equipment trust, tax lien (other than a Federal Tax lien) or of other lien or other instrument which affects the title to, or any interest in, such aircraft. All this serves to emphasise the importance of full discussions with local legal counsel in the state of registration of an aircraft (or any other jurisdiction that is relevant), although Field Fisher Waterhouse LLP will

be able to issue "preliminary advice" on the laws of a particular jurisdiction in order to highlight, at an early stage, the various liens and detention rights which will arise.

Practical steps to deal with liens and rights of detention

An undertaking can be obtained from the borrower in the documentation not to permit the creation of any liens other than those permitted by the transaction documents, arising in the ordinary course of business and only in the event that the borrower has satisfactory funds to cover the amounts in respect of which the liens have arisen, and also a covenant to discharge any liens promptly, although breach of this only gives rise to a contractual right against the borrower. In relation to Eurocontrol liens, certain other navigational liens and airport charges liens, secured financiers often seek a letter from the operator of the aircraft directing Eurocontrol, other air navigation authorities and airports to provide them with details of outstanding charges on request. Therefore, we recommend that as a matter of best practice (where aircraft are being flown in and out of countries which impose these "fleet" liens) such a letter should be obtained from the operator. However, the financier should be aware that the information obtained may be incomplete or out of date.

This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal advice on any of the topics discussed.

Contact



Andrew Evans

t. +44 (0)20 7861 4169

e. andrew.evans@ffw.com



Field Fisher Waterhouse LLP 35 Vine Street London EC3N 2AA
t. +44 (0)20 7861 4000 f. +44 (0)20 7488 0084 info@ffw.com www.ffw.com

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