AIRCRAFT LEASES

(1) General

(a) Characterisation (legal)

- Under the common law, although an aircraft lease agreement is a contract, the lease itself pursuant to that agreement is actually a form of bailment. The essence of bailment is possession. The term is derived from the French verb bailler, meaning "to deliver" and involves the separation of possession from ownership. The bailee (i.e. the lessee) acquires, on delivery, a legal possessory interest in the aircraft which the courts will recognise and enforce, even against the owner. This is not merely a contractual right but is a proprietary or property right (per Browne-Wilkinson V.C. in Bristol Airport plc v. Powdrill [1990] 2 All E.R. 493 at 501-502).

  A proprietary right is a right in the aircraft itself, involving a right of recourse to the aircraft, whereas a contractual right is merely a personal right, or right in personam, to bring an action against a defaulting party. Accordingly, since the lessee's proprietary rights are dependent upon possession, until the aircraft is actually delivered, the lessee has only a personal or contractual claim under the lease agreement against his bailor (i.e. lessor).

  Under the civil law, the position seems to be different. Under French law, the lessee's interest is purely contractual, he has no proprietary interest in the aircraft, even after delivery, merely a personal right to possession.

- In England, leases are governed by the Supply of Goods and Services Act 1982, Sections 6 to 10, which create implied terms as to quiet possession, fitness for purpose and merchantability. (These implied terms are, in practice, expressly excluded in the lease agreement).

- In the U.S., the basic rights and obligations of the parties to a lease were established by the common law (i.e. decided cases) rather than by statute, although the New York, and other, courts held that the sales warranty provisions of Article 2 of the Uniform Commercial Code were applicable to chattel leases (Owens v. Patent Scaffolding Co. (1974) 354 NYS 2d. 778). Similarly, the UCC provisions governing exclusions and disclaimers were held to apply to such leases (Hertz Commercial Leasing Corp. v. Transportation Credit Clearing House (1969) 298 NYS 2d. 392). Leasing law has now been codified in Article 2A of the Uniform Commercial Code. Article 2A has been enacted in various States, including New York (with effect from 30th June 1995) and California. There are certain UCC provisions which cannot be waived (Section 1-102(3)), including principles of good faith

(Section 1-203). Section 2A-108 provides that any lease or clause of a lease which was unconscionable when made is unenforceable.

- In France, Articles 1719 to 1733 of the Civil Code impose various obligations on the lessor (quiet enjoyment, fitness for purpose, necessary repairs) and the lessee (take reasonable care, pay the agreed rent, return the aircraft in the state in which it was delivered, save as to fair wearand tear, risk of loss or damage due to fire). These issues are invariably regulated expressly in the lease agreement.

(b) Characterisation (functional)

- Dry - where lessee obtains complete operation and control of the aircraft

- Wet - where lessor leases the aircraft to the lessee but agrees to provide certain incidental services, typically crew, maintenance and insurance.

- Charter - not strictly a lease, possession of the aircraft remains with the owner who contracts with the charterer to carry passengers or goods on behalf of the charterer for a flight or series of flights.

- In practice, the distinction between the above categories can become blurred, particularly as between wet leases and charters. Wassenbergh (see Appendix D) identifies 12 different forms of lessor/lessee/charterer relationship. The differences can have legal significance, not only in relation to the exercise of traffic rights (as Wassenbergh explains) but also in relation to issues of liability under the Warsaw regime, surface liability, registration of the aircraft and liability for airport and navigation charges.

(c) Types of dry lease

- operating lease

  - basically, where lessee obtains use of aircraft on short to medium term basis and pays rent for such use.

  - rationale

    - off balance sheet for lessee (i.e. not recorded as an asset/liability on the lessee's balance sheet at the outset, unlike a finance lease where, in accordance with IAS17, SSAP21 or FSAB 13, the lessee records the aircraft on its balance sheet at its fair value and also records an equivalent liability), although there is at present a drive towards re-classifying longer term operating leases as finance leases, thus bringing them "on-balance sheet";

- uniform cash flows (but not always - such as with GPA leases) with minimal up-front deposits;

- flexibility for fleet management purposes;

- no residual risk.

- lease rates

  - generally, between 1.0% and 1.8% per month of the fair market value of the aircraft. New Stage III aircraft generally between 1.0% and 1.2%. Older aircraft can exceed 2%. Currently there exists a lessee's market and considerably better rates can be achieved, particularly in the case of short-term leases.

  - rates may be fixed or linked to a floating rate, such as LIBOR. If fixed, broken funding costs can be significant in the event of early termination.

- finance lease

  - as the term suggests, this is essentially a method of financing the acquisition of an aircraft. Fundamentally, the lessee assumes all the risks and rewards of ownership (i.e. access to aircraft residual value) and the lease rentals fully amortise the lessor's investment plus margin (i.e. "full pay-out").

    May be single investor (where the lessor provides the entire purchase price) or leveraged (where an aircraft is acquired with a mixture of equity and non-recourse debt and the non-recourse debt is used to magnify the effect of the tax benefits available to the equity participant).

    Often tax-based and, if cross-border, can involve double or triple "dips", whereby tax benefits are obtained in more than one jurisdiction by exploiting differences in entitlement to depreciation allowances, so that a lessor in a jurisdiction applying a legal ownership test (e.g. France, UK) will qualify as will a lessee in a jurisdiction applying an economic ownership test (e.g. Germany, US, Japan).

    May also be defeased, so that the rent stream is prepaid, usually by way of a deposit equal to the present value of the future rent and any purchase option, which is placed with a third party (typically a bank) who then uses the principal and interest to retire the rental obligations.

Such an arrangement will often enable the lessee under a sale and lease-back to receive an up-front cash benefit (i.e. the difference between the deposit and the fair market value of the aircraft).

- rationale

  - lease financing is an alternative to debt financing and is generally motivated by the desire of the lessor to take advantage of tax capacity not generated by the airline itself so as to produce a yield to the lessor in excess of that obtainable from a comparable loan and allow the airline the benefit of low cost funding; frequently involves highly complex and sophisticated structures - this is a function, in part, of the need to maximise the tax benefits and/or avoid tax pitfalls, such as withholding taxes and stamp duties, and, in part, of the lessor's (and its lenders') security concerns in relation to the state of registry.

(2) **Typical Lease Provisions**

(a) **Contents**

- Definitions and Interpretation
- Agreement to Lease and Conditions
- Term
- Representations and Warranties of the Lessee
- Delivery and Acceptance
- Damage prior to Delivery
- Rental Payments
- Insurance
- Loss, Damage and Requisition
- Maintenance and Repair
- Operation and Use
- Taxes and Costs
- Events of Default
- Re-Delivery
- Exclusion and Indemnity
- Notices

- Governing Law, Jurisdiction and Service of Process
- Assignment
- Miscellaneous

Schedules

- Aircraft Specification
- Manuals and Technical Records
- List of Documents and Evidence
- Acceptance Certificate
- Certificate of Insurance
- Broker's Undertakings
- Return Conditions
- Legal Opinion

(b) **Some key issues:**

(i) **Quiet enjoyment**

- the relationship between a head lessor and a sub-lessee can cause problems, as can the relationship between a lessor's mortgagee and the lessee. As between a head lessor and a sub-lessee, in the absence of any contractual link, there is no basis, at least under English law, for applying the statutory implied terms as to quiet possession, etc. under the Supply of Goods and Services Act 1982 (because Section 6 of that Act makes it clear that it only applies to contracts and there is no contract between the head lessor and the sub-lessee) or equivalent terms at common law. The position seems to be different in the U.S. where the courts have been prepared to extend the terms which apply to a contractual leasing relationship to a non-contractual one (Lovely v. Burroughs Corp. 527 P.2d 557 (1974)). Even under English law, there are arguments that, where a head lessor has consented to the sub-lease, the sub-lessee should have the benefit of the head lessor's covenants as to the right to lease, quiet possession and freedom from encumbrances.

  Particular problems can arise if the head lease is terminated following the head lessee's

default. Does this automatically terminate the sub-lease? Termination in such circumstances could be unfair to the sub-lessee but non-termination could be unfair to the head lessor since the sub-lease rentals would not be payable to him but to the lessee (or his administrator or trustee in bankruptcy). Arguably, if the head lessor consented to the sub-lease, then the sub-lessee's rights under the sub-lease should prevail. This has not been conclusively determined by the English courts but most commentators take the view that the sub-lease should fall with the head lease, subject to the sub-lessee's right to seek relief from the court under Section 146(4) of the Law of Property Act 1925.

For these reasons, it is normal (and preferable) to create a direct contractual link between the head lessor and the sub-lessee. Typically, the head lessor will take a security assignment of the benefit of the sub-lease and will, as part of the formal notification and acknowledgment process, receive from, and give to, the sub-lessee various appropriate covenants.

- Broadly similar considerations apply as between a mortgagee and a lessee. If the mortgagee has notice of the lease, then there are cases which establish that the lessee's right of quiet possession will prevail if the lessor defaults under the mortgage, provided the lessee can establish that he has a proprietary interest in the aircraft (De Mattos v. Gibson (1858) 4 De G&J 276; Lord Strathcona S.S. Co. Ltd v. Dominion Coal Co. Ltd [1926] A.C. 108). However, these cases have been criticised and it is, again, important to regularise the position formally as between the parties at the outset.

(ii) **Termination payments**

- enforceability will generally depend on whether such payment constitutes a genuine pre-estimate of the lessor's loss arising out of the lessee's breach, or amounts to a penalty (in which case the lessor will only be entitled to recover its actual loss).

- In the U.K., any sum payable on termination as a consequence of a breach by the lessee must represent a genuine pre-estimate of the lessor's loss, otherwise it will be struck down as a penalty (Cooden Engineering Co. Ltd. v. Stanford [1953] 1 Q.B.86; Campbell

Discount Co. Ltd v. Bridge [1962] A.C. 600). Furthermore, there must be a discount allowed for the early return of the lessor's capital outlay (Overstone v. Shipway [1962] 1 W.L.R. 117). Curiously, under English law, the penalty rules only apply in the case of a breach and not where there is a voluntary termination (ECGD v. Universal Oil Products Co. [1983] 2 All E.R. 205). It is important to the Lessor that any termination results from a repudiatory breach and not as a result of the lessor's election to terminate for what would not otherwise constitute a repudiatory breach (Lombard North Central plc v. Butterworth [1987] Q.B. 527). Termination for a non-repudiatory breach only entitles the Lessor to recover arrears of rent, plus interest (Financings Ltd. v. Baldock [1963] 2 Q.B.104). Accordingly, all events of default will usually be expressly characterised as repudiatory breaches.

- **In the U.S.**, the position is broadly similar. At common law, liquidated damages clauses are enforceable if (a) the anticipated damages from the breach would be uncertain or difficult to prove (United States v. Bethlehem Steel Co. 205 U.S. 105 (1907)); (b) the parties intended to liquidate the damages when making the contract; and (c) the fixed damage amount is reasonable in relation to the anticipated loss or injury (Bignall v. Gould 119 U.S. 495 (1886)).

  Section 356(1) of the Restatement (Second) of Contracts provides that:

  > "Damages for breach by either party may be liquidated in the agreement only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."

  Article 2A-504(1) of the UCC allows liquidated damages provisions in a lease "but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default or act or omission". Alternatively, Sections 2A-523 to 2A-531 contain detailed remedies available to the Lessor following a Lessee default.

- In France, the position is regulated by two provisions of the Civil Code, Article 1152 which provides that, when the parties have stipulated in their contract the amount of damages payable in the event of a breach, the court can only vary that amount if it is "manifestly excessive or derisory" and Article 1231 which provides that, where a party has partially performed its obligations, the court may reduce the agreed damages in proportion to the benefit derived by the other party from such part performance.

(iii) **Maintenance reserves**

- these provisions give rise to various commercial issues - whether interest should be credited to the reserves; whether the reserves can be adjusted to reflect changes in flight hour: cycle ratios and inflation; exactly what maintenance processes they cover; in the case of the lease of a used aircraft, the reserve fund should be credited at the outset with an amount calculated to reflect prior utilisation.

- they can also cause legal problems, depending upon the basis on which they are paid. Under English law, they should ideally be paid into a separate account in the name of the lessee and charged to the lessor, then they remain the property of the lessee. If they are characterised as supplemental rent and paid to the lessor, problems could arise in the event of the liquidation of the lessor - the lessee could simply become an unsecured creditor unless the partricular arrangements are capable of being construed as creating a charge or a trust (Quistclose Investments Ltd v. Rolls Razor Ltd [1970] AC 567; Swiss Bank Corporation Ltd v. Lloyds Bank Ltd [1979] 1 Ch. 548). One possible solution is to provide letters of credit instead of paying reserves.

  In the U.S., depending on the particular arrangements, the lessee's position would seem to be better. Under Section 7-101 of the New York General Obligations Law, if money is deposited under a lease agreement as security for the performance of obligations under it, the money, plus interest, is subject to a trust in favour of the lessee and must be deposited with a bank or trust company.

  Under French law, the trust concept does not exist. Furthermore, there would appear to be no statutory protection for the lessee. One

possible solution is to create a "sequestre" (an escrow arrangement with a third party, such as a bank). Otherwise, the maintenance reserves will simply be a debt due to the lessee and would form part of the lessor's "patrimoine" in the event of its bankruptcy.

(iv) **Return Conditions, A.D. incorporation, Major Checks**

- often give rise to difficult commercial issues, return conditions should ideally mirror delivery conditions, with cost equalisation formulae for disparities but maintenance reserves should then be taken into account; in short-to-medium term leases, there should be cost apportionment formulae for incorporation of A.D.s and performance of major checks (because most of the benefit is conferred on the lessor).

(v) **Lessor's liability to third parties**

- generally predicated on negligence, but not necessarily. EEC Directive of 25 July 1985 on Liability for Defective Products and UK Consumer Protection Act 1987, impose strict liability for any defect causing death, injury or damage on anyone importing an aircraft into the EEC in order, as part of his business, to lease it to another party. Under the Act (but not under the Directive) there is an exemption for finance lessors.

  In some U.S. jurisdictions, doctrines of strict liability and crashworthiness have been extended to aircraft lessors (Rudisaile v. Hawk Aviation, Inc. P.2d 175).

- statutory protection

  - Section 504 - Federal Aviation Act 1958 exonerates aircraft lessor from liability for surface damage if lease is for 30 days or more and lessor is not in actual possession or control. However, the drafting is defective and has given rise to a claim that liability for death, injury or damage in the air is not excluded (Storie v. Southfield Leasing Inc. 90 Mich. App. 612)

  - Section 76(4) - Civil Aviation Act 1982 exonerates aircraft lessor from liability for surface damage if lease exceeds 14 days and no "operative" crew member is in the employment of the lessor

- Rome Conventions of 1933 and 1952 imposes liability for surface damage on the "operator". However, only five States have ratified the 1933 Convention and although 38 States have ratified the 1952 Convention, very few of the major aviation countries have done so.

(vi) **Taxation Indemnities**

- The lease agreement will typically contain very wide tax indemnities, together with a very wide tax definition. In a tax lease, these indemnities will be extremely complex. In an operating lease, it is essential that appropriate "carve-outs" are inserted to protect the Lessee. These will typically include income or corporation taxes imposed on the Lessor in any jurisdiction unless the only reason for the imposition of such taxes in a particular jurisdiction is the lease agreement itself, taxes imposed in respect of periods occurring before or after the lease agreement and taxes imposed as a result of the sale of the Aircraft.

- There will invariably be a requirement for the Lessee to "gross-up" in the event of a withholding tax. Note that the actual cost of grossing-up is greater than the amount of the withholding. Lessee should try to include a "reverse indemnity" whereby the Lessor will repay any savings realised (in the form of a refund, deduction or credit) in respect of any gross-up or other indemnity payment.

- The Lessee should attempt to include an appropriate tax contest provision, requiring the Lessor to contest the payment of any taxes covered by the Lessee's indemnity.

(vii) **Unrecorded Liens**

- As previously noted in the section dealing with purchase contracts for used aircraft, unrecorded liens can cause problems. In the case of leased aircraft, such liens can be particularly troublesome to the lessor. In the U.K., the wide-ranging statutory rights of detention and sale in the case of unpaid airport and/or navigation charges mean that the lessor's aircraft can be detained to satisfy charges incurred not only by his own lessee but also by a <u>previous</u> operator or charges incurred in respect of <u>other</u> aircraft operated by his lessee.

- Since airport and navigation authorities are generally unwilling to disclose details of outstanding charges to anyone other than the operator concerned, most lessors will typically seek a written authorisation from the lessee, addressed to the relevant authorities, permitting such disclosure. This enables the lessor to monitor the position.

ENGINE PURCHASE CONTRACTS

(1) Engine Purchase Contracts

- Contract for purchase of new aircraft will provide for delivery with installed engines. To the extent that there is a choice of powerplant, Buyer is required to make its choice not later than a given period prior to scheduled delivery date. Airframe manufacturer will normally acquire engines from engine manufacturer and will either transmit benefit of engine manufacturer's warranties and product support package to buyer or the engine manufacturer will grant the warranties and product support package direct to buyer.

- Major manufacturers will typically provide a service life policy covering engine and primary parts failure, ultimate life limit reductions and campaign changes (i.e. replacement or modification of a part pursuant to a Service Bulletin). In addition, performance guarantees are usually granted, covering such matters as in-flight shutdown rates, shop visit rates and EGT deterioration.

- For spare engines, carrier will contract directly with engine manufacturer, usually by way of a General Terms Agreement which will provide for purchase of engine, related equipment and spares and will provide product support services package which will generally extend to the following:

  - spare parts provisioning
  - technical data
  - technical training
  - customer service
  - product support engineering
  - operations engineering
  - ground support equipment

(2) Engine Leases

- Developed as an alternative to owning or pooling. Main lessors include AAR, AGES, Airmotive Ireland and Charles F. Willis Co.

- Basically 2 types:

  - short-term (typically 30-90 days) emergency leases. Rates very high (2-3% of cost per month), usually calculated on daily flat rate plus use charge.

- medium term (typically 3-7 years), where engine is used as a standby. Rates lower (1.5-1.75% of cost per month), calculated on flat monthly rate plus use charge.

- Attractions to carrier of medium-term lease

  - off balance sheet

  - cash liberation for other investment

  - enhanced spare engine cover

  - flexibility

  - no residual risk

- Problem areas

  - title protection

    - difficulties presented by modular concept, i.e. modern aero engines have three basic and fairly easily interchangeable components - turbine, compressor and combustion module. Engine outer casing tends to conceal modular concept.

    - difficulties also presented by interchange and pooling arrangements.

    - title protection techniques (need to reconcile carrier's engine management policy with lessor's title concerns)

      - title exchange

        - such a provision stipulates that, if the lessee replaces the engine for any reason (other than a temporary replacement), then title to the substitute engine automatically vests in the lessor. This can cause problems if the substitute engine is owned by a third party, since the provision will not usually bind the third party. Also, there could be problems if the lex situs does not recognise such a form of title transfer.

      - title reservation

        - this type of provision stipulates that title to the leased engine will remain vested in the lessor until it is replaced by an engine title to which is properly vested in the lessor. This can cause problems if the engine is installed on an aircraft which is repossessed (particularly if a title exchange mechanism operated in relation to any lease or mortgage of that aircraft), or which becomes a total loss and the engine lessor is not a loss payee under the aircraft insurance.

- name-plates (usually attached to compressor, which is simply one module) and log-book entries. Such precautions may or may not constitute constructive notice to a third party.

- registration

  - 1948 Geneva Convention on International Recognition of Rights in Aircraft provides registration machinery for engines but few countries have implemented it. In any event, not many Common Law countries have ratified the Convention.

- insurance

  - aircraft hull policies will only cover ingestion damage caused by single recorded incident. Most policies specifically exclude wear and tear, deterioration, breakdown, defect or failure in any "unit" (which includes an engine).

  - engine breakdown policies are available but tightly circumscribed.

- product liability

  - risk transferred to lessee by way of indemnities.