

A Guide to Corporate Jet Finance

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Introduction

With confidence in the business jet market finally starting to improve, we thought it an opportune time to update and refresh our guide to corporate jet finance.

Aviation is of course a specialist forum in which to lend and corporate jet financing in particular can be complex for a variety of reasons.

The aviation industry is highly regulated and the domestic laws of a number of jurisdictions and conflicts between these laws will need to be considered in connection with the operation of aircraft. 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 which remain distinctly lender-unfriendly.

In some jurisdictions, such as the UK, the validity of the aircraft mortgage will be dependent on the aircraft being physically located in that jurisdiction (or another jurisdiction which recognises an English law mortgage) at the time such mortgage is entered into.

A financier must also ensure that adequate maintenance and insurance covenants are contained in the loan documentation so that the aircraft's value is not jeopardised, and also that the right amount of checks are in place to enable the financier to monitor the value of the aircraft. 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. In respect of new aircraft, it is becoming increasingly popular for financiers to require that the airframe and engines are enrolled on the manufacturers' maintenance care programmes.

An aircraft can be the subject of various liens (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.

In this guide we set out the main structural and documentary issues which financiers should take into account throughout an aircraft finance transaction: from the early stages to taking delivery of the aircraft, as well as the ongoing monitoring of the aircraft during the term of the facility.

INITIAL ISSUES TO CONSIDER

The Purchase Agreement

In the case of a financing of a new aircraft, it will always be necessary for the financier to review the aircraft purchase agreement. This contract is normally made between the airframe manufacturer and the borrower (purchaser), but will nevertheless include the supply of engines.

The purchase price of a new aircraft will usually be paid in stages with the first payment due upon the signing of the purchase agreement, one or more payments due at various stages throughout the construction of the aircraft and the final payment due at the time of delivery of the aircraft (each a **"stage payment"**). If the financier is providing pre-delivery finance (i.e. funding all or part of the stage payments), the aircraft purchase agreement needs to be reviewed to ascertain that it is freely assignable or, at least, that the right to take title of the aircraft is assignable. Ideally, in the event that if either the manufacturer or the purchaser defaults, 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.

Prior to delivery of the aircraft by the manufacturer, given that the aircraft will not yet exist (i.e. it will not yet be capable of registration on to any aircraft registry) and title to the aircraft will not have passed to the borrower, 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.

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Any such assignment agreement would need to be governed by the laws of the same jurisdiction which govern the law of the aircraft purchase agreement. Also at this stage, the financier will normally take a guarantee from the ultimate beneficial owner of the borrower and a charge over the borrower's issued share capital.

Where a used aircraft is being purchased, the content of the aircraft purchase agreement will be of less importance to the financier, although they would still look to review it (alongside the prior bills of sale) to confirm that the borrower / purchaser has taken good title to the aircraft and to assess the extent to which any manufacturer warranties may still exist.

STRUCTURAL ISSUES TO CONSIDER

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) aircraft rights whilst shielding the aircraft from other creditors of the borrower and minimising the possibility of any prior banking 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. In some jurisdictions, for example where high stamp duty is payable on the mortgage or where a mortgage is not recognised, a lease of the aircraft may be the only viable option. The remainder of this guide will assume that the financier is taking a security interest as mortgagee, as this tends to be the preferred form of financing by our banking clients.

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 and Luxembourg) there are requirements that the mortgage and underlying loan documents have to be translated into the local language, notarised, legalised and filed in several central registries (such as

the companies registry, the aviation registry and a specific aircraft mortgage registry). The cost of registration of the aircraft mortgage may also be expensive in some jurisdictions. 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.

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 recognise aircraft mortgages in any form as a valid type of security and where such jurisdictions are involved, different forms of security interest will have to be considered. The effectiveness of such security 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 which involves an operator taking possession of the aircraft on behalf of the financier.

Normally the priority of mortgages will be dealt with by reference to the time that the mortgage is registered on the aircraft register / mortgage register in the state of registration. It may be possible to arrange pre-registration protection for a potential mortgage. For example a "Priority Notice" can be registered at the UK CAA which "reserves" the financier's priority over the aircraft for a period of 14 days (consecutive Priority Notices can be filed so that the period is extended for a further 14 days with each Notice). Although a subsequent lender will still be able to register their interest under another mortgage, that subsequent lender's security interest will rank behind the initial lender that filed the Priority Notice provided that the initial lender files their mortgage over the aircraft within the 14 day protected priority period.

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 the register in question is an owner or an 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. The Chicago Convention provides that an 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 governed by 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, such as the UK, the aircraft register is 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, such as 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. A degree of 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 2001 (the "**Cape Town Convention**"). Effective registration in the

International Registry (established pursuant to the Cape Town Convention) is only available to aircraft registered in 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 (for instance, the 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.

The jurisdiction of registration of an aircraft will also need to be taken into account when considering the use and operation of the aircraft, and in particular with respect to cabotage rules. Cabotage is the right to carry cargo (goods or passengers) between two airports within the same state. A breach of a state's cabotage rules can result in large penalties and any financier will need to be comfortable that the registration mark of an aircraft will not mean that it will be operated in breach of such rules.

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 beneficial owner 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 a 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.

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In circumstances where a US trust company is used, it is necessary for the US trust company (as 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 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 provisions which will be relevant on an aircraft financing transaction (although this list is by no means comprehensive).

Conditions Precedent

The conditions precedent ("CP's") 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 CP's to satisfy, the CP's are normally listed at the back of the loan agreement in a schedule. It is important that the borrower is made aware of the CP's at the beginning of any transaction as often it will take the borrower a considerable amount of time to satisfy the CP's and it is usually fulfilment of these conditions (as opposed to negotiating the documents) which can delay an aircraft financing, particularly where a third party (e.g. the airframe manufacturer or the operator) is involved in the provision of the information/documents. The following are usually contained within the list of CP's:

Valuation: There will nearly always be a requirement for a valuation of the aircraft prior to drawdown to be paid for by the borrower. This may either be carried out by the financier internally, be made by reference to the Blue Book or carried out by an independent valuer.

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 its own independent report.

Ownership: There should be an obligation on the borrower to provide evidence that it will acquire 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" is often required and it is important to check that full market consideration was paid for the aircraft by each entity in the chain.

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 "Insurances" 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 it is, in fact, a condition subsequent rather than a condition precedent.

Certificate of Registration of Aircraft: A copy of the Certificate of Registration noting the owner of the aircraft should be delivered to the financier (the original Certificate will need to remain on board the aircraft). If the aircraft is new and therefore only going on to an aircraft registry at delivery, or if the aircraft is changing from one jurisdiction of registration to

another, as a CP the financier will 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 of the aircraft on behalf of the borrower (often the operator) to this effect.

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:

Loan to Value Covenant: This is an essential covenant in any loan agreement providing that the amount outstanding under the loan should not, on the value testing date (often annually), be more than, say, 70% of the value of the aircraft. If the covenant is breached, the borrower is normally given a short time to pay down the loan to the extent necessary to remedy the breach. The cost of the annual valuation will be borne by the borrower and the borrower will also bear the cost if a valuation is made following an event of default. This type of covenant has been vital to financiers over the past few years when the value of corporate jets plummeted.

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.

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.

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 from the borrower and often also the operator requiring that the manuals and technical records are securely kept, written up in English and properly kept up-to-date, a right for the financier to inspect them and a provision enabling the financier to take possession of the manuals and technical records if it enforces its security over the aircraft.

EU ETS Laws: The European Union Emission Trading System ("EU ETS") was launched in 2005. Under this scheme, companies receive an emission cap and are allowed to buy and sell allowances as needed. Failure to have sufficient allowances at the end of each year will make a company subject to civil fines.

Since 2012, the EU ETS applied to airlines and, notably, "aircraft operators" which are defined under regulation 3 of the Aviation Greenhouse Gas Emissions Trading Scheme Regulations 2010, SI 2010/1996 as a person that performs an aviation activity. An aviation activity covers any flight which departs from or arrives in an airport situated in the territory of a Member State to which the Treaty applies. Aircraft operators will therefore have to submit an application to the regulator for an emissions plan, monitor emissions and have these verified on a yearly basis by a regulator. They have to comply with the plan and support the regulator in its role.

In order for the financier to ensure the borrower and operator comply with the scheme, the loan agreement should include undertakings stating that: (i) the borrower will comply with all EU ETS Laws applicable to it and / or the aircraft; (ii) the borrower will ensure that it or any operator shall be the "aircraft operator" for the purposes of the EU ETS Laws; and (iii) the borrower shall identify itself, or procure that any operator identify itself, as such to any EU ETS whenever required under the EU ETS Laws or whenever requested by the financier.

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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 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, demand immediate repayment 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 may be appropriate in a number of circumstances, for example, if the borrower accidentally fails to pay an airport charge it would be draconian to require immediate repayment of the loan. 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.

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 repossess and 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 (e.g. a pledge) and the effectiveness of such arrangements, or simply not lend where those countries are involved and consider a lease structure instead.

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 it is the laws of the jurisdiction where the asset is physically situated at the time the interest (i.e. the mortgage) is created which determines whether security interest has been effectively created.

In the case of *Blue Sky One Limited & O'rs v Mahan Air Et Ano'r* [2010] EWHC 631 (Comm), the English High Court specifically considered the issues and principles involved in deciding the validity of mortgages over, and transfer of title to, tangible moveable property such as aircraft. The decision in this case has confirmed the English position that although mortgages over aircraft registered outside the United Kingdom may continue to be expressed to be governed by English law, in order for any English law governed mortgage over an aircraft (whether registered in the UK or elsewhere) to be recognised by an English court, either:

- the mortgage must be effective under the domestic laws of the jurisdiction where the aircraft is located at the time of its creation, in other words, that jurisdiction must recognise the validity of the English law created mortgage over a chattel such as an aircraft; or
- the aircraft must be in England at the time that the mortgage is executed.

If the second option above is being followed, as a point of evidence, the financier should obtain proof of the location of the aircraft at the exact time and date the mortgage is entered into by the parties, for example by way of certified copies of the aircraft's log book entries (showing the aircraft's entry into and out of a UK airport). If the first option is followed, then the financier should obtain a *lex situs* opinion from the jurisdiction where the aircraft is located at the time of entry into the mortgage, confirming that that jurisdiction recognises English chattel law mortgages.

The Blue Sky case also applies in certain other jurisdictions, such as the Cayman Islands, the Isle of Man and various US states. However, it should be noted that many jurisdictions (France, Switzerland and Norway, to name a few) do not recognise the validity of an English law mortgage over chattels.

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 a Certificate of Registration of the aircraft mortgage as well as a Certificate of Registration of the aircraft itself. The UK, for example, is a jurisdiction where the mortgage register is separate from the aircraft register. Fees may be payable in connection with the registration of a mortgage on the register. In the UK, the fee is a nominal amount and will be between £174 – £1038 (depending on the aircraft's maximum take off weight)¹.

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 individual guarantor will usually be the ultimate beneficial owner of this SPV. 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 with its only asset being the aircraft and also (given the issues referred to in the introduction to this guide) to ensure maximum co-operation from the beneficial owner of the aircraft should the financier need to realise its security over the aircraft.

Share Charge: It is 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, but a secondary purpose is to enable the financier to realise its security by a sale of the shares in the borrower as opposed to the aircraft itself (this

might be more attractive to a potential purchaser for, say, tax reasons). Legal advice should be obtained from lawyers in the jurisdiction of incorporation of the borrower (whose law will normally govern the share charge if the shares 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, it may also be advisable to enter into a tri-party agreement especially in transactions where the aircraft is based in a foreign jurisdiction. A tri-party agreement may not itself necessarily 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 co-operate with the lender and will fly the aircraft to a lender-friendly jurisdiction of the financier's choice to enable the financier to enforce its security. It can also include covenants on the part of the operator to keep the aircraft insured and airworthy and regularly to provide information to the financier concerning the aircraft. The tri-party agreement is particularly important where the aircraft is registered and/or operates in a lender-unfriendly jurisdiction where it might be difficult for the financier to realise its security in a quick and efficient manner.

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 jurisdiction may be effected. In certain countries the consent of the borrower as well as the mortgagee financier may be necessary for this deregistration to be effected and accordingly the financier should seek an irrevocable power of attorney from the borrower so that it can deregister the aircraft without the need for the co-operation of the borrower when it wishes to enforce. 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.

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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 aircraft. 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, meaning that an aviation authority could not be successfully sued if it failed 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 on the insurance market will be influenced by current trading conditions and this can change over time.

It is desirable for a financier to be an additional named insured as well as taking an assignment of the hull and all risks insurances. Joint insurance and being nominated as sole loss payee 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;
- 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 where the financier is merely noted on the policy; and
- the proceeds of the insurance will be paid to the financier.

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: 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.

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 (for example, 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 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. Generally, 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 to finance future maintenance works to be undertaken on the aircraft. This is particularly the case with larger aircraft or super mid-size business jets. 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 (which will usually be an SPV) 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 to be paid off before its own loan.

Assuming that 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 i.e. equity or debt. Also, if the borrower is an SPV and not chartering the aircraft, who is funding the running costs? 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 to the financier's loan unless, perhaps, the only companies involved are the borrower and a guarantor to the financier.

Legal Opinions: The financier's lawyers will advise on what legal opinions should be obtained in any given aircraft financing. Broadly speaking, legal opinions will be sought from the financier's lawyers in the borrower's jurisdiction, the jurisdiction of any guarantor (including a guarantor who is an individual) 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. Also, a financier may wish to obtain a legal opinion in respect of the operator especially if it is entering into a tri-party agreement with the financier

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 well as, for example, enforceability of a judgment or arbitral award against the assets of a guarantor. The legal opinions should be delivered as conditions precedent to the loan facility and should not be disclosed to the borrower.

The financier should also consider requiring the borrower to provide a legal opinion as to the tax treatment of the purchase and / or the ongoing operation of the aircraft, in particular in respect of VAT. Please see the section "Value Added Tax (VAT)" below for more detail on this subject.

Completion of the transaction

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 application is made to register the aircraft 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. There can be up to 90 different items on this list and certain original documentation – such as the mortgage document – may need to be located in specific places at completion, for example so that they are ready to be filed immediately at a jurisdiction's aircraft registry by the financier's local counsel.

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).

Frequently the financier is faced with a 'chicken and egg' situation in that the aircraft will not be able to be registered with the relevant aviation authority in the new owner's name without the bill of sale, however the seller will not want to release the bill of sale (which proves title to the aircraft) unless and until it receives the funds, and finally a financier will not want to release funds until its mortgage is in place over the aircraft. Frequently an escrow agent would be appointed in this situation, so as to give each party comfort that the sequence of events will occur almost simultaneously and that each of their respective interests are protected as far as possible. A financier will always need to be comfortable with the financial standing and insurance coverage of any escrow agent, and an escrow agreement will need to be entered into between each party participating on the completion of the transaction.

Miscellaneous

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

Insurances

Adequate insurance for the aircraft itself (hull all risks insurance) and also third party liability insurance is very important. The insurance may be in the name of the operator rather than the owner.

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).

The borrower/operator may also take out (and the financier may also require) country risk insurance (i.e. insurance against a change of government in the relevant jurisdiction resulting in the aircraft being e.g. confiscated or requisitioned).

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Broadly speaking, a financier will wish to ensure that:

- the level of cover is satisfactory;
- the insurances are on an "agreed value" basis (that is, 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 prevent the insurance policy from being avoided due to the borrower/operator failing to disclose any information; and
- 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 various standard endorsements (the latest being AVN67C), although industry standard continues to be 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.

Leasing and Chartering

It is a commercial decision of the financier as to whether or not leasing and / or chartering of the aircraft may be permitted during the term of the loan. This may provide an important revenue stream for the borrower, and financiers are often amenable to such an arrangement as long as any leases or charters are entered into only with the financier's prior written consent and approval and are operated within certain parameters (for example as to the maximum number of hours per month / year which the aircraft may be operated under the lease).

It will also be a condition of the financier's consent to any lease or charter arrangement that the borrower assigns the lease / charter agreement in favour of the financier and that the lessee is aware of and obliged to comply with the same undertakings in respect of the aircraft as contained on the loan agreement, for example in respect of maintenance and insurance. Any lease or charter agreement should contain express provisions confirming that the rights of the borrower and lessee in respect of the aircraft shall at all times be subject and subordinate to the financier's rights and security interest in the aircraft and that the lessee shall give the financier such assistance as it reasonable requests in connection with the exercise of these rights.

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 unless it qualifies for relief under Article 148 of Directive 2006/112/EC. Article 148 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.

Prior to 1 January 2011, the UK's implementation of Article 148 (including the Isle of Man) was more generous: zero rating applied to the importation or supply of an aircraft of a weight of not less than 8,000 Kg. (The weight was 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 was frequently advantageous for an aircraft qualifying under the UK legislation to be imported into the UK or Isle of Man where it could benefit from zero rating and then be in free circulation throughout the EU.

On 1 January 2011, the UK legislation was amended so as to implement Article 148 literally. Where a privately owned aircraft is managed by a company holding an Air Operator Certificate ("**AOC Company**") HM Revenue & Customs do not accept that the aircraft qualifies for relief. However, IOM Customs will usually accept that an aircraft can qualify where a structure is adopted in which the AOC Company charges, instead, for chartering the aircraft.

This is an important issue for the financier as VAT would affect the cash flow of the borrower and, if unpaid, result in the detention of the aircraft or possibly a prior ranking lien over the aircraft.

The Cape Town Convention

A number of International Conventions regulate the registration and operation of aircraft. This is a logical consequence of the fact that aircraft have an extensive multi-jurisdictional range of activity and are not physically restricted in terms of territorial boundaries. The Cape Town Convention is of particular relevance to financiers.

The enactment of the Cape Town Convention was a recognition of the confusion that conflict of law rules cause and a response to concerns of how long it takes parties to enforce. 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 (a "contracting state" is a country which has ratified and brought the Convention into force into its own domestic law). The simple effect of the Convention is that an internationally registered interest will always trump any unregistered or subsequently registered interest.

As well as simple priority rules, the Cape Town Convention provides 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.

Pursuant to Article 3 of the Cape Town Convention, a debtor must be situated in a contracting state or the aircraft must be registered in a contracting state, in order for the Convention to be applicable. Consequently if a financier is dealing with an aircraft which is registered in a contracting state (for example the US, Ireland or Luxembourg, but not yet the UK) 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 to ensure that the correct authorisations are in place so that the financier's security interests in the airframe and engines can be registered on the International Registry at completion. For more detail on the Cape Town Convention please consult Field Fisher Waterhouse LLP's separate guide on this topic.

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 because as mentioned above, 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:

- 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
- 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, for example providing the pilots, overseeing the maintenance and checks on the aircraft and providing the hanger for the aircraft whilst it is on the ground. Therefore, on any aircraft financing transaction a financier will have to perform due diligence upon the proposed operator of the aircraft.

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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:

- 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
- 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 (this is not likely to apply to private jets but is 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 infringements 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 should 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.

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 guide on this.

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