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July 2012

Global Transportation Finance Newsletter

Dear Friends:

The Global Transportation Finance team at Vedder Price is pleased to present its latest Newsletter, which features articles from attorneys based in each of our four offices.

Our lead article discusses a common industry issue: what happens when a leased part is installed on another financier's aircraft. This summary of the RPK Case, provided by our Chicago attorneys Adam Beringer and Chris Shalvoy, examines the protections that should be taken by a parts lessor to ensure return of its equipment. Another significant ruling for aircraft lessors recently occurred in the English courts. Our London colleagues, Gavin Hill and John Pearson, provide a helpful analysis of the Olympic Case, which highlights that properly drafted "as-is, where-is" and "hell or high water" clauses provide protections for lessors. An article contributed by John Bradley and Frank Nolan, our maritime team in New York, summarizes the essential issues in third-party ship management contracts. Given the numerous passive investors interested in maritime opportunities, this article is a helpful primer on potential management contract pitfalls. Finally, Ed Gross of our DC office updates us regarding the on-going discussions between the FAA and various aviation industry representatives with respect to the use of non-citizen trusts.

Feel free to contact us if you have any questions or comments regarding any of the items contained in this Newsletter.

Dean N. Gerber
Chair, Global Transportation Finance

Lessors of Major Aircraft Parts Take Heed, Your Parts May Be At Risk

Wells Fargo Bank Northwest, N.A. v. RPK Capital XVI, L.L.C. et al.[1] (the RPK Case) is a recent case that presents a cautionary tale to leasing companies in the market of leasing major aircraft parts to operators. Because aircraft are moveable assets that are regularly traded in the secondary market, lessors of major aircraft parts always have faced the risk that an unscrupulous lessee could transfer possession of, and possibly title to, the leased parts to a buyer of the aircraft on which the leased parts are installed. The Uniform Commercial Code (the UCC) generally provides that a lessee of goods may not transfer an interest beyond the leasehold interest it holds in those goods. However, an exception to this general rule exists, whereby a buyer in the ordinary course of business[2] (a Buyer in the Ordinary Course)

[1] *Wells Fargo Bank Northwest, N.A. v. RPK Capital XVI, L.L.C. and RPK Capital Management, L.L.C.*, 360 S.W.3d 691 (Tex. App. Dallas 2012).

[2] A "buyer in the ordinary course of business" is a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person in the business of selling goods of that kind. A person buys goods in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices. A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale. Only a buyer that takes possession of the goods or has a right to recover the goods

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may acquire title to those goods.[3] This so-called "Buyer in Ordinary Course Exception" also applies to leased goods that have become accessions to other goods, in that a Buyer in the Ordinary Course may acquire title to leased goods that have become accessions when it acquires title to the whole goods to which the accessions were installed or affixed.[4]

Facts of the Case

The RPK Case involved a lease of an aircraft engine, thrust reverser and other related equipment by RPK Capital XVI, L.L.C. (RPK) to ATA Airlines, Inc. (ATA). ATA installed the leased thrust reverser onto an aircraft it leased from FINOVA Capital Corporation (FINOVA). During the term of the lease, ATA filed for bankruptcy. As part of the bankruptcy proceedings, ATA assumed the RPK equipment lease and rejected the FINOVA aircraft lease, returning the aircraft to FINOVA with the leased thrust reverser still installed. FINOVA then sold the aircraft to Talos Aviation Limited (Talos), which conveyed title to Wells Fargo Bank Northwest, N.A. (WFB) as owner trustee in order to hold the aircraft in trust. RPK and RPK Capital Management, L.L.C. (collectively, the RPK Parties) sued WFB for conversion of the thrust reverser. The trial court awarded the RPK Parties possession of the thrust reverser, and WFB appealed the decision.

Court's Analysis of the Buyer in Ordinary Course Exception

In applying the Buyer in Ordinary Course Exception, the appellate court posited that a lessor's interest in a good it leases can be subordinated to a third party's interest in such good if the following factors are satisfied:

(i) the leased good becomes an "accession" to other goods;

(ii) the subsequent buyer acquires the entire set of goods in good faith, without knowledge that the lessee is not the true titleholder to the individual good that has become an "accession";

(iii) the transaction occurs in the ordinary course of business of such buyer; and

(iv) the purchase is from a seller whose business is selling goods of the kind that has been purchased.

The appellate court rested its decision on the fourth factor finding that, as part of a prior bankruptcy filing, FINOVA's business plan was limited to an orderly liquidation of its portfolio of aircraft over time in an effort to wind down its operations and dissolve its entities. The appellate court determined that FINOVA was selling the aircraft to pay creditors as part of such liquidation, and that FINOVA was not engaged in the business of leasing aircraft or selling aircraft to third parties in connection with a leasing and financing business. Accordingly, the court (i) ruled that the Buyer in Ordinary Course Exception did not apply, (ii) recognized RPK's title to the thrust reverser and (iii) ordered WFB to return the thrust reverser to RPK.

Conclusion

Because the appellate court in the RPK Case did not address the threshold question of whether the thrust reverser was an accession to the aircraft, it remains uncertain whether major aircraft parts, such as thrust reversers, landing gear or auxiliary power units would constitute accessions.[5] Lessors of major aircraft parts

from the seller under Article 2 of the UCC may be a buyer in ordinary course of business. *See* UCC Section 1-201(9).

[3] *See* UCC Section 2A-305.

[4] A good becomes an "accession" when it is installed in or affixed to other goods, thereby resulting in the "accession" becoming part of the whole. The interests of a lessor or lessee under a lease contract entered into before the goods became accessions is superior to all interests in the whole, subject to the Buyer in Ordinary Course Exception (and a similar exception for creditors). The interests of a lessor or lessee under a lease contract entered into at the time or after the goods became accessions is superior to all subsequently acquired interests in the whole, subject to the Buyer in Ordinary Course Exception (and a similar exception for creditors), but is subordinate to interests in the whole existing at the time the lease contract was made unless the holders of such interests in the whole have in writing consented to the lease or disclaimed an interest in the goods as part of the whole. *See* UCC Section 2A-310.

[5] In your typical operating lease for an aircraft, the lessee is oftentimes permitted to return the aircraft at lease-end with replacement parts in lieu of parts installed on the aircraft at delivery (including major parts such as engines, thrust reversers, landing gear and auxiliary power units), subject to such replacement parts satisfying conditions specified in the lease. If a lessee does redeliver an aircraft with a replacement engine, the lessor and the lessee typically document the transfer of title to the engines by exchanging bills of sale for both the original engine and the replacement engine, which lends support to the conclusion that an engine is not an accession to the aircraft. However, the practice of separately documenting a title transfer in connection with a part replacement is less common for thrust reversers, landing gear and auxiliary power units. In these circumstances, the parties oftentimes rely on the general lease provisions that provide that title to such a replacement part automatically transfers to the lessor, and title to the replaced part transfers to the lessee, upon installation of the replacement part on the aircraft. Furthermore, as part of a buyer's due diligence in connection with the purchase and sale of a used aircraft, it is common for the buyer to request a copy of a bill of sale for each engine evidencing transfer of title of each engine to the seller (and oftentimes back-to-birth bills of sale evidencing the chain-of-title to each engine back to the manufacturer), again supporting the position that an engine is not an accession to the aircraft. This same practice does not exist for less substantial aircraft parts, such as thrust reversers, landing gear and auxiliary power units, primarily because title transfers of major aircraft parts less substantial than an engine are not documented separate and apart from a general reference to "parts" on a bill of sale for a whole aircraft. While these market practices with respect to the documentation of title transfers for

should nonetheless take heed of the court's analysis as there are certainly market factors that support the conclusion that aircraft parts less substantial than engines would constitute accessions. To the extent such parts do constitute accessions, lessors of major aircraft parts are subject to the risk that a Buyer in the Ordinary Course may acquire title to such parts free and clear of any interest of the lessor.

In light of the RPK Case and the attendant risks presented by the Buyer in Ordinary Course Exception, lessors of major aircraft parts should ensure that their lease agreements contain provisions that impose obligations on lessees designed to reduce the risk that a Buyer in the Ordinary Course may acquire title to such parts. Potential lease provisions include those imposing affirmative obligations on a lessee of a major aircraft part to take the following actions:

(i) **Install Data Plates:** require the lessee to physically mark the leased parts by installing a data plate identifying the parts as being owned by the lessor;

(ii) **Placards:** require the lessee to place a placard in a prominent place in the cockpit or cabin of the aircraft on which such parts are installed identifying the lessor as the owner of the leased part;

(iii) **Lessee Reporting Obligations:** require the lessee to notify the lessor, and require the lessor's consent, of any proposed installation of a part on a different aircraft; and

(iv) **Acknowledgment from Aircraft Owner/ Financier:** to the extent a leased part is installed on an aircraft that the lessee leases from a third party or is subject to third party financing, require the lessee to obtain a written acknowledgment from an aircraft owner or financier consenting the installation of the leased part on the aircraft and disclaiming any interest in the leased part.

While it is impossible to eliminate the risk that an unscrupulous lessee may transfer title to an aircraft on which a leased part is installed, lessors of major aircraft parts can certainly reduce the risk of losing title to their leased parts in connection with any such transfer through proactive asset management coupled with lease agreements containing some or all of the provisions described above.

major aircraft parts are not determinative, they certainly suggest that aircraft parts less substantial than an engine may constitute accessions in that the market does not view it as necessary to separately document title transfer for such parts (apart from an aircraft as a whole).

If you have any questions about this article, please contact **Adam Beringer** at +1 (312) 609 7625 or **Christopher Shalvoy** at +1 (312) 609 7635, in Vedder Price's Chicago office. ■

ACG v. Olympic - Affirmation of "As-Is, Where-Is" and "Hell or High Water" Clauses

A standard commercial operating lease setting forth a process for delivery of a used aircraft has two essential components. First, the lessee is responsible for inspecting the aircraft (which is delivered on an "as-is, where-is" basis) and, upon completion of its inspection, issues an acceptance certificate confirming that the lessee has completed its inspection and accepted the condition of the aircraft. Second, the lease is a net lease with a "hell or high water" clause, which provides that, once the lessee has accepted delivery of the aircraft, the lessee must pay rent on an absolute and unconditional basis. In *ACG Acquisition XX LLC* (ACG) *v. Olympic Airlines S.A.* (Olympic), a closely watched case in England, the courts have affirmed that this delivery process, if conducted properly, functions as intended, protecting the lessor from liability and obligating the lessee to pay rent.

Background

In August 2008, Olympic took delivery of a Boeing B737-300 Aircraft (the Aircraft) from ACG, under a 5-year operating lease between the parties.

Prior to delivery to Olympic, the Aircraft had been on lease to AirAsia and was redelivered immediately prior to delivery to Olympic. In court, it was shown that the redelivery from AirAsia was accepted by ACG only because Olympic agreed to accept the Aircraft on lease following such redelivery.

The Hellenic Civil Aviation Authority (the CAA) issued a Certificate of Airworthiness upon delivery to Olympic, but shortly afterwards a defective cable was discovered, and the Aircraft was withdrawn from commercial service. Investigations by Olympic then revealed further defects and, in September 2008, the Aircraft's Certificate of Airworthiness was suspended.

The Aircraft subsequently was sent for repair and maintenance to an MRO, but upon its return to Athens eight months later the CAA refused to reinstate its Certificate of Airworthiness, determining that Olympic's compliance with airworthiness directives was unsatisfactory.

Olympic failed to pay any rent or maintenance reserves following delivery. In September 2009, ACG sued Olympic in the High Court of England and Wales for unpaid rent and maintenance reserves and Olympic counter-claimed for its alleged damages. Olympic ceased to trade in October 2009. ACG terminated the lease in March 2010 and required the return of the Aircraft, which finally was returned in November 2010 pursuant to a court order issued in August.

The Claims

ACG's principal claims were for (a) possession of the Aircraft, (b) payment of rent and maintenance reserves up to the date of return and (c) damages relating to the period from the return date until the scheduled lease termination date.

Olympic claimed that the Aircraft was not airworthy when delivered, that this breached the terms of the lease agreement and that the airline therefore was not obliged to pay rent or maintenance reserves. The airline further claimed that, even if this was not the case, there had been a total failure of consideration or that performance under the lease agreement was frustrated by the suspension of the Certificate of Airworthiness. As a consequence, the airline claimed it was entitled to recover its costs for repairing the Aircraft and obtaining a replacement aircraft as damages.

ACG claimed that (a) the Aircraft met the terms of the lease agreement and was airworthy, (b) even if the Aircraft was not airworthy, estoppel prevented Olympic from asserting that the Aircraft was not delivered in accordance with the lease agreement because it had signed the acceptance certificate or was otherwise estopped by law and (c) the failure to pay rent and maintenance reserves amounted to a repudiatory breach of the lease agreement by Olympic.

Key Provisions in the Lease

The lease agreement required that the Aircraft be delivered by ACG in "as-is, where-is" condition and that the Aircraft be in the required delivery condition (which included a requirement that the Aircraft be "*airworthy and in a condition for safe operation*").

Under the acceptance certificate signed by Olympic at delivery, the airline represented (a) that it "*irrevocably and unconditionally accepts and leases from Lessor*" the Aircraft and (b) that the Aircraft "*complied in all respects with the condition required at delivery...*"

The lease agreement itself provided that Olympic's execution of the acceptance certificate was conclusive proof that it had "*irrevocably accepted the Aircraft for lease*" but did not also state that its execution was conclusive proof that the Aircraft was in the required delivery condition. The court determined that the terms of the lease agreement itself did not preclude a claim by the airline for ACG's purported failure to deliver the Aircraft in the required delivery condition; and as a result considered whether the Aircraft actually met this condition.

Airworthiness - a "New" Objective Test

The court considered whether the Aircraft was, in fact, airworthy for the purposes of the required delivery condition. The court could not identify any previous authority for the meaning of the term "airworthiness" and looked to the world of shipping for assistance, adopting the following objective definition:

> *"would a prudent operator of an aircraft have required that the defect should be made good before permitting the aircraft to fly, had he known of it. If he would, the aircraft was not airworthy."*

Whether an aircraft is airworthy does not rely on the knowledge of a particular defect by either party. On the basis of the definition, the court found that the Aircraft was not airworthy. As the court's ultimate decision in the case did not rest on its finding on this matter, the definition is *obiter dictum*, and other courts need not be bound by this definition.

Estoppel

The court then turned to Olympic's specific representation in the acceptance certificate and agreed with ACG that Olympic was prevented from alleging that the Aircraft did not comply with the required delivery condition under the lease because of Olympic's representation in the acceptance certificate (a) that it "*irrevocably and unconditionally accepts and leases from Lessor*" the Aircraft and (b) that the Aircraft "*complied in all respects with the condition required at delivery...*" Olympic asserted that ACG had not believed the representation, but the court found that it was improbable that ACG, as a major lessor, leasing to a national airline, would deliver an aircraft that it believed was defective and did not meet the required delivery condition. ACG believed Olympic's representation and relied upon it to its detriment, by agreeing to the redelivery from AirAsia. The court consequently denied Olympic's claim as a result of the action of estoppel by representation.

In the circumstances, two of Olympic's advisors had recommended a detailed inspection of the Aircraft and a series of pre-delivery inspections had provided Olympic with the opportunity to determine the condition of the

Aircraft, with rectification work undertaken by AirAsia in relation to defects discovered during those inspections. The fact that there might have been hidden defects that could not have been detected by Olympic must have been appreciated by Olympic before signing the lease and agreeing to provide an acceptance certificate.

The court distinguished a case relating to the acceptance by a consumer of a car under a hire purchase contract (*Lowe v Lombank [1960] 1 WLR 196*), which was not fit for use as a means of transport on the grounds that (a) the representation as to condition differed ("good order and condition" versus "airworthy"), (b) the nature of the parties differed and (c) there was no reliance by the hire purchase company on the representation of the hire purchaser.

The scope of the court's analysis leaves open the possibility that an unsophisticated lessee may have scope to argue that it did not intend any statement as to condition to be relied upon, but the strength of this argument is, at the very best, questionable.

The court went on to reject a claim by Olympic that ACG's failure to deliver an airworthy aircraft had been a breach of a "fundamental" obligation under the lease. The court clearly took into consideration that the agreed terms had been the subject of a free negotiation of the lease agreement between a leading participant in the aircraft leasing industry and a major airline.

Olympic's Further Claims

As the court decided that delivery of the Aircraft had taken place (and that Olympic was estopped from claiming it had not):

- Olympic was obliged to pay rent and maintenance reserves from the date of delivery;
- there was no total failure of consideration, as the Aircraft had been properly delivered by ACG in August 2008; and
- the contract had not been frustrated by the withdrawal of the Certificate of Airworthiness.

The court further noted that the withdrawal of a Certificate of Airworthiness is an inherent risk in the leasing of aircraft, which, pursuant to the "hell or high water" clauses of the lease, was a risk borne by Olympic. The clause specifically identified "*any prohibition or interruption of...Lessee's use, operation or possession of the aircraft" and "any lack...of airworthiness*" as matters which would not affect the Lessee's obligation to pay rent and maintenance reserves.

Conclusions

Financiers and operating lessors should ensure that the delivery condition of an aircraft (including the requirement for airworthiness) is an objective condition precedent in favour of the lessee. In this way, no positive obligation need be imposed on the lessor to ensure the delivery of an aircraft in any particular condition.

Lessees must take care to inspect the Aircraft at delivery and be absolutely satisfied that the Aircraft is in a condition acceptable to them. Lessees must be aware that any residual risk of an undetected defect rests with them.

The inclusion of clear wording in a lease acceptance certificate, which states that execution constitutes "conclusive proof that the aircraft is delivered in the delivery condition" (rather than merely irrevocable acceptance for lease), will make it difficult for an airline to bring a claim for failure to satisfy delivery condition.

A thorough "hell or high water" clause that identifies the risks inherent in leasing an aircraft that are to be borne by the Lessee will help prevent a claim for frustration of contract. Lessors should ensure that their clauses identify all the elements of operational risk that are to be borne by the lessee, so that it can be plainly shown that the parties intended that such risk was to be borne by the lessee.

If you have any questions about this article, please contact **Gavin Hill** at +44 (0)20 3440 4690 or **John Pearson** at +44 (0)20 3440 4693, in Vedder Price's London office. ■

Third-Party Ship Management: A Nutshell Guide for Investors

Third-party ship management has witnessed significant growth since the 1980s. Today, with approximately one-third of the world's oceangoing fleet under third-party management of some kind,[1] ship managers appear in many marine transactions for a multitude of reasons. For example:

- Financial investors often appoint managers to provide comprehensive services to their acquired shipping assets which they are unable to otherwise provide in-house.
- Fully integrated ship owners may place some of their vessels under independent management as a means of benchmarking costs.[2]

[1] *See* https://www.bimco.org/en/Education/Seascapes/Sea_View/The_modern_ship_manager.aspx (last accessed June 20, 2012).

[2] Id.

- Publicly listed ship owners may outsource ship management to address investor concerns and to achieve better overall risk management, among other goals.[3]
- Marine lenders often appoint managers to assume operational and technical control of a vessel that has been retaken following mortgage foreclosure and judicial sale.

Third-party ship management services available in today's marketplace are varied, but the three most common forms are technical, crew and commercial management. Technical management typically involves the delivery of services relating to the maintenance, repair and running of the vessel, including compliance with flag state requirements and international operating standards. Crew management covers the selection, training, administration and transportation of the crew. Commercial management largely involves seeking and negotiating employment for the vessel.

Until recently, contracts for ship management services varied greatly in form. In 1988, as a consequence of the growth of the ship management industry, the Documentary Committee of The Baltic and International Maritime Council (BIMCO)[4] began publishing a series of standardized ship management forms known as SHIPMAN, with the most recent iteration being SHIPMAN 2009.[5] The current form–which has replaced all prior forms[6]–is widely used as the starting point for individual negotiations between the manager and owners.

The engagement of third-party ship managers on the SHIPMAN 2009 form raises a number of important considerations and choices for shipping investors. Among them:

1. **Maritime Liens** - Under U.S. law, ship managers have statutory authority to order "necessaries" for a ship.[7] The provision of necessaries by a supplier or vendor gives rise to a maritime lien against the ship by operation of U.S. law and, unless discharged, such lien is enforceable against the ship in the U.S. through judicial proceedings *in rem*.[8] Accordingly, it is important that investor owners be mindful of charges incurred by their manager that may give rise to maritime liens in the U.S. and elsewhere. In addition, subject to their obligation to fund the manager in accordance with the terms of the agreement, owners should seek to restrict the manager from creating, incurring or permitting maritime liens against the ship other than ones commonly allowed, such as liens for crew wages and salvage. A related question is whether the manager possesses a maritime lien enforceable *in rem* against the ship for management fees billed to the owners and advances incurred on behalf of the ship. While most U.S. courts that have considered the issue have ruled that a manager does not have a maritime lien,[9] such rulings do not bind non-U.S. courts and tribunals. Accordingly, a negotiated waiver of maritime lien claims (and covenant not to sue the vessel) by the manager would be a prudent and beneficial addition to SHIPMAN 2009 from the standpoint of the investor owners.

2. **Term and Termination** - SHIPMAN 2009 provides for a minimum contractual term during which time the agreement is non-cancellable by either party except for events of default and extraordinary events (such as the loss or requisition of the ship).[10] Following the minimum term, the agreement will continue on an evergreen basis until terminated by either party for any reason or no reason upon the giving of notice.[11] However, considering that a ship management contract is a personal services contract, there is nothing in SHIPMAN 2009 which effectively allows the owner to cancel the agreement during the initial term if the ship is consistently underperforming relative to the market or under some ascertainable financial formula. Such "early out" provisions—commonly seen in container management agreements—should be given consideration in circumstances where commercial management services are provided, particularly in connection with longer term engagements.

3. **Dispute Resolution: Choice of Law and Forum Selection** - For dispute resolution purposes, SHIPMAN 2009 allows the parties to choose English law and LMAA arbitration in London <u>or</u> U.S. maritime law and SMA arbitration in New York <u>or</u> any other governing law and arbitration mechanism.[12] If no selection is made, English law and LMAA arbitration will apply by default.[13] While

[3] R, Giorgi, *Challenges in Ship Management*, Presentation at Capital Link Forum, 2d Annual Invest in International Shipping Conference (Mar. 20, 2008), *reprinted at* http://www.capitallinkforum/shipping/2008/files/vships032008.pdf.

[4] Headquartered in Denmark, BIMCO is the largest of the international organizations representing ship owners controlling approximately 65% of the world's tonnage and with members in over 120 countries. Members are stakeholders in the shipping industry having a variety of interests, including ship brokerage, management, accounting and law. BIMCO is also an accredited NGO.

[5] A copy of SHIPMAN 2009 can be accessed on the BIMCO website: https://www.bimco.org/Chartering/Documents/Ship_Management/SHIPMAN2009.aspx (last accessed June 20, 2012).

[6] The immediate predecessor to SHIPMAN 2009 was the SHIPMAN 98 form.

[7] 46 U.S.C. § 31341(a)(3).

[8] 46 U.S.C. § 31342.

[9] *See e.g., Community Bank of LaFourche v. M/V MARY ANN VIZIER*, 2012 U.S. Dist. LEXIS 66842 (E.D. La. May 14, 2012).

[10] SHIPMAN 2009, Part I, Box 18, Part II, Clause 21(a).

[11] *Id.*

[12] SHIPMAN 2009, Part I, Box, 21, and Part II, Section 5, Clause 23.

[13] SHIPMAN 2009, Part II, Section 5, Clause 23(e).

English law and London arbitration and U.S. law and New York arbitration may be acceptable alternatives in the abstract, owners should be aware of possible jurisdictional nuances in the interpretation of certain clauses[14] which might make the substantive law of one jurisdiction more or less favorable to one of the parties. In addition, rights to discovery, protection of confidentiality, rules regarding assessment of attorneys' fees against the losing party, etc., also will be influenced by the parties' choice of law and forum selection, and must be considered as well.

Another key consideration is one of jurisdictional alignment. The choice of law and dispute resolution provisions contained in the ship management agreement should be aligned as much as possible with similar provisions contained in related contracts such as charter parties and related investment agreements or joint venture agreements having management features. For example, if the corresponding investment agreements, joint venture agreements or charters for the managed fleet will be subject to U.S. law and New York arbitration, it makes little sense to choose English law and London arbitration for SHIPMAN 2009, inasmuch as consolidation of arbitral proceedings becomes all but impossible in such circumstances and the potential for inconsistent results increases.

4. **Conflicts of Interest** - Under SHIPMAN 2009, the manager undertakes to use its "best endeavors" to provide services in accordance with "sound ship management practice."[15] Such duty of care is one that is "generally understood in the shipping industry"[16] and one that New York maritime arbitrators are well equipped to interpret and apply. However, since large ship managers often manage the fleets of more than one owner, SHIPMAN 2009 specifically allows the manager to "allocate available supplies, manpower and services in such manner and in the prevailing circumstances" as the manager deems to be "fair and reasonable."[17] The potential conflict between a manager's obligations to one owner and its obligations and allegiance to others is often not apparent. While the manager needs flexibility in this regard, the investor owner needs some comfort that its ships will be managed evenly relative to other fleets that are in the manager's portfolio, particularly fleets belonging to the manager's affiliated companies. A form of "most favored nation" provision should be considered as a practical means of addressing potential conflicts.

5. **Liability and Indemnification of Manager** - The degree of risk and responsibility to be assumed by the manager in connection with the services to be provided is a frequent point of contention. The stated philosophy of the draftsmen of the SHIPMAN standardized forms was to apportion "liability between owners and managers on the basis that the owners should not be in a better position than they would have been in if they managed the vessel for themselves."[18] Consistent with this philosophy, SHIPMAN 2009 is decidedly pro-manager in its approach to the allocation of risk and liability. Such an approach is not necessarily in the best interests of investor owners who entrust their ships to third-party managers and rely heavily upon their judgment, skill and experience.

SHIPMAN 2009 isolates the manager from all liability to the owners for loss, damage, delays, etc., unless the owner can affirmatively prove that its loss was caused solely by the negligence, gross negligence or willful misconduct of the manager or its employees, agents or subcontractors.[19] This places a substantial evidentiary burden on the owners. In cases where sole negligence can be established by the owners, the manager's liability nevertheless is limited to 10 times the annual management fee.[20] Liability will exceed the limitation only where the loss results from the manager's "personal act or omission" committed recklessly or with the intent to cause same and with the knowledge that such loss would likely result.[21] In addition, the owners have full indemnity obligations to the manager in connection with the latter's performance of the agreement, excluding only matters and amounts for which the manager would be otherwise liable under the agreement.

In its explanatory notes on the SHIPMAN 2009 form, BIMCO stated that these limitation and indemnity provisions have been reviewed by Queen's Counsel "and found to be in compliance with the English Unfair Contract Terms Act 1977."[22] It is unclear whether BIMCO had these same provisions reviewed by U.S. maritime counsel. Possibly not. The current SHIPMAN form has been before U.S. maritime arbitrators on a number of occasions and has been discussed or referred to in at

14 *See* Paragraph 5 *infra*.
15 SHIPMAN 2009, Part II, Section 3, Clause 8(a).
16 *Associated Transport Line, LLC v. Colonial Marine Industries, Inc.*, SMA No. 3870 (Dec. 17, 2004) (N.Y. Arb., J. Berg, D. Martowski and D.J. Szostak, Arbitrators).
17 SHIPMAN 2009, Part II, Section 3, Clause 8(a).
18 *See* https://www.bimco.org/Chartering/Documents/Ship_Management/Withdrawn_Forms/SHIPMAN98/Explanatory_ Notes_SHIPMAN98.aspx (last accessed June 20, 2012).
19 SHIPMAN 2009, Part II, Section 5, Clause 17(b)(i).
20 *Id.*
21 *Id.* The description of conduct barring limitation is taken from Article IV of the Convention on Limitation of Liability for Maritime Claims, 1976.
22 BIMCO, *Comparison between SHIPMAN 2009 and SHIPMAN 98*, reprinted at https://www.bimco.org/Chartering/Documents/Ship_Management/SHIPMAN2009/~/media/Chartering/Document_Samples/Sundry_Other_Forms/Explanatory_Notes_SHIPMAN_2009.ashx (last accessed June 20, 2012).

least four reported decisions.[23] In two of these decisions, the manager's liability for alleged poor performance came into play under U.S. law. In the first of the two decisions, the arbitrators decided whether the owner's negligence claims against its manager were cognizable, taking into account the manager-friendly limitation of liability provisions and the heavy evidentiary burdens placed on the owner in the SHIPMAN 2009 form.[24] At no point in their award did the arbitrators indicate or suggest that these provisions were contrary to U.S. law and policy. However, in the second decision, *Lin Shipping Ltd. v. V.Ships Management Ltd.*, the arbitrators (all of whom were lawyers) reviewed substantially similar limitation of liability provisions and found them to be contrary to U.S. general maritime law.[25]

The arbitrators in *Lin Shipping* specifically determined that any contractual exculpation of the manager based upon its own "gross negligence or willful misconduct" was contrary to "the weight of decisional law" and should be stricken from the contract. The arbitrators also struck the word "solely" from the contract on similar grounds, the result being that the manager would not be relieved from liability to the owners for its own fault. Lastly, the arbitrators avoided the contractual limitation of liability clause which capped the manager's liability at 10 times its annual fee. Among the reasons cited, the arbitrators determined that such a cap was "too low to reasonably provide any deterrent to potential misfeasance or nonfeasance of the managers."[26] As a result of the award, the undoubtedly surprised manager in *Lin Shipping* was left with the potential of unlimited liability to the owner on account of its own negligence.

From the standpoint of the manager, the outcome in *Lin Shipping* was clearly not what it bargained for given the language of the contract. From the standpoint of the owners, the outcome was what it had hoped for during the negotiating process notwithstanding the language of the contract. For investor owners, the lesson of *Lin Shipping* with respect to the negotiation of liability provisions is straight from the songbook of the Rolling Stones:

[23] *See Wallem Shipmanagement, Ltd. v. Linea Naviera de Cabotaje Linaca*, C, SMA No. 3839 (Apr. 23, 2004) (N.Y. Arb., A. Nichols, C. Tsagaris and K. Mordhorst, Arbitrators); *Associated Transport Line, LLC v. Colonial Marine Industries, Inc.*, SMA No. 3870, *supra; American Roll-On Roll-Off Carrier, LLC v. Pacific-Gulf Marine, Inc.*, SMA No. 3891 (N.Y. Arb., M. Arnold, J. Ring and D. Martowski, Arbitrators); *Lin Shipping Ltd. v. V.Ships Management Ltd.*, SMA No. 4147 (Nov. 8, 2011) (N.Y. Arb., J. Lillis, L. Sheinbaum and J. Berg, Arbitrators).

[24] *Associated Transport Line, LLC v. Colonial Marine Industries, Inc.*, SMA No. 3870, *supra*.

[25] *Lin Shipping Ltd. v. V.Ships Management Ltd.*, SMA No. 4147, *supra*.

[26] *Id.*

You can't always get what you want,

But if you try sometimes, well you just might find,

You get what you need!

If you have any questions about this article, please contact **John Bradley**, of Vedder Price's New York office, at +1 (212) 407 6940. ■

Non-Citizen Trusts - What Industry Should Take From Recent FAA Public Meeting

Aviation industry and Federal Aviation Administration (FAA) representatives met recently to discuss their perspectives regarding the purposes and implications of the proposed policy clarification (the PPC),[1] regarding Non-Citizen Trusts (NCT).[2] The meeting, held on June 6, 2012 in Oklahoma City (the Public Meeting) provided the first opportunity for the two sides to meet officially since the publication of the PPC on February 9, 2012. Industry optimists might have been encouraged by some of the exchanges with the FAA, and pessimists might have perceived the FAA's reaction to industry concerns as non-committal (at best) and unconvinced (at worst).

Various industry representatives, including the AWG/ICG, made submissions to the FAA prior to the public meeting expressing concerns regarding the PPC.[3] The AWG/ICG Submission noted the industry's many procedural and substantive concerns regarding the PPC, and the AWG/ICG and other industry attendees reiterated many of these concerns during the Public Meeting.[4]

[1] *Proposed Policy Clarification for the Registration of Aircraft to U.S. Citizen Trustees in Situations Involving Non-U.S. Citizen Trustors*, Docket No. FAA-2011-0012.

[2] The author of this update attended the meeting as part of the steering and drafting committees of the Aviation Working Group (AWG) Industry Consultative Group (the AWG/ICG) organized under the aegis of the AWG to address various aviation industry concerns, including with respect to NCTs.

[3] AWG/ICG's submission to the FAA included a letter with an attached comment summary and proposed Trust Agreement excerpts pertaining to the matters addressed in the PPC (the AWG/ICG Submission), and was authorized by numerous aviation industry participants (e.g., manufacturers, financing providers and lessors, trade associations, law firms, etc.) referenced as "Supporting Entities" in the letter.

[4] The procedural issue with the PPC pertains to the FAA's approach to changing the NCT process. These proposed changes include information gathering and other requirements to be undertaken by owner trustees (OTs) in future NCT trust agreements. Whether the FAA's proposals constitute "policy clarifications" or "policy changes" is an important characterization when considering their procedural validity. By way of explanation, note that the FAA seeks to address its NCT concerns by issuing "policy clarifications," not by rulemaking. The AWG/ICG made clear in the cover letter to the AWG/ICG Submission that it expected the FAA to limit its NCT efforts to "true clarifications, not changes in policy, as measured against the FAA's interpretation and practice over the last 30 years." Any "fundamental changes in policy, or any attempt to impose mandatory obligations via legislative-type

As discussed in our previous articles regarding the FAA's ongoing NCT initiatives,[5] the PPC is worrisome to the aviation industry, especially to financing providers, in both obvious and subtle respects. By proposing to make OTs responsible for a variety of aircraft-related obligations, the FAA has created various risks on a number of issues, including valid registration and tort liability.

The AWG/ICG's Submission and Public Meeting comments included objections to the PPC's imposition of absolute responsibility on non-operating owners for the full or timely delivery of requested information from operators, as well as the FAA's justifications for imposing this responsibility. AWG/ICG representatives explained that imposing this responsibility on passive or otherwise compliant OTs and/or non-operating trustors could drive OTs, financing parties and other investors out of the aircraft finance market. Industry members cautioned that deterring these parties from participating in NCT-structured or other financings could further weaken an already fragile U.S. aircraft industry.[6]

The AWG/ICG and other industry representatives endeavored to narrow the FAA's focus to the most likely cause of an investigation and any enforcement impediments relating to NCT-registered aircraft. These circumstances were highlighted in the PPC and referred to again by the FAA during the Public Meeting. Specifically, the FAA is particularly concerned about an NCT trustor operating an aircraft, when either its operator status is not disclosed to the FAA, or the trustor operator and/or the OT fails or refuses to cooperate with the FAA's investigation-related inquiries and requests. Industry members have acknowledged that changes to the NCT procedures and trust agreement to the extent focused on these circumstances is appropriate and industry representatives remain committed to participate in collaborative efforts to address these circumstances.[7]

By the end of the Public Meeting, the FAA and industry representatives appeared to make some progress on other issues relating to the PPC. The AWG/ICG Submission and Public Meeting comments proposed some procedural and trust agreement changes intended to facilitate the FAA's stated purposes. The FAA, once again, reassured industry representatives that it was not the FAA's intention to invalidate NCT registration. Both the FAA and industry representatives confirmed their respective intention to collaborate on mutually acceptable solutions to the FAA's investigation and enforcement concerns regarding NCT-registered and foreign operated aircraft. Industry representatives reminded the FAA that making NCT registration impractical might have the same result.

On June 13, 2012, the AWG/ICG submitted a request to Kathryn Thomson, the FAA's Chief Counsel, asking that the public comment period with respect to the PPC be extended until September 15, 2012 so that the FAA and industry representatives will have additional time to consider the Public Meeting transcript and the respective positions shared. The AWG/ICG also requested an opportunity to participate in an informal meeting (subject to appropriate protocols) between Chief Counsel Thomson, other FAA representatives and certain industry representatives prior to any final action by the FAA regarding the PPC.

If you have any questions about this article, please contact **Edward Gross**, of Vedder Price's Washington, DC office, at +1 (202) 312 3330. ■

rulemaking", would require a different procedure. The substantive issues raised in the AWG/ICG Submission and in the meeting pertained to the specific requirements PPC imposes on NCT OTs and the proposed changes to the NCT procedures and trust agreement forms. The FAA justifies these proposals by asserting that the use of NCTs is of particular concern because NCT-registered aircraft are frequently based, operated and maintained outside of the U.S. Consequently, per the FAA, this foreign operation impedes the FAA's national and international responsibilities to monitor, enforce and ensure compliance with the airworthiness and operational standards required of FAA-registered aircraft. See, "FAA Publishes Proposed Policy Clarification Regarding Non-Citizen Trusts: Permitted, but Conditioned," *Vedder Price Global Transporation Finance Bulletin* (Feb. 2012) "*Such impediments could result in dereliction of the FAA's responsibilities under the Convention on International Civil Aviation (Convention on International Civil Aviation, Dec. 7, 1944, 61 Stat. 1180, 15 U.N.T.S. 295, imposing obligations on contracting states to oversee matters pertinent to the airworthiness, licensing and operations of the aircraft registered in those states) regarding the airworthiness of 'N' registered aircraft.*"

[5] See, "FAA NCT Update," *Vedder Price Global Transporation Finance Newsletter* (Apr. 2012), and "FAA Publishes Proposed Policy Clarification Regarding Non-Citizen Trusts: Permitted, but Conditioned," *Vedder Price Global Transporation Finance Bulletin* (Feb. 2012).

[6] United States International Trade Commission. *Business Jet Aircraft Industry: Structure and Factors Affecting Competitiveness*, Investigation No. 332-526, USITC Publication 4314. *See* http://www.usitc.gov/publications/332/pub4314.pdf

[7] By way of example, industry representatives agreed that a compliant trustor's replacement of a non-compliant OT could be made easier, and the reputational risk associated with removal would serve as a means by which non-compliant OTs could gradually be eliminated from the NCT market. Similarly, if an operator trustor is the source of the FAA's concerns, the OT could "encourage" the operator trustor's compliance by threatening to resign, especially if resignation is made easier by loosening the related requirements. However, the scope of the FAA's policy clarifications should not subject an OT or non-operator trustor to sanctions or endanger the registered status of the aircraft if the OT or non-operator trustor are taking actions consistent with achieving the FAA's legitimate purposes as soon as may be practicable under the circumstances.

Global Transportation Finance—Team Members

Chicago

Shareholders

Jonathan H. Bogaard .... +1 (312) 609 7651
Dean N. Gerber, *Chair* .... +1 (312) 609 7638
Timothy W. O'Donnell .... +1 (312) 609 7683
Geoffrey R. Kass .... +1 (312) 609 7553
John T. Bycraft .... +1 (312) 609 7580
Theresa Mary Peyton .... +1 (312) 609 7612
Joshua D. Gentner .... +1 (312) 609 7887
Jordan R. Labkon .... +1 (312) 609 7758
James P. Lambe .... +1 (312) 609 7567
Adam R. Beringer .... +1 (312) 609 7625

Counsel

Ronald J. Rapp .... +1 (312) 609 7895
David S. Golden .... +1 (312) 609 7686

Associates

Robert J. Hankes .... +1 (312) 609 7932
Mark J. Ditto .... +1 (312) 609 7643
Michael E. Draz .... +1 (312) 609 7822
Clay C. Thomas .... +1 (312) 609 7668
Antone J. Little .... +1 (312) 609 7759
Christopher J. Shalvoy .... +1 (312) 609 7635

New York

Shareholders

John I. Karesh .... +1 (212) 407 6990
Francis X. Nolan, III .... +1 (212) 407 6950
Denise L. Blau .... +1 (212) 407 7755
John E. Bradley .... +1 (212) 407 6940
Ronald Scheinberg .... +1 (212) 407 7730
Jeffrey T. Veber .... +1 (212) 407 7728
Cameron A. Gee .... +1 (212) 407 6929

Counsel

Amy S. Berns .... +1 (212) 407 6942

Associates

Ji Woon Kim .... +1 (212) 407 6922
Andrew T. Park .... +1 (212) 407 7768
Christopher A. Setteducati .... +1 (212) 407 6924
T. Miles Grandin .... +1 (212) 407 7791
Olga Miller .... +1 (212) 407 6962
Blake Smith .... +1 (212) 407 7649
Sascha Yim .... +1 (212) 407 6989
Robert G. Gucwa .... +1 (212) 407 6953

Washington, DC

Shareholders

Edward K. Gross .... +1 (202) 312 3330
David M. Hernandez .... +1 (202) 312 3340

Associates

Cristina M. Richards .... +1 (202) 312 3365
Kathleen G. Oliver .... +1 (202) 312 3342

London

Partners

Gavin Hill .... +44 (0)20 3440 4690
Derek Watson .... +44 (0)20 3440 4692

Counsel

Claire Mathew .... +44 (0)20 3440 4696

Solicitors

Natalie Chung .... +44 (0)20 3440 4695
John Pearson .... +44 (0)20 3440 4693
James Kilner .... +44 (0)20 3440 4694

VEDDER PRICE®

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
+1 (312) 609 7500 | +1 (312) 609 5005 • FAX

1633 BROADWAY, 47TH FLOOR
NEW YORK, NEW YORK 10019
+1 (212) 407 7700 | +1 (212) 407 7799 • FAX

1401 I STREET NW, SUITE 1100
WASHINGTON, D.C. 20005
+1 (202) 312 3320 | +1 (202) 312 3322 • FAX

200 ALDERSGATE
LONDON EC1A 4HD
+ 44 (0)20 3440 4680 | + 44 (0)20 3440 4681 • FAX

www.vedderprice.com

Global Transportation Finance Team

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