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American Airlines Relieved from Paying Make-Whole Premiums Under Plain Reading of Indentures

The United States Bankruptcy Court for the Southern District of New York (the Bankruptcy Court) recently issued a memorandum decision in the American Airlines, Inc. (the Debtor) bankruptcy cases holding that the Debtor does not have to pay a make-whole premium when repaying certain of its outstanding note and EETC financings, due to the plain language of the underlying financing arrangements.[1] The dispute arose in October 2012 when the Debtor filed a motion (the Refinancing Motion) seeking (a) authority to obtain replacement financing for three separate financings (which debt totaled over $1.3 billion) and (b) a declaratory ruling that the proceeds from the replacement financing could be used to repay the existing debt without the need to pay the make-whole premium required under each of the underlying trust indentures (the Indentures) in connection with a voluntary redemption. In the Refinancing Motion, the Debtor stated that its interest savings by repaying the debt, without make-whole, at then-current interest rates, would amount to over $200 million. The indenture trustee under each Indenture (collectively, the Indenture Trustees), acting on behalf of the lenders under the Indentures, objected to the Refinancing Motion on the grounds that such repayments were voluntary redemptions that required the payment of the make-whole premium.

Facts of the Case

The Indentures provided financing for three groups of aircraft purchased by the Debtor prior to the petition date, and each financing benefited from the protections provided by section 1110 (Section 1110) of the United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq*. (the Bankruptcy Code). Under the Indentures, the parties agreed that make-whole premium would be payable by the Debtor if it repaid the debt early, but that no make-whole premium would be due if the debts were accelerated. Further, the Indentures provided that the debt would be automatically accelerated in the event that the Debtor filed for bankruptcy, and that no make-whole would be payable upon such a bankruptcy acceleration.

The Debtor filed for chapter 11 bankruptcy protection before the Bankruptcy Court on November 29, 2011. In late December 2011 and early January 2012 (well within the first 60 days after the chapter 11 petition date), the Debtor made Section 1110(a) elections for each of the

Indentures. In so doing, the Debtor agreed to cure and timely perform all obligations under these financings in order to retain the protections of the automatic stay under section 362 of the Bankruptcy Code – at least for the period that these financings were subject to such Section 1110(a) election agreements. Then, on October 9, 2012, ten and one-half months after the petition date, the Debtor filed the Refinancing Motion, seeking authority to obtain replacement financing for the accelerated debt without paying the make-whole premium.

Court Adopts Plain Reading of Contractual Entitlement to Make-Whole Premium After Bankruptcy Acceleration

The Bankruptcy Court ruled that the Debtor is not required to pay make-whole premium when repaying the bankruptcy accelerated financings based upon a plain contractual reading of the Indentures. This ruling is not surprising because the documents (a) expressly provide that the financings automatically accelerate upon a bankruptcy filing and (b) also expressly provide that no make-whole premium is due when the debt is so accelerated. Although the Bankruptcy Court noted that make-whole premiums are recognized as valid under law, it held that entitlement to a make-whole premium is dependent upon the terms of the contract at issue. Given the plain language of the Indentures, the Bankruptcy Court determined that no make-whole premium was required to be paid because the debt was automatically accelerated upon the Debtor's chapter 11 filing.

The Bankruptcy Court's decision is currently subject to appeals pending before the United States Court of Appeals for the Second Circuit (the Second Circuit), with oral argument currently scheduled for June 20, 2013.

Troublesome Aspects of Ruling for Aircraft Financiers

Although the Bankruptcy Court's ruling that no make-whole premium is required appears to be grounded in well-established contractual construction principles, the Bankruptcy Court made additional rulings that were both unnecessary and lacking firm foundation, especially in light of the Section 1110(a) election made by the Debtor with respect to the Indentures.

First, the Bankruptcy Court ruled that the Indenture Trustees could not decelerate the debt. In so holding, the Bankruptcy Court reasoned that such a deceleration would take away from the Debtor's contractual rights and, accordingly would be barred by the automatic stay. Such a ruling, however, was not necessary because none of the Indenture Trustees ever actually decelerated the debt. Substantively, the ruling also is suspect because it fails to recognize the existing contractual rights of the Indenture Trustees under the Indentures. Contrary to the Bankruptcy Court's reasoning, a deceleration of the debt does not "change" the contractual rights between the parties – such rights are expressly fixed by the Indentures – but changes only which contractual terms are applicable given the actions of the parties.

Second, because these transactions are subject to the protections provided by Section 1110, the Bankruptcy Court's decision fails to recognize that the Debtor is required to honor *all* contractual obligations (other than defaults triggered by *ipso facto* provisions of the contracts) during the period in which a Section 1110(a) election is in effect. Unless specifically excused by the Bankruptcy Code, a chapter 11 debtor's failure to honor a contractual term would normally create a default under the contract that would allow a Section 1110(a) protected financier to exercise its remedies against its aircraft collateral. In the instant case, if the Indenture Trustees had actually decelerated the debt (and not simply sought relief from the automatic stay to seek to decelerate in the future) and the Debtor did not honor this right, this breach should provide grounds under Section 1110 for the Indenture Trustees to have exercised remedies against their aircraft collateral. In sum, the Bankruptcy Court's rulings that narrow the rights enjoyed by Section 1110 financiers lack basis.

Instead of actually decelerating the debt, the Indenture Trustees requested relief from the automatic stay so as to decelerate the debt and force the Debtor to effect a voluntary redemption of the debt – which would require the payment of the make-whole premium. The Bankruptcy Court denied stay relief, reasoning that deceleration amounts to an action to "exercise control over property of the estate" and "assess claims against the estate."[2] This reasoning, however, also appears suspect because the Bankruptcy Code expressly recognizes the rights of parties to assert claims against a debtor to the full extent of their contractual rights[3] unless prohibited under Section 362 (such as prohibitions upon enforcement of claims and assessing levies to support claims). Similarly, the automatic stay does not invalidate proper claims made under a contract (unless, like claims for unmatured interest, such claims are expressly prohibited under the Bankruptcy Code), but prohibits actions to assess claims against a debtor. Accordingly, absent some additional action, it is hard to see how a deceleration of debt would be a violation of the automatic stay. Deceleration, in fact, seems to be the exact opposite of an effort to assess claims against a debtor.

In reaching its decision, the Bankruptcy Court did not have to rely upon any of these suspect rulings. Rather, the Bankruptcy Court could have supported its contractual rights interpretation ruling with its findings that Indenture Trustees waited too long to enforce their rights (whether under the theories of waiver or laches or the like). By waiting nearly an entire year before petitioning the Bankruptcy Court for permission to decelerate the debt, the Indenture Trustees allowed the Bankruptcy Court to view their actions as a money grab intended to deprive the Debtor's estate of property rights in violation of the automatic stay – instead of actions to protect their contractual rights.

Conclusion

Regardless of the outcome of the appeal of the Bankruptcy Court's decision, there are several lessons that aircraft financiers can and should take away from the Bankruptcy Court's decision to deny the financiers any make-whole premium.

- **Importance of Acting Early to Protect Section 1110 and Contractual Rights**
  Here, the Indenture Trustees failed to act early to assert and protect their Section 1110 and other contractual rights. Each of the Indenture Trustees would have been prudent to seek to enforce or preserve the right to decelerate the Indenture debt as soon as practicable upon the Debtor's making its Section 1110(a) elections on the Indenture transactions, thereby protecting the right to claim the make-whole premium granted under the Indentures. If the Indenture Trustees had asserted these rights at the time of the Section 1110(a) elections, the focus of any dispute would have been whether the Indenture Trustees could enforce contractual rights under their respective Indentures. By waiting to enforce the right to the make-whole premium until after the Debtor filed the Refinancing Motion, the Indenture Trustees allowed the focus of the dispute to become the Indenture Trustees' efforts to deprive the Debtor of a refinancing opportunity. Here, timing no doubt greatly influenced the Bankruptcy Court's decision. Further, the Indenture Trustees could have issued a deceleration notice in a manner that minimized the risk that the Bankruptcy Court would view the issuance as a violation of the automatic stay by (a) raising these issues in response to the Debtor's Section 1110(a) election agreement notices and (b) making the deceleration notices expressly conditioned upon whether the right of deceleration is a contractual right protected under Section 1110 of the Bankruptcy Code.
- **Importance to Actually Move to Decelerate the Debt**
  Further, by failing to actually decelerate the debt, the Indenture Trustees allowed the Bankruptcy Court to avoid the issue of the interplay between Section 1110(a) and the automatic stay regarding the lenders' exercise of statutorily protected contractual rights under Section 1110(a). The Indenture Trustees made a strategic error by never actually decelerating the debt.
- **Importance of Contract Terms**
  Another important lesson in the Bankruptcy Court's make-whole decision is the primary importance of the controlling contractual provisions. The entitlement to make-whole premium is only as good as the express contractual terms granting such make-whole premium. Aircraft financiers and other lenders should carefully consider whether to carve-out make-whole premiums for debt that is automatically accelerated upon a bankruptcy filing. If the commercial arrangement is that the make-whole should be due and owing in connection with a repayment that is made after an automatic bankruptcy acceleration, the parties to the contracts should make sure that this arrangement is clearly set forth in their financing transactions–and expressly state that the make-whole remains due after an automatic bankruptcy acceleration.

* * *

The impact and scope of the Bankruptcy Court's decision upon aircraft financing and the sanctity of the protections provided by of the Bankruptcy Code Section 1110, of course, is highly dependent upon the forthcoming appellate ruling of the Second Circuit. Nevertheless, the Bankruptcy Court's decision highlights the importance for aircraft financiers to carefully review the terms of their financings and ensure that they act promptly to preserve the protections provided under their contracts and Bankruptcy Code Section 1110.

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1 The memorandum decision is set forth in *In re AMR Corp., et al.*, Case No. 11-15463 (SHL) (Bankr. S.D.N.Y. Jan. 17, 2013) (Lane, B.J.) (Docket No. 6265).

2 *See* Decision at 21–22.); *see also In re Solutia, Inc.*, 379 B.R. 473, 485

(Bankr. S.D.N.Y. 2007) (deceleration, which would cause a lender's claims to increase, "is an attempt to 'assess' an increased claim against" the debtor estate that violates automatic stay).

3 *See* Bankruptcy Code § 502(b).

Olympic and Beyond: Airworthiness as a Delivery Condition and the Importance of Acceptance Certificates

In an aircraft sale or lease transaction, the condition of the aircraft at delivery or re-delivery typically is heavily negotiated. In certain circumstances the result of these negotiations is a requirement that the aircraft be delivered in "airworthy" condition. This article will examine *ACG Acquisition XX LLC v. Olympic Airlines S.A.*,[1] a closely followed case in the English courts, as well as some recent cases in the United States courts that demonstrate (i) the uncertainty surrounding use of the term "airworthy", (ii) the consequences of accepting delivery or re-delivery of an aircraft that is supposed to be airworthy or in a specified condition when it is not in the required condition and (iii) the importance of clear contractual provisions that allocate risk as to the condition of an aircraft after delivery.

ACG v. Olympic Airlines

The *Olympic* case involved an operating lease agreement between ACG and Olympic relating to a Boeing 737-300 aircraft and the related acceptance certificate. The lease agreement required ACG to deliver the aircraft to Olympic "as is, where is" and in the condition required in Schedule 2 (except for certain items noted as discrepancies). Schedule 2 required, among other things, that the aircraft be in airworthy condition. ACG delivered the aircraft to Olympic, which signed an acceptance certificate for the aircraft and placed the aircraft into service. After the aircraft completed 112 flights over approximately 21 days, defects were discovered that eventually that led the Greek Civil Aviation Authority to suspend the aircraft's certificate of airworthiness and ground the aircraft. In response to the grounding of the aircraft, Olympic ceased paying rent and maintenance reserves. ACG sued to recover amounts due. Olympic counterclaimed, among other things, to recover damages on the basis that the aircraft was not in airworthy condition upon delivery. After an appeal was taken from a decision of the Commercial Court, the Court of Appeal recently issued its decision in *Olympic*.

In its decision, the Court of Appeal held that the clear and unambiguous language contained in the lease agreement and acceptance certificate was enforceable not only to preclude Olympic from ceasing to pay rent, but also to preclude Olympic from claiming damages for improper delivery condition. At delivery, Olympic signed and delivered an acceptance certificate to ACG that included a confirmation by Olympic that the Aircraft complied in all respects with the condition required at delivery, including the conditions required by schedule 2 to the lease agreement, subject only to discrepancies noted on an annex. The lease agreement provided that it was a condition to Olympic's obligation to accept delivery of the Aircraft that the Aircraft must be in the condition required in schedule 2 to the lease agreement (except for any identified discrepancy items) and that delivery by Olympic of the acceptance certificate would constitute conclusive proof that (i) Olympic had examined and investigated the aircraft, (ii) the aircraft and related documents were satisfactory to Olympic, and (iii) Olympic had irrevocably and unconditionally accepted the aircraft without reservation (except as noted in the discrepancy annex).

In addressing Olympic's claims that the aircraft was not airworthy at delivery, the Commercial Court found as a matter of fact (and the Court of Appeal did not dispute) that unbeknownst to either ACG or Olympic, the aircraft was not in airworthy condition at delivery. The Commercial Court, in *dictum*, defined "airworthy" by reference to maritime law and held that an aircraft would not be airworthy if a prudent operator of an aircraft would have required that defects be made good before permitting the aircraft to fly had he known of the defects. In other words, even an unknown defect could render an aircraft unairworthy. Although the Court of Appeal did not itself articulate a definition of the term "airworthy," it rejected the maritime-based definition articulated by the Commercial Court because in the charter of a ship, the owner of the ship is responsible for its maintenance, crewing and navigation, whereas in an aircraft operating lease, the lessor is in the role of a finance party—it neither operates nor is responsible for the maintenance of the aircraft. The Court of Appeal also pointed out that the complexity of modern passenger aircraft is such that a contractual mechanism to measure compliance with a required delivery condition is necessary to avoid years of uncertainty and to allocate the risk of defects of which neither lessor nor lessee is aware. The Court of Appeal ruled that the lease agreement was sufficient to allocate this risk to Olympic and acknowledged that short of complete disassembly of an aircraft, it is impossible fully to inspect an aircraft and eliminate all risk of undiscovered defects upon delivery and that "… *the parties know that neither of them can be absolutely certain of an aircraft's condition at the point at which the lessee is called upon to accept delivery and the on-going risk*." The lease agreement provided Olympic with ample opportunity to inspect the Aircraft and its technical records and to have discovered, and required the rectification of, discrepancies prior to delivery, and Olympic availed itself of those opportunities.

Despite its finding that the aircraft was not airworthy at delivery, the Commercial Court held that the language in the lease documents was sufficient to preclude Olympic from revoking its acceptance of the Aircraft or ceasing to pay rent, but that it could, under the terms of the Lease Agreement, nevertheless seek to recover damages for the deficient delivery condition of the Aircraft. However, Olympic was estopped under the facts of the case from doing so because ACG had relied in good faith to its detriment in accepting redelivery of the Aircraft from the previous operator based on Olympic's confirmations of acceptance and satisfactory condition set out in the Acceptance Certificate and the Lease Agreement. The Court of Appeal rejected this reasoning and held that the language of the lease agreement and the acceptance certificate alone was sufficient to preclude Olympic from seeking damages based on the delivery condition of the Aircraft.

In issuing his decision, Tomlinson LJ said:

> "In my judgment, the natural meaning of the relevant provisions is clear. There is no ambiguity about paragraph 2(e) of the Certificate of Acceptance—the lessee confirms that the aircraft at delivery complied in all respects with the condition required under clause 4.2 and Schedule 2, except for the items listed on Annex 2. Clause 7.9 provides that delivery by lessee to lessor of a certificate in that form will be conclusive proof that the aircraft and the aircraft documents are satisfactory to the lessee. For my part, I have no difficulty with what is meant by the aircraft being "satisfactory" to the lessee. The contract provides only one yardstick by which the lessee's satisfaction with the aircraft is to be measured, and that is compliance with the condition required by Schedule 2, as spelled out by clause 4.2(a). When the lessee confirmed that the condition of the aircraft at delivery complied in all respects with that required under Schedule 2, the lessee was confirming that the aircraft was satisfactory to it in the only sense in which it was entitled, or expected, to express its satisfaction."

The decision sends a clear message that aircraft leases and their related certificates of acceptance should be construed in accordance with their plain, unambiguous terms, and that the risk allocation set forth in those documents between lessee and lessor should be given effect.

Recent United States Cases

A number of recent decisions in the United States further highlight the uncertainty created when a seller or lessor agrees to deliver an aircraft in airworthy condition and the importance of utilizing clear and unambiguous acceptance certificates.

Pritchard Enterprises, Inc. v. Adkins[2]

In *Pritchard*, the seller of a Cessna aircraft warranted to the buyer among other things that the aircraft would be in an "airworthy condition" at the time of sale. The buyer arranged to have the aircraft and its records inspected. During the inspection, the buyer's representatives identified 35 discrepancies from the required delivery condition, all of which were rectified prior to delivery. On the delivery date, the buyer's representative successfully flew the aircraft and the parties completed the sale of the aircraft. Approximately 10 months thereafter, following five successful flights, numerous mechanical problems were discovered that the buyer's expert said required correction in order for the aircraft to be considered airworthy. The buyer, claiming that the defects existed at the time of sale and rendered the aircraft not airworthy, sued the seller, seeking to rescind the purchase of the aircraft or recover damages.

The court found that the buyer did not prove that the aircraft was not airworthy at the time of sale, in part because the alleged defects were not sufficient to affect the "airworthy condition" of the aircraft.[3] In reaching this decision, the court applied a definition of "airworthy" proffered by the seller (the sale agreement did not define the term): "a flight-by-flight determination that evaluates the physical aspects of the aircraft … to determine an aircraft's safety and ability to *undertake a given flight*…." (emphasis supplied).

JDI Holdings LLC v. Jet Management, Inc.[4]

In *JDI Holdings*, the seller of a Cessna Citation 650 agreed to deliver the aircraft to the buyer in an airworthy condition. The court found that the aircraft was airworthy at delivery, based largely on the testimony of the seller's expert witnesses that the defects that the buyer cited did not affect airworthiness. The court also relied on the fact that no airworthiness defects were detected in pre-closing inspections that were not rectified or in flights conducted immediately after the closing. Although neither the contract nor the court defined "airworthy," the court found that the term "airworthy condition" was well understood by those in the aircraft industry, and that "different mechanics can have differing views and opinions on what is and is not airworthy." The court further stated that "an opinion on airworthiness attests only to the condition of an individual item at that point in time; *it could break the next day*." (emphasis supplied).

The *Pritchard*, *Tice* and *JDI Holdings* decisions turn on the failure of the buyers to sustain their burden of proof and do not foreclose the possibility that *if* the court had found that a defect at issue rose to the level of affecting airworthiness, and *if* the buyer could prove that the airworthiness defect existed at the time of delivery (these facts were established in *Olympic*), the buyer might have a claim against the seller for deficient delivery condition even though the buyer had accepted the aircraft. It is unclear whether the buyers in *Pritchard and JDI Holdings* executed acceptance certificates. However, as was the case in *Olympic*, such a claim should be precluded by a sufficiently clear acceptance certificate and sale agreement.[5]

Conclusion

The cases summarized above provide lessons for the parties to an aircraft sale or lease agreement. These include:

- **Clear and Unambiguous Acceptance Certificate**
  The seller or lessor should require the buyer or lessee to execute an acceptance certificate that contains (i) clear language in which the buyer or lessee unequivocally, irrevocably and unconditionally accepts delivery of the aircraft *and* confirms that the aircraft is satisfactory and in the condition required at delivery, and (ii) an express waiver of any and all claims and warranties (express or implied) related to the condition of the aircraft at or after delivery and acceptance.
- **Airworthy Does Not Have a Clear Definition**
  To the extent an aircraft is required to be "airworthy," parties should consider defining "airworthy" in their underlying agreement. Absent a definition of "airworthy" in a sale or lease agreement, a court could look to the U. S. Federal Aviation Regulations for the definition: "Airworthy" means the aircraft conforms to its type certificate and is in a condition for safe operation." 14 C.F.R. 3.5(a). This definition has the potential to be susceptible to unknown defects as was the case in Olympic.

- **Airworthiness Should Be a Condition Precedent, Not a Warranty**
  Where possible, sellers and lessors should fashion any agreement to deliver an aircraft in "airworthy" condition as a condition precedent that is satisfied or waived at delivery, as opposed to a warranty that survives delivery or a covenant that could give rise to a claim for damages after delivery.

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1 *ACG Acquisition XX LLC v. Olympic Airlines S.A. (in special liquidation)*, [2013] EWHC 1070 (Civ. 369).

2 *Pritchard Enterprises, Inc. v. Adkins*, 858 F. Supp. 2d 576 (E.D.N.C. 2012).

3 *See also Tice v. Ron Farish Aircraft, Inc.*, No. 11-91-293-CV, 1993 WL 13141539 at *2 (Tex. App. July 22, 1993) (unpublished), where the aircraft was required to be in airworthy condition at the time of sale, but the aircraft suffered an electrical system failure approximately two months after delivery and acceptance by the buyer. The court did not define "airworthy" but held that the buyer failed to prove that the defects which presumably would have affected airworthiness in fact existed at the time of sale.

4 *In JDI Holdings LLC v. Jet Management, Inc.*, 732 F. Supp. 2d 1205 (N.D. Fla., Pensacola Div. 2010).

5 While the *Olympic* decision is not binding precedent in the United States, a

recently decided New York case supports the conclusion that a clear acceptance certificate in which a party confirms that an aircraft is in the condition required by a contract, will preclude that party from later claiming otherwise. *See Wells Fargo Bank Northwest, N.A. v. US Airways, Inc.*, 100 A.D.3d (First Dept., 2012). In the *US Airways* case, US Airways returned aircraft to Wells Fargo at lease-end and Wells Fargo executed a redelivery certificate confirming that US Airways had redelivered the aircraft to Wells Fargo in the condition required by the leases except for defects noted on a schedule, and that by executing the certificates, Wells Fargo certified that US Airways had fully performed its obligations under the leases and that the aircraft were redelivered in compliance with the requirements of the leases. The *US Airways* court found that Wells Fargo's execution of the redelivery certificate precluded it from later claiming that the aircraft did not satisfy certain redelivery conditions. A discussion of the *US Airways* case can be found in the November 2012 edition of the *Vedder Price Global Transportation Finance Newsletter* at www.vedderprice.com/US-Airways.

English High Court Confirms Enforceability of One-Sided Jurisdiction Clauses in Wake of *Rothschild*

Following a decision of the French Supreme Court, the Cour de Cassation, in *Mme. X v. Banque Privée Edmond de Rothschild*,[1] the High Court (Commercial Division) has issued a decision confirming that one-sided jurisdiction clauses will be upheld by the English courts. This decision, issued in *Mauritius Commercial Bank Limited* (MCB) *v Hestia Holdings Limited* (Hestia) *and Sujana Universal Industries Limited* (Sujana),[2] is of considerable importance to aircraft lessors, lenders and airlines.

Nature of the Clause

One-sided jurisdiction clauses are often included in aviation financing and leasing documents, and provide that:

- Each of the parties to the document submits to the jurisdiction of the courts of a specified jurisdiction; but
- Any finance party under a finance document, or the lessor under a lease document, (in either case, Party A) may also pursue the other party (Party B) in any other court.

The primary purpose of a one-sided jurisdiction clause is (a) to provide certainty to Party A that litigation will be conducted in a jurisdiction that is acceptable to it and (b) to allow Party A to pursue Party B in any jurisdiction in which that second party has any assets.

The Rothschild *Case*

Mme. X entered into a private banking relationship with the Edmond de Rothschild Private Bank (the Bank) in Luxembourg. The standard terms and conditions of the Bank were governed by the law of Luxembourg and included a one-sided jurisdiction clause in the Bank's favour.

The Cour de Cassation ruled that the jurisdiction clause was of "*a potestative nature as regards the bank*" and that it was "*contrary to the object and finality of prorogation of jurisdiction under Article 23 of the Brussels Regulation*."[3] Pursuant to Article 1174 of the French Civil Code, a potestative condition is void for lack of mutuality of obligations.

The MCB *Case*

In November 2010, Hestia entered into a facility agreement with MCB (the Agreement), pursuant to which MCB provided a banking facility in favour of Hestia in an amount of up to US$10,000,000. Sujana entered into a guarantee in favour of MCB, guaranteeing Hestia's obligations under the facility agreement. This facility was increased in 2011 and the guarantees amended to extend to the full amount of US$20,000,000. The documents were governed by Mauritian law and subject to the exclusive jurisdiction of the Mauritian courts.

By June 2012, Hestia had drawn down the full amount under the increased facility. Hestia failed to make payments when due in August 2012.

Following this default, MCB, Hestia and Sujana entered into an amendment and restatement agreement, which amended, replaced and restated the Agreement, effectively restructuring and rescheduling Hestia's debts. The replacement facility agreement was stated to be governed by English law and included a one-sided jurisdiction clause in favour of MCB. Hestia defaulted on the repayment of the rescheduled loan payments, with US$15,000,000 (plus interest) outstanding.

The defendants argued:

- that the jurisdiction clause remained subject to Mauritian law because the governing law of a contract could not be amended by simply choosing to amend it in an agreement—it must be terminated and a new agreement entered into;
- that, as a result of this, the clause was invalid because Mauritian law would follow French law and the *Rothschild* decision would apply; and
- even if Mauritian law did not apply, the clause was invalid under English law because it permitted MCB to bring proceedings against Hestia anywhere in the world (whilst Hestia could only bring proceedings against MCB in England) and this would be contrary to public policy, in that it

was contrary to the principle of "equal access to justice" (as enshrined in Article 6 of the European Convention on Human Rights).

Responding to each point in turn, Popplewell J held:

- the parties had replaced the Agreement, rather than merely amending it;
- even if the Agreement had not been replaced, the parties were free to agree to amend the jurisdiction clause:

  "If commercial parties freely agree to change their governing law, the court should strive to give effect to their bargain unless there are overwhelming policy objections. None apply in this context.";
- that Mauritian law was, therefore, irrelevant. Even if Mauritian law were relevant, the expert evidence presented to the court was that the *Rothschild* decision is (i) controversial, (ii) subject to criticism domestically and in the context of Article 23 of the Regulation and (iii) inconsistent with previous decisions of the Court de Cassation. At best (following the defendants' expert witness) there was a 50/50 chance that *Rothschild* would be followed whilst at worst (following MCB's expert witness) there was no compelling reason why the courts would follow Rothschild. In the circumstances, Popplewell J found that there was a "good arguable case" that *Rothschild* would not be followed;
- that the construction of a one-sided jurisdiction clause as permitting MCB to bring proceedings against Hestia in any jurisdiction in the world is incorrect – the clause:

  "preserves MCB's right to sue in any court which would regard itself as of competent jurisdiction, notwithstanding what would otherwise have been the effect of [the exclusive jurisdiction part of the one-sided jurisdiction clause], which, if it had stood alone, would have required MCB to sue in England."; and
- that Article 6 of the European Convention on Civil Rights is inapplicable as it is directed at access to justice within a forum, rather than a choice of the forum.

Conclusion

This decision confirms that English courts will be unlikely to follow *Rothschild*. It also highlights the controversial nature of *Rothschild* in France and the jurisdictions whose laws are influenced by decisions of the French courts. As there are now two recent cases of Member States which appear to contradict each other, and the interpretation of EU law should be uniform across all Member States, a European Court of Justice may still be required to clear up any remaining uncertainty.

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1 *Cour de cassation*, Civil Division 1, 26 September 2012, 11-26022 (Rothschild). A more complete discussion of the Rothschild decision, which held that one-sided jurisdictional clauses were unenforceable as a matter of French law, can be found in the February 2012 edition of the *Vedder Price Global Transportation Finance Newsletter* at www.vedderprice.com/Rothschild.

2 [2013] EWCH 1328 (Comm).

3 Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (as amended).

Priority of Ownership and Security Interests in a Repossession Scenario:

Ensuring that Leases, Subleases and Mechanics' Liens Remain Subordinate

One of the key components to any aircraft leasing or financing arrangement is the ability of the lessor or financier, as applicable, to repossess the aircraft if the lessee or borrower defaults. A lessor's or financier's ability to repossess an aircraft may be impeded if (i) the relevant obligor has transferred possession of, or rights in, the aircraft to a third party pursuant to a lease, sublease or other arrangement and such third party claims a superior right to the aircraft, or (ii) a party that has performed maintenance on the aircraft has not been paid and asserts a lien on the aircraft. *PNCEF, LLC v. South Aviation, Inc*.[1] (the PNCEF Case) is a recent case that illustrates how lessors and financiers may mitigate these risks through the use of clear contractual provisions that (i) require subordination arrangements in the case of third party possessory or other rights, (ii) restrict the ability of lessees to assert mechanics' liens against an aircraft, and (iii) require lessees to clear mechanics' liens asserted by third-party maintenance providers.

Facts of the Case

The PNCEF Case involved the purchase of four business jets by affiliated buyers (each, a Borrower, and collectively, the Borrowers). Each Borrower financed the purchase of its aircraft with a loan from PNCEF, LLC (the Lender) and granted the Lender a security interest in its aircraft pursuant to a mortgage agreement. Under each mortgage agreement, the Lender was entitled to immediate possession of the relevant aircraft if (i) the Borrower defaulted under the related financing arrangement and (ii) the Lender requested the Borrower to return such aircraft. Subsequent to purchase, each Borrower leased its aircraft to South Aviation, Inc. (the Lessee) pursuant to a lease agreement. Each lease agreement provided that:

- the Lessee's rights thereunder were "at all times, even when no event of default exists [under the related lease agreement], subject and subordinate to the rights of [the Lender] in and to the Aircraft"; and
- the Lessee was expressly prohibited from (i) creating any liens on the aircraft or (ii) allowing any liens to be placed on the aircraft, except for inchoate workmen's, repairmen's or similar liens that had to be cleared by the Lessee.

After taking delivery of the aircraft under the lease agreements, the Lessee performed maintenance on the aircraft[2] and subsequently filed mechanics' liens against each aircraft. Subsequently, each Borrower defaulted under the financing arrangements, causing the Lender to invoke its right to immediate possession of the aircraft. In turn, the Borrowers attempted to procure the return of the aircraft from the Lessee, which refused the Borrowers' requests on the basis that the liens that the Lessee had filed against the aircraft were superior to those of the Lender. In response, the Lender sued the Lessee requesting the court to enter an order requiring the Lessee to return the aircraft to the Lender. The court denied this request, and the Lender appealed the ruling.

Court's Analysis

The appellate court reversed, concluding that the Lender was entitled to possession of the aircraft. In reaching this conclusion, the appellate court determined that each Borrower and the Lessee had expressly provided in its lease agreement that the Lessee's quiet enjoyment rights were subordinate to the Lender's rights in the aircraft. Consequently, the appellate court concluded that the Lessee had waived any priority that its liens may have otherwise had. In its waiver analysis, the appellate court determined that (i) the Lessee's rights under the lease agreements were waivable, (ii) the Lessee had actual or constructive knowledge of such rights and (iii) the Lessee had intended to relinquish such rights. In addition to its ruling with respect to the subordination language, the appellate court determined that the right to create any liens on the aircraft had also been waived by the Lessee pursuant to the provision expressly prohibiting the Lessee from filing liens against the aircraft. As such, the appellate court ruled that the Lender's rights ranked higher in priority than those of the Lessee and that the Lender was entitled to possession of the aircraft.

Conclusions

Subordination Language

The PNCEF Case serves as a reminder to lessors and financiers (each, a Superior Party) of the benefits of including covenants in lease and financing agreements (each, a Superior Agreement) that require lessees and borrowers to obtain express subordination undertakings in connection with subleases, leases or other third party arrangements (each, a Subordinate Agreement) pursuant to which a lessee or borrower transfers possession of an aircraft to a third party (a Subordinate Party). In the event any Subordinate Party attempts to impede (i) the Superior Party from exercising any of its rights against the lessee or the borrower or (ii) the lessee or borrower from fulfilling any obligation it may have to the Superior Party, carefully drafted subordination undertakings will protect the Superior Party's priority and ability to repossess and foreclose. Financiers and lessors should ensure that the subordination covenants require each Subordinate Agreement to have clear subordination undertakings that address the points set forth below.

- **Identify the Agreements**
  The Superior Agreement and the Subordinate Agreement should be clearly identified, and it should be noted that the rights of the Subordinate Party under the Subordinate Agreement are subject and subordinate to the rights of the Superior Party under the Superior Agreement.
- **Specific Language**
  The priority of interests, rights and/or claims and any alteration to the priority ranking that would otherwise exist as a matter of law absent such a provision should be clearly delineated.
- **Eliminate Qualifications**
  If the subordination undertakings are intended to apply notwithstanding the fact that the Subordinate Party may not be in default under the terms and conditions of any such Subordinate Agreement, the subordination provision should clearly state so.
- **Direct Enforcement Rights**
  The Superior Party should be granted the ability to directly enforce its rights against the Subordinate

Party. This can be accomplished through (i) an assignment to the Superior Party of the rights of the borrower or lessee, as applicable, in the Subordinated Agreement or (ii) a letter addressed to the Superior Party from the Subordinate Party or an express provision in the Subordinate Agreement (that the Superior Party is made an express third party beneficiary of), whereby the Subordinate Party agrees to the subordination and grants the Superior Party the right to exercise any rights it might have under the Superior Agreement or that the borrower or lessee may have under the Subordinate Agreement against the collateral.

In addition, parties involved in multi-tier lease structures or other structures where a Subordinate Agreement may be entered into simultaneously with, or prior to, a Superior Agreement, should ensure that the Subordinate Agreement contains subordination provisions consistent with that described above, or obtain stand-alone subordination undertakings from the Subordinate Party, at the outset of the transaction. For example, in the case of a multi-tier lease structure, such subordination provisions will ensure that the relevant sublease remains in effect only so long as the head lease remains in effect and subjects the sublessee's rights to the termination provisions in the head lease.

Mechanics' Liens

Because the appellate court in the PNCEF Case concluded that the Lessee had waived any right it had to assert a superior lien based on the express language in the lease agreements, the court never addressed whether the Lessee would have had a valid superior lien on the aircraft absent the express language contained in the leases. Accordingly, the PNCEF Case leaves open the possibility that, in a lease arrangement where (i) the lessee is permitted or required to perform maintenance and is entitled to some form of payment or reimbursement for such maintenance and (ii) the lessee is not prohibited from placing a lien on the aircraft for the cost of maintenance, the lessee could perform maintenance on the aircraft and assert a mechanics' lien on the aircraft to secure payment for such performed maintenance. Given that certain possessory liens are afforded statutory priority over other security interests in the same collateral, there is risk that a lessee in default could assert its rights under such a lien to prevent a financier or lessor from exercising its repossession rights.

In light of this implication and more generally to reduce the risk that a third party maintenance provider will be in a position to assert a valid mechanics' lien on a financed or leased aircraft, financiers and lessors should ensure that leases contain clear provisions that (i) prohibit a lessee from creating liens or (ii) prohibit or restrict the ability of a lessee to assert a claim against the lessor for cost of maintenance. Without such language, a financier or lessor could find itself in a situation in which it has to pay its lessee or third party to release a possessory lien before the financier or lessor can regain possession of, and begin to collect any proceeds generated from, the repossessed collateral.

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1 60 So. 3d 1120 (Fla. Dist. Ct. App.) (May 11, 2011).

2 It is not clear from the court's decision or the briefs filed in the case whether the Lessee was required to perform such maintenance under the lease agreements. The appellee's brief noted that "[the Lessee] had invested a substantial sum of money in the subject aircraft in the form of repairs and maintenance, including parts and labor… In order to compensate [the Lessee] for its investment in the respective aircraft [the Lessee] was afforded a reduced monthly rental." Appellee Answer Br., PNCEF, LLC v. South Aviation, Inc., No. 4D10-2860, 2010 FL App. Ct. Briefs LEXIS 394, at 3 (4th Dist. Sept. 3, 2010).

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