

## Commercial Aircraft Finance Team

### Model Equipment Leasing Law Draft In Final Stages

#### Background

Drafting of a Model Law on Commercial Leasing (“MLL”) began in 2004 under the auspices of UNIDROIT.<sup>1</sup> This effort has been supported by governmental and private organizations alike, and is intended primarily for use in developing countries and those transitioning to a market economy (e.g., countries in Africa, Eastern Europe and certain parts of Asia). It is highly unlikely the MLL would be considered in jurisdictions with established bodies of commercial law such as the US, Canada or members of the European Community.

**The goal of the MLL is to agree upon a series of principles covering commercial finance and operating leases**

On the other hand, countries such as Brazil and China might well look favorably on such legislation. This Client Bulletin will be of particular interest to lessors and lessees of aircraft.

The MLL is comprised of a series of principles covering commercial (but not consumer) finance and operating leases.<sup>2</sup> A wide variety of assets are intended to be covered—everything from capital goods to unborn animals.<sup>3</sup>

A number of meetings have taken place, several drafts have been circulated and UNIDROIT is aiming for final approval in November 2008. In addition to those mentioned in the endnotes, two major issues remain open which may delay the process: the scope of the model law’s coverage and lessor liability.<sup>4</sup>

#### Scope of Coverage

Draft Article 3 of the MLL specifically excludes certain (but not all) of the following:

- (a) secured transactions;
- (b) transactions involving real property; and
- (c) transactions involving aircraft, vessels, rolling stock or space assets to the extent they are covered by existing law or international agreement.

Significant concerns have been expressed that the exclusion in Article 3, clause (c), relating to “aircraft” does not go far enough to isolate assets covered by the Aircraft Equipment Protocol to the Cape Town Treaty.<sup>5</sup> Those who object stress the fact that the Cape Town Treaty and Aircraft Protocol constitute a comprehensive framework for the financing and leasing of “aircraft objects.”<sup>6</sup> For countries that have yet to ratify Cape Town, there are reservations as to whether the MLL is

sufficiently clear or accurately represents market practice in the allocation of risk between lessors and lessees of commercial aircraft and engines.<sup>7</sup> These same parties are pressing for express exclusion of transactions, which are or could be covered by the Cape Town.

**Two major issues remain open, which may delay the process: the scope of the model law’s coverage and lessor liability**

A principal objective of the MLL is to promote international trade through the creation of a predictable set of laws. If any leasing arrangement with respect to “aircraft objects” is excluded from the MLL, this could have far reaching effect and, perhaps, some unintended consequences for equipment lessors in the aviation sector.

For example, where *neither* the Cape Town Treaty and Protocol *nor* the MLL are in effect, the parties could be left without a well-developed body of commercial law, and lessors would be no more (or less) comfortable leasing high-value aircraft objects into such a jurisdiction than they are today. Such a situation would frustrate a principle purpose of the MLL.

In jurisdictions that will adopt the MLL only, a strange result could occur with respect to assets just coming into the marketplace, in the form of so-called “Very Light Jets.” The MLL might cover VLJ airframes, but not the engines.<sup>8</sup> The uncertainty created by having two perhaps conflicting legal regimes cover the whole of one asset would likely make prudent lessors pause, or even refrain altogether, from agreeing to lease an asset like a VLJ into such a jurisdiction.

Finally, with respect to the “scope” issues, it is unclear whether, and to what extent, rolling stock and space assets covered by the Cape Town Treaty’s recently enacted Rail Protocol and its contemplated Space Protocol would be subject to the MLL.<sup>9</sup>

### *Liability of a Lessor under the MLL*<sup>10</sup>

Article 9 of the current draft of the MLL now reads as follows:

*“In a financial lease, the lessor shall not, in its capacity of lessor, be liable to the lessee or third parties for death, personal injury or damage to property caused by the asset or the use of the asset.”*

As one can imagine, a number of questions have arisen concerning this provision, and they are currently the subject of vigorous debate. For example:

- Is there different treatment under an operating vs. a financial lease? Is an operating lessor automatically open to third-party liability claims?
- Notwithstanding the limitation on liability in its capacity as “lessor,” is it contemplated that the same party might still be liable as the “owner?”
- In the policy context, could the narrow nature of limited liability af-

forded an “owner” lead one to favor a secured loan vs. a lease? Doesn’t that create tax and accounting problems and defeat a significant goal of the MLL: to promote rational economic development?

This particular issue finds certain civil law and common law jurisdictions at polar opposites. In addition, the apparent open door to owner liability is contrary to existing US law.<sup>11</sup>

### *Conclusion*

Despite best efforts to create a sensible set of common legal principles for use by developing nations and those with transitioning economies, a number of significant and fundamental issues are very much open. Lessors of high value assets should carefully monitor the formative process of the UNIDROIT Model Leasing Law. Now is the time to make one’s views known so they can be considered prior to the scheduled final consideration of the MLL by the UNIDROIT General Assembly in November 2008.

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<sup>1</sup> UNIDROIT is an independent intergovernmental organization headquartered in Rome. One of its purposes is to study and propose modernization of commercial law. The end product can take the form of an international convention or treaty (2001 *Cape Town Convention on International Interests in Mobile Equipment* (the “Cape Town Treaty”)); a model law (*Model Franchise Disclosure Law*); or a legislative guide (*Guide to International Franchise Agreements*). The official website for UNIDROIT is <http://www.unidroit.org>.

<sup>2</sup> See UNIDROIT statement Preparation of a Model Law on Commercial Leasing at

<http://www.unidroit.org/english/workprogramme/study059a/overview.pdf> The current discussion draft of the MLL can be found at <http://www.vedderprice.com/model.pdf>. Note that the definition of *lease* is broad enough to include more than “true” leases and will cover certain types of loan transactions as well.

<sup>3</sup> The definition of *asset* can include software in certain instances. There may be a “deal breaker” disagreement between certain South American countries as to whether the term *asset* covers only embedded software or extends to all software. Certain countries strongly support the “embedded” concept. If the latter interpretation prevails, stakeholders from the international intellectual property community are likely to voice strenuous objections and may seek wholesale changes to the entire protocol.

<sup>4</sup> Other areas of disagreement include: specific limitations on the freedom to contract (Article 5); enforceability *viz.* insolvency laws (Article 6); “deemed” contractual relationship between a vendor/supplier/manufacturer and the lessee (Article 7); and limitations on parties’ ability to negotiate covenants of quiet enjoyment (Article 16).

<sup>5</sup> References to the “Aircraft Protocol” or “Protocol” are to “Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Johannesburg, 2001).” The official text of the Cape Town Treaty and the Aircraft Protocol can be found at <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm> and <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm#NR2>, respectively.

<sup>6</sup> The term “aircraft objects” is defined in Article 1, clause 2(c) in the Aircraft Protocol.

<sup>7</sup> For example, MLL Article 7 creates a “deemed” relationship between the manufacturer and the lessee. This relationship would extend beyond the usual and customary agreement which is limited to equipment warranties.

<sup>8</sup> Aircraft engines such as the Williams FJ-33 and PWC 600 probably qualify for Cape Town Treaty and Protocol coverage, but the airframes on the Eclipse 400 or the Hondajet might not. <http://www.eclipseaviation.com/eclipse400/operation/specifications.php>; <http://hondajet.honda.com/specifications/index.aspx?bhcp=1>

<sup>9</sup> See “Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock” (Luxembourg, 2007) <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm#NR3>. Initial discussions have taken place on the Space Protocol, but no text has been published to date. Comments from interested rail and space asset stakeholders have been solicited regarding coverage of the MLL.

<sup>10</sup>For a recent discussion on the issue of lessor and lender liability in the aviation area, see the Vedder Price client bulletin at: [http://www.vedderprice.com/docs/pub/8e6960cc-8d28-4366-a1c0-9b8d6c271283\\_document.PDF](http://www.vedderprice.com/docs/pub/8e6960cc-8d28-4366-a1c0-9b8d6c271283_document.PDF)

<sup>11</sup>49 U.S.C. §44112 and *Aircraft Lessor and Lender Liability Bulletin*. The position is also inconsistent with discussions underway with respect to the draft ICAO Treaty on Third-Party Damages.

## Future Seminars and Events

### Aircraft Finance Aviation Finance Summit

October 21–22, 2008

Marriott Residence Inn Times Square  
New York, NY

Speaker: Douglas Ochs Adler

For more information please visit:  
<http://www.aviationfinancesummit.com>

### Annual Conference on Aircraft Finance

December 8–10, 2008

Westin Times Square, New York City

Speakers: Jonathan Bogaard, Ronald Scheinberg and John Karesh

Please contact Jonathan Bogaard for more information: 312.609.7651

### Business Aviation NBAA Annual Convention

October 6–8, 2008

Orlando, FL

Please contact Ronald Rapp for more information: 312.609.7895

### 2nd Annual Business Aviation Seminar

November 12, 2008

Standard Club, Chicago, IL

Hosted by Vedder Price

Please contact David Hernandez for more information: 202.312.3340

### Project & Infrastructure Finance US India Chamber of Commerce Monthly Meeting re: Infrastructure in India

November 18, 2008

Vedder Price, Chicago, IL

Speaker: Douglas Ochs Adler

Please contact Douglas Ochs Adler for more information: 202.312.3325

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