Aviation Finance & Leasing

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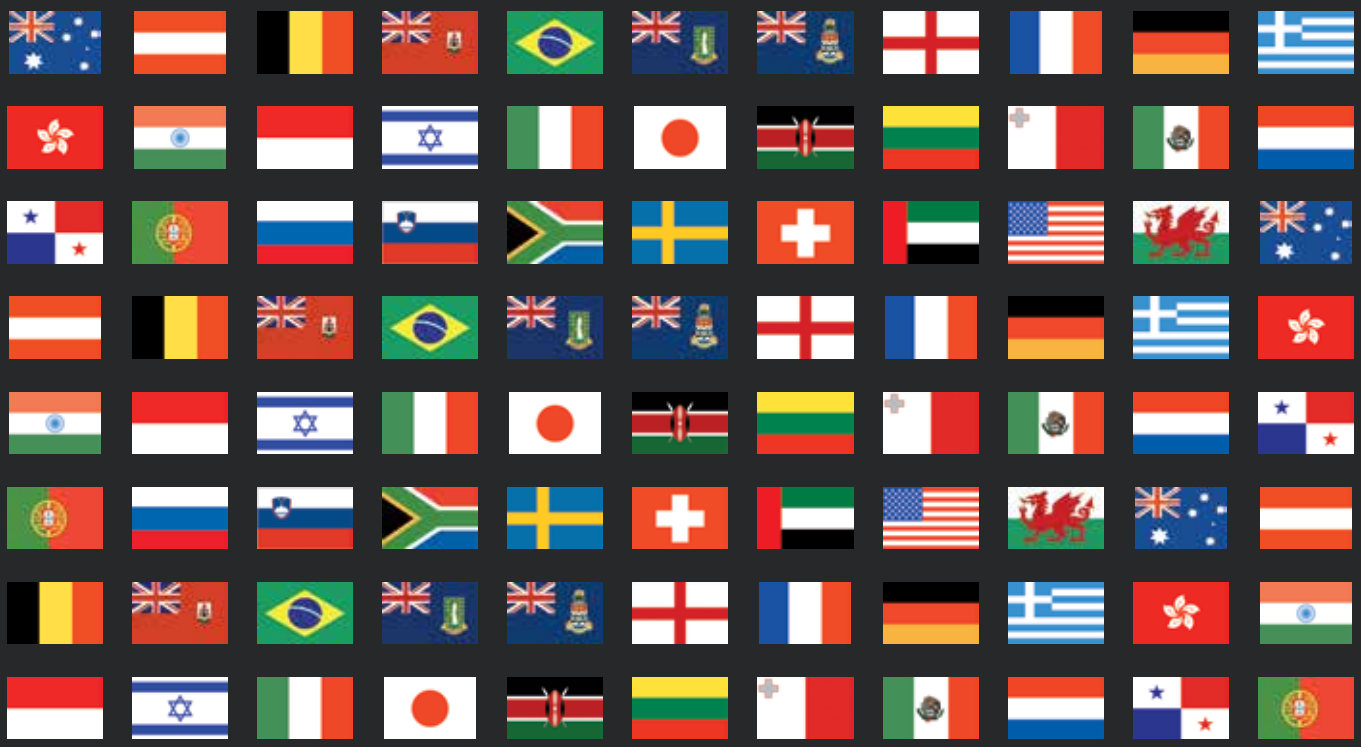

2018

GETTING THE DEAL THROUGH

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Aviation Finance & Leasing 2018

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Aviation Finance & Leasing 2018

Fifth edition

Getting the Deal Through is delighted to publish the fifth edition of *Aviation Finance & Leasing*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on British Virgin Islands, Greece, Hong Kong and Slovenia.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Mark Bisset of Clyde & Co LLP, for his continued assistance with this volume.

GETTING THE DEAL THROUGH

London
May 2018

Aircraft operating leases – New York law or English law?

Thomas A Zimmer and Neil Poland

Vedder Price

Aircraft operating leases – choice of law

It is common for leases of commercial and business aircraft to select either New York law or English law as the governing law. Most lenders, investors and lessors of aircraft are comfortable with leases governed by either New York or English law.

While the similarities between New York and English law-governed aircraft leases far outweigh the differences, lessors and lessees should understand the differences and use a lease tailored for the chosen governing law that takes into account these differences.

Similarities between New York law and English law

The key similarities between the New York and English legal systems include the following:

- freedom of contract – both systems recognise the fundamental principles of freedom of contract. Generally, the courts in both jurisdictions will uphold the terms of a contract freely entered into between commercial parties, although there are certain public policy exceptions in both jurisdictions;
- common law – both jurisdictions are common law legal systems, with the courts bound by legal precedent. With well-established precedents on many of the issues presented by leases, each system provides a high level of stability and certainty when it comes to enforcing the terms of an aircraft lease;
- security interests against aircraft and lease rentals – both New York and English law allow a lessor to grant a security interest in the rent receivable payable under the lease and the ownership rights of the lessor in the aircraft that is subject to the lease. Such rights can be perfected as against third-party claims against the lessor or the lessee, although there are differences in the validity and perfection requirements under the two legal systems that are noted under 'Filing requirements for aircraft leases and security assignments';
- enforcement rights – both legal systems provide 'self-help' remedies of enforcement of certain contractual or security rights and relatively speedy procedures for pursuing legal redress in the event of a default by the lessee either through the courts or other alternative disputes procedures subject to the dispute resolution process provided for in the lease; and
- ratification of Cape Town Convention – both the United States and the United Kingdom have ratified the Convention on International Interests in Mobile Equipment (2001) and the Protocol to the Convention on Matters Specific to Aircraft Equipment (together, CTC), although there are some differences in the implementation of the CTC.

Some key differences between aircraft leases governed by New York law and English law

There are a number of differences between aircraft leases governed by New York and English law that should be taken into account when choosing the governing law for an aircraft lease. The following is a brief description of some of the differences that we would advise parties to consider.

Recharacterisation risk

Under New York law and in certain circumstances, an instrument that purports to be a lease may be recharacterised as a security agreement (a security interest disguised as a lease) and not a 'true lease'. This can happen if the economic substance of the transaction is such that the lessee, and not the lessor, is deemed the economic owner of the aircraft. If an aircraft lease is recharacterised as a security interest, the lessor must take steps to perfect its security interest. Further, the remedies available to the titular lessor following a default by the lessee would be those of a secured creditor, and not those of an owner or lessor. Any excess proceeds resulting from a foreclosure sale of the aircraft beyond the secured amount would have to be paid over to the lessee.

In contrast, under English law there is no risk of recharacterisation of an aircraft lease as a security interest. There is no general legal definition of a finance lease or an operating lease, although the distinction is relevant for accounting and tax purposes.[1] If an instrument is structured as a lease under English law, a lessor may exercise its rights as owner as against the lessee regardless of the economic substance of the transaction. English law permits a lender or lessor to use 'finance lease' arrangements with the owner or lessor retaining ownership rights as against the lessee even if the transaction would not be deemed a 'true lease' under New York law.

Enforceability of foreign judgments

English or New York law-governed aircraft leases will typically provide that courts located in that jurisdiction shall have jurisdiction to resolve disputes under the lease, and that a judgment entered by those courts can be enforced in the jurisdiction where the lessee is based or where the aircraft is registered. However, the enforceability of a judgment entered by the courts of a foreign jurisdiction (for example, in the jurisdiction where the lessee is based or where the aircraft is registered) will require an examination of the laws of such jurisdiction and its position with respect to the enforcement of foreign judgments. This will include analysing any bilateral or multilateral treaties governing the enforcement of foreign judgments to which such foreign jurisdiction may be a signatory.

The United States has not ratified any treaty with the recognition and enforcement of foreign judicial judgments as a principal focus. Therefore, the recognition and enforcement of a judgment entered by a court in New York with respect to an aircraft lease would be subject to a case-by-case analysis, with input from foreign counsel being of critical importance. The courts of many jurisdictions outside the United States will recognise judgments issued by the courts in New York and it is customary for local counsel to provide a legal opinion to that effect.

In contrast with this position, as a member state of the EU,[2] the United Kingdom benefits from a number of instruments that regulate jurisdiction and the recognition and enforcement of judgments as between EU member states. The Brussels Regulation (Recast),[3] for example, applies to the enforcement of judgments across the EU in proceedings instituted on or after 10 January 2015 and is directly effective in the United Kingdom and all other member states.[4] Similarly, the 2007 Lugano Convention extends the recognition and enforcement of English judgments to certain European Free Trade Association countries, those being Denmark, Iceland, Norway and Switzerland.

The United Kingdom also benefits from a number of bilateral arrangements for the enforcement of judgments with certain non-EU countries (including members of the Commonwealth, the British Overseas Territories and a number of former British colonies). Importantly for a lessor, these arrangements extend to jurisdictions

often experienced in aircraft leasing transactions such as the Cayman Islands, Bermuda and the British Virgin Islands.[5]

To the extent that the parties cannot satisfy themselves that a judgment on the lease entered by a New York court or English court would be recognised and enforced in the courts of a foreign jurisdiction, the parties might consider providing for the arbitration of disputes if the foreign jurisdiction has adopted the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention). Under the New York Convention, to which both the United States and the United Kingdom are a party, an arbitral award determined by a New York arbitration tribunal on a New York law-governed lease or English arbitration tribunal on an English law-governed lease should be recognised by the courts of a foreign jurisdiction that has also adopted the New York Convention (subject to any requirements of the New York Convention).

Filing requirements for aircraft leases and security assignments

Under English law, there are no filing requirements for an aircraft lease per se, although, given that the United Kingdom aircraft register is an operator registry, a domestic operator would be responsible for aircraft registration as charterer by demise under the lease. Since the ratification of the CTC in the United Kingdom, a lease may be, and in practice often is, registered at the International Registry as an international interest.

Similarly, under English law, there is no requirement to make any filings with respect to such an assignment at Companies House (other than with respect to an assignor incorporated in the United Kingdom, in which case a filing at Companies House in the United Kingdom will need to be made to ensure that the security is enforceable). The only formality to perfect an assignment by way of security of a lessor's rights under an English law-governed lease is to serve notice of the assignment on the debtor. Again, since the ratification of the CTC in the United Kingdom, an English law-governed security assignment will typically be registered at the International Registry as an international interest.

Under New York law, while there is no filing requirement in respect to a 'true lease' under the Uniform Commercial Code (UCC), it is customary for a precautionary financing statement to be filed. In the case of aircraft registered with the Federal Aviation Administration (FAA), an aircraft lease must be filed for recording with the FAA in order to be valid against third parties without notice of the aircraft lease. If the CTC applies to the lease, the international interest created under the lease must be registered with the International Registry in order to have priority over subsequently registered international interests or unregistered interests, except for certain unregistered interests that are given priority over even registered interests.

Under New York law, a titular lessor whose lease is recharacterised as a security interest will be treated as a secured party and not as a lessor, and must take steps to perfect the security interest in order to be effective against third parties. These steps include the filing of appropriate financing statements under the UCC, the filing of the lease with the FAA in the case of FAA-registered aircraft and, if the CTC applies, registering the international interest created under the lease with the International Registry. If an aircraft lease is perceived to have a substantial risk of being recharacterised, the lease should include language expressly granting to the lessor a security interest in the aircraft along with appropriate remedies in the event that the lease is recharacterised as a security interest.

Under New York law, a lender who takes an assignment of the lessor's rights under an aircraft lease also must take steps to perfect the security assignment in order to be effective against third parties. These steps include taking possession of the chattel paper original of the lease, the filing of appropriate financing statements under the UCC, the filing of the security assignment with the FAA in the case of FAA-registered aircraft and, if the CTC applies, registering the international interests created under the lease and the security assignment with the International Registry.

Mitigation of damages (common law)

English common law establishes that the purpose of damages is to compensate the injured party for loss, so as to put the innocent party in the position in which it would have been had the relevant contract not been breached.[6] To quantify the damages to be awarded, English courts must be satisfied that, after the breach of contract that gave rise to the loss, a claimant has taken reasonable steps to mitigate (ie, avoid or reduce) the loss. This 'duty to mitigate',[7] is framed by three principles:

(i) a claimant cannot recover damages for any loss that could have been avoided by taking reasonable steps;
(ii) if a claimant in fact avoids or mitigates his or her loss resulting from a defendant's breach, he or she cannot recover for such avoided loss, even though the steps he or she took were more than could reasonably be required under (i); and
(iii) where a claimant incurs loss or expense in the course of taking reasonable steps to mitigate the loss resulting from a defendant's breach, a claimant may recover any expenses incurred in taking such steps, even if these prove to be greater than the loss thereby avoided.

Importantly, the English courts have confirmed that the burden of proving that a claimant failed to take reasonable steps to mitigate its loss falls on a defendant and that a lessor claiming damages against a lessee in default, for example, would not be 'under any obligation to do anything other than in the ordinary course of business' to mitigate its loss.

During negotiation of an English law-governed lease, lessees commonly request that the lessor agree to a contractual duty to mitigate losses. Lessors need to consider carefully whether it is in their commercial (and legal) interest to agree to a contractual obligation that is likely to impose a greater burden on the lessor than would be imposed by common law if the lease were otherwise silent on mitigation of loss.

While New York law recognises a general duty to mitigate damages, this is subject to the parties' freedom to contract with respect to remedies and other rights under the UCC. The statutory remedies granted to a lessor under the UCC, upon a default by the lessee, provide for a statutory mitigation mechanism. However, the UCC allows the parties to override the statutory remedies provided that the obligations of good faith, diligence, reasonableness and care may not be disclaimed by agreement. The obligations of good faith, diligence, reasonableness and care might be construed in specific circumstances to impose a mitigation obligation on a lessor whether or not one is imposed expressly. One advantage of the parties setting forth a specific contractual mitigation measure is that the UCC allows the parties to determine by agreement what standards should be applied in measuring performance as long as such standards are not manifestly unreasonable. This is often set forth in a non-exclusive liquidated damages provision setting forth an agreed formula for determining the lessor's damages following a lessee default.

Remoteness of damage in the context of aircraft leasing (common law)

English common law places a further check on the ability of an injured party to recover contractual damages, where a loss results from a breach of contract that is deemed to be too remote. In order for damages to be recoverable, the loss claimed must either arise 'in the usual course of things' or 'may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract as the probable result of the breach of it'. In *Pindell Limited and BBAM Aircraft Holdings 98 (Labuan) Limited v AirAsia Berhad* [2010] EWHC 2516, the English courts examined the 'second limb' test for remoteness in the context of an aircraft leasing transaction. The court held that the loss of an onward sale of a 20-year-old Boeing 737-300 aircraft, owing to the late re-delivery of the aircraft by the lessee to the lessor, was not something which 'reasonable contracting parties in the shoes of [the parties] would, when making this contract, have had it in mind'. The court also highlighted that, on the proper interpretation of the contract against its commercial background, the loss of the onward sale was not something that the lessee had assumed responsibility for and, as such, the lessor was precluded from claiming damages for the loss of the future onward sale.

To offset risks as to a reduction in damages payable to a lessor as a result of a failure to mitigate loss or losses being deemed too remote, lessors may seek to draft express provisions in their lease that specifically address these points at the outset.

Under English law, one way this may be achieved is for a lessor to stipulate in its lease a predetermined amount of damages ('liquidated

damages') that will be payable by the lessee upon the breach of certain of the lessee's obligations under a lease.[8] Similarly, to address claims that a loss suffered may be too remote, a lessor may seek to include broad indemnification provisions that contemplate, at the outset, potential losses that may occur throughout the lease term or as a result of the leasing of an aircraft or both. It should be noted, of course, that the ability of a lessor to incorporate such terms will depend on the relative bargaining power it has as regards a potential lessee and will ultimately be a matter for commercial negotiation.

Under New York law and the UCC, the parties to a lease may include rights and remedies for default in addition to or in substitution for those provided for under the UCC, subject to the obligations of good faith, diligence, reasonableness and care mentioned previously, which cannot be disclaimed by agreement. In the case of liquidated damages clauses, these are permissible but only in an amount that is reasonable in light of the then-anticipated harm caused by default. If the parties to a lease desire to allow for the recovery of certain losses, such as lost profit on an onward sale or lease of an aircraft, they would be well advised to expressly provide for such recovery in the lease.

Conclusion

While there are some differences in the treatment of aircraft leases governed by New York law and English law, if due care is taken in the drafting of the lease and attending to all actions required to perfect and protect the interests created under the lease, it should be possible to accomplish the commercial and other objectives of the parties in an aircraft lease whether it is governed by New York law or English law.

Notes

1 The International Accounting Standards Board's 'IFRS16 Leases' takes effect in January 2019, which will change the basis for reporting of leases, including the requirement for lessees to report leases on balance sheets.

2 As a result of the United Kingdom's referendum result on its continued EU membership and the commencement of its exit from the EU, the future applicability of relevant conventions is not currently clear.

3 Council Regulation (EU) No. 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).

4 Other than Denmark, however, note that the 2001 Brussels Regulation (Council Regulation (EC) No. 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters) is directly effective in Denmark.

5 Such bilateral reciprocal enforcement treaties are implemented into English law by the Administration of Justice Act 1920, Part II, and the Foreign Judgement (Reciprocal Enforcement) Act 1933.

6 *Robinson v Harman* (1848) 1 Ex 850.

7 R Goode, *Commercial Law* (4th edn 2010) notes that 'this is not a positive duty at all, merely a factor limiting the recoverability of damages.'

8 Such liquidated damages must not be 'penal in nature'. *Cavendish Square Holding BV v El Makdessi and ParkingEye Ltd v Beavis* [2015] UKSC 67.

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