RECENT DEVELOPMENTS IN THE TRANSPORTATION LEASING AND FINANCE INDUSTRY IN THE US

In this article, we highlight recent trends, legislation, cases and developments in the United States pertinent to transportation equipment leasing and finance, in particular in connection with commercial law, aircraft and vessel finance issues.

As the rail-specific developments this year were relatively less significant than the aircraft and marine finance developments, we have not focused on rail finance issues in this article. Although this discussion is limited in scope, the highlighted developments are important for both US and non-US lessors and financiers who participate in the air and marine financing US market.

Commercial law: Getting rid of paper. As technology advances, the US transportation equipment industry trudges along. Electronic or digital signatures through services such as "DocuSign", and in some cases electronic (i.e. not papered) documents, have become increasingly popular due to their convenience and perceived security. This trend is especially prevalent with respect to vendor financings, and other financings that do not contemplate sophisticated transaction terms or significant negotiated changes, but it is not yet commonplace among other industry participants.

In the transportation finance sector, these practices are more likely to be used first in vehicle financing before becoming the norm in other transportation asset financings.

Financiers of transportation assets may be reluctant to change their approach from papering their transactions for practical reasons such as additional technology costs and service provider fees or concerns that electronically signed or documented transactions might be more difficult to sell or leverage in capital markets transactions. In many cases, financiers may be concerned about enforceability challenges given the lack of case law regarding enforcement of smart contracts.

Although more industry participants have been implementing digital signatures into their documentation processes, it is not yet commonplace. The Federal Aviation Administration (the "FAA") made an important but small step in 2016 by accepting "printed duplicates of electronic documents that display legible, digital signatures that are filed in compliance with Parts 47 and 49 of the FAA regulations."[1] While it is still not a true online filing system (as noted in our discussion of the FAA Registry modernisation below), it represents progress and is likely to be further modernised in the coming years.

Despite the lack of pertinent case law, it does not mean that digital signatures or smart contracts are unenforceable as both electronic signatures and electronic (only) documents are supported by Federal and state laws;[2] one of most important of these for transportation and other equipment financiers is the Uniform Commercial Code ("UCC").[3]

The UCC contemplates "records" to include "information that is…stored in an electronic or other medium and is retrievable in perceivable form."[4] and that a security assignee or transferee may obtain first priority over electronic records constituting "electronic chattel paper",[5] just as they might have such priority over tangible chattel paper. Determining what party has "control" of the electronic chattel paper pursuant to UCC § 9-105 can become more difficult, particularly as related legal opinions and representations and warranties in contracts rely on a number of assumptions that are largely unverifiable (i.e., control of electronic records stored in e-vaults).

There is also an emerging trend regarding "as a service" and "bundled transactions." These transactions contemplate that the customer will purchase immediate or future services, related supplies or licensed software, and may or may not be acquiring any interest in the asset.

As these and other evolving trends and technologies become more integrated into standard transactional practices, the laws implicated by those practices and transportation asset financing will also evolve. By way of example, a committee is currently studying whether further revisions should be made to the UCC to better address emerged and emerging technology and other market trends. Any related revisions to the UCC could have an impact on how future leasing and financing documents are executed, documented and interpreted.

Aircraft-related legislative and regulatory updates. *Liability safe-harbor legislation.* The FAA Reauthorization Act of 2018[6] (the "Reauthorization Act") was signed into law on October 5, 2018, part of which addressed certain vulnerabilities in the prior version of a federal liability "safe harbor" statute intended to protect passive aircraft owners, lessors and lenders.

Prior to the revision, certain state courts, such as the Supreme Court of Florida in *Vreeland v. Ferrer*,[7] interpreted the liability protection to exclude claims for the death or injury of passengers who were located *inside* an aircraft during a crash because the passenger was not "on land or water" but in the aircraft (even if the aircraft crashed on land or water). This exclusion was relied upon by the court in *Vreeland* when applying Florida's strict liability laws to hold a passive-lessor liable for the claim by the lessee/decedent's estate for damages relating to the crash.

The statute as now revised no longer requires that the subject injury occur "on land or water", thereby obviating that excuse in future cases that might have otherwise followed the *Vreeland* case.

The revised statute also clarified the "control" element of the statute for the benefit of passive lessors and other interest holders. Specifically, the statute now provides that a "lessor, owner, or secured party is liable for personal injury, death, or property loss or damage only when a civil aircraft, aircraft engine, or propeller is in the actual possession or *operational control* of the lessor, owner, or secured party …".[8] The prior version merely referenced "control", and plaintiffs often relied upon the non-specific nature of the term to make many imaginative arguments as to how a lessor or other party's conduct might constitute "control" as contemplated in the statute. As revised, the statute references "operational control", which term is defined in 14 C.F.R. § 1.1 as "... the exercise of authority over initiating, conducting or terminating a flight."

FAA modernisation, DOT IG report and aircraft registration concerns. The US Department of Transportation ("DOT") Inspector General ("IG") has recently reviewed the FAA's management of the Civil Aviation Registry (the "Registry") in

connection with the FAA Modernization Act of 2012,[9] and the IG issued its report (the "Report") on May 8, 2019.[10]

The objectives sought by Congress when requesting the IG's audit were to assess the FAA's "(1) progress in modernising the Registry and (2) policies for providing public access to Registry-related activities."

The Report notes numerous challenges facing the FAA to achieve modernisation of the Registry by October 2021 which is the Congressional mandated deadline for completion as a result of the Reauthorization Act. Among others, the IG noted outdated software, lack of real-time registration information, paper-based submission process and back-log of registration submission.

Of particular interest to business aircraft and individual owners wishing to register their aircraft on the Registry is the increased focus on the accuracy of the information submitted to the Registry by prospective applicants. In that regard, the Report notes that additional security controls may be introduced into the Registry processes, which may include "requiring aircraft owners to submit additional information, cross-checking aircraft registration with non-DOT databases prior to acceptance, or using business intelligence software to detect errors in applications."

The focus on transparency regarding the "ultimate" owner of each "N" registered aircraft may be attributed, at least in part, to certain news accounts over the past few years highlighting what were characterised as abusive use of ownership trusts, especially non-citizenship trusts ("NCTs").

There have also been legislative and agency initiatives to address resulting concerns that current registration practices, including the use of NCTs, may facilitate criminal activity, terrorism or sanction violations by hiding the true identity of an aircraft owner. The Report notes that a second audit will also be conducted in connection with Congress's concerns "over the accuracy and completeness of the Registry information and its compliance with Federal law."

The industry will be monitoring this situation and advocating for a balanced approach to these registration concerns so that any new requirements not impose overly intrusive or impractical information gathering responsibilities either for the Registry or registration applicants.

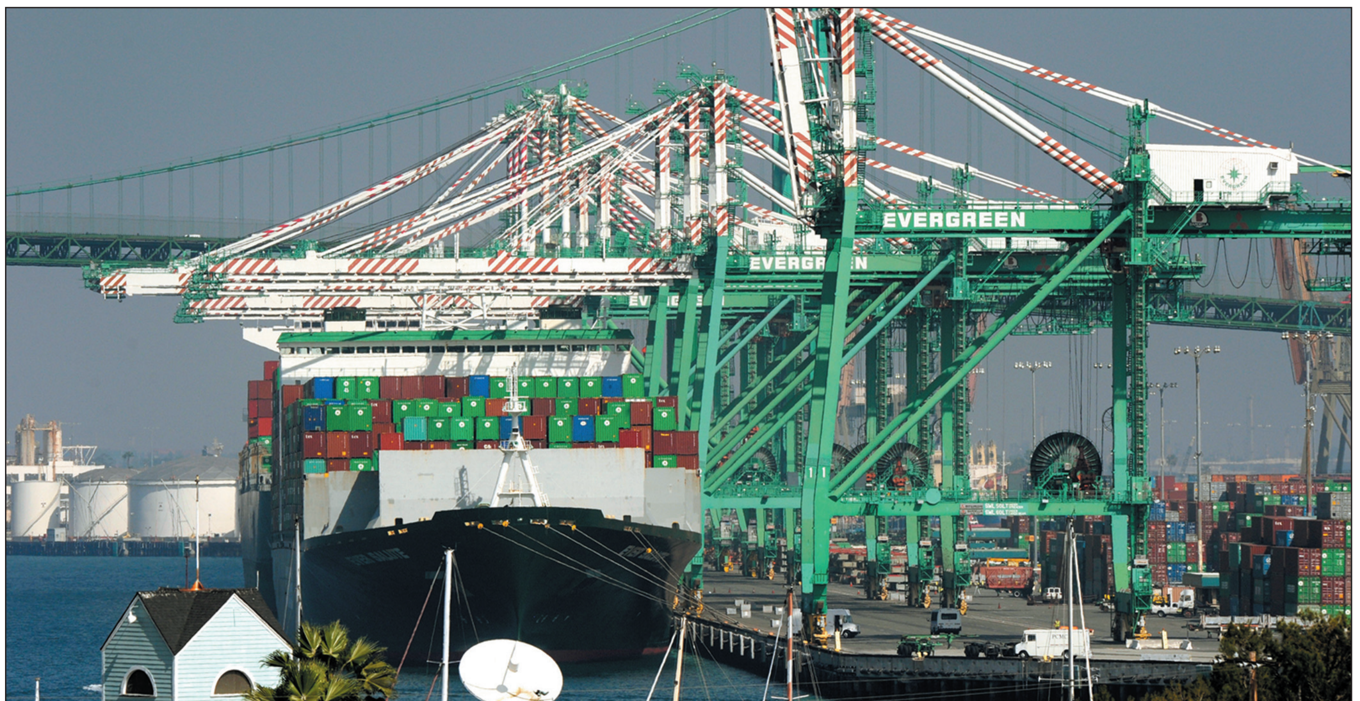
Gray chartering. The Federal Aviation Regulations ("FARs") regulate business and personal use operations under Part 91, and compensated transportation operations under Part 135.

Part 135 operations require an air carrier certificate and are more stringent. Part 91.501 permits transportation of affiliated users and guests, but subject to operational control, compensation and other limitations. Customers that operate under Part 91 sometimes mistakenly or otherwise engage in illegal or "gray" chartering by making the aircraft available to related or unrelated parties and being compensated in amounts exceeding the limits provided in Part 91. Examples include, "flight department company" SPE operators, illegal dry leases of aircraft and crew, and excessive timeshare agreements.

The FAA has recently been pursuing investigations and enforcement against violators. One of the most salient examples of the FAA's recent focus on enforcement against gray chartering operations was the proposed US$3.3m civil penalty against The Hinman Co.[11] which was referred to the US attorney's office.[12]

Lenders and lessors should take care to perform due diligence on any management or charter companies that are used to operate their aircraft as violation of such regulations can lead not only to significant fines, but also unanticipated taxes and invalidation of insurance coverage, among other undesirable outcomes.

Notable cases. *The Republic case.* The Southern District of New York's bankruptcy court's decision in the Republic Airway's



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bankruptcy case released earlier in 2019 in *In re Republic Airways Holdings Inc.*[13] has precipitated ongoing discussion and concern for US aircraft and other equipment lessors.

The court in this case did not uphold a stipulated loss value ("SLV") based liquidated damages remedy in its seven leases with the lessor, but instead held that this particular remedy was unreasonable because it shifted the decline-in-value risk to the lessee during the term of the lease.

It is noteworthy that the liquidated damages formula in the remedy provisions of the leases had been negotiated by both of the sophisticated parties in this transaction, and is recognised under UCC § 2A-504. However, the lessee argued and the court agreed, that the liquidated damages formula in the leases was unreasonable and therefore unenforceable because there was a significant, but unanticipated, decline in value of the aircraft since lease inception, and the disposition proceeds were insufficient to reduce the liquidated damages amount. In doing so, the court relied upon enforceability tests from pre-UCC Article 2A precedent that were overridden when UCC § 2A-504 was enacted.

In addition, contrary to New York precedent, the court refused to enforce the guarantor's absolute and unconditional guaranties of the lessee's obligations under the related leases because the court deemed that the liquidated damages formula to be invalid and unenforceable for public policy reasons.

Although the holding of this case seemed to contradict settled law and legal commentary,[14] it does serve as a reminder that US courts are reluctant to uphold any provisions which can be viewed as punitive to lessees or creating a windfall for lessors. Not only should prudent lessors take care to include a specific formula in liquidated damages provisions, but they should also consider whether there are appraisals and/or other support, to establish that any liquidated damages amounts from such formulas are reasonable in light of the anticipated harm caused by the default.

Other cases. The case of *Huntington National Bank v. Bristow U.S. LLC*[15] involved a dispute regarding the conditions to be complied with by a lessee when returning a helicopter at lease expiration. The lessor claimed that the lessee failed to comply with these conditions by failing to enroll the helicopter's engines in an engine maintenance programme. The court denied the lessor's motion for summary judgment regarding the alleged non-compliance because the return provisions of the lease did not clearly provide how or when the lessee was to fulfil its obligation to arrange for such enrollment.

Given the reliance by lessors on the residual value of the leased aircraft assets to achieve their investment purposes, the risk of imprecision is especially great when documenting these requirements.

The most recent decision in *Escobar v. Nevada Helicopter Leasing, LLC,*[16] is one of the first after enactment of the amendment of the "safe harbor statute"[17] discussed above. In this decision, the Ninth Circuit reversed summary judgment and sent the case back to the United States District Court of the District of Hawaii for further review.

Following a deadly helicopter crash, the widow of one of the deceased sued the lessor. Contrary to the *Vreeland* case, the district court in this case had previously granted summary judgment in favour of the lessor as it found that the safe harbor statute pre-empted state claims, and that because the helicopter was not in the actual possession or control of the lessor at the time of the crash, the case should be dismissed against the lessor.

However, in 2019 the Ninth Circuit found that there was an issue of material fact as to whether or not David Chevalier (who is owner of both the lessor and lessee) and other lessee employees were acting as agents of the lessor and actually exercised control over the helicopter when it crashed.

The Ninth Circuit also expressly referenced the recent change to the safe harbor statute in a footnote and instructed the district court to consider whether the amendment adding the word "operational" to control altered or merely clarified the exception to the lessor's liability and whether such change should have any effect on this case.

Although this is a case that lessor and lenders should follow closely, particularly as to whether any analysis is made as to the revised safe harbor statute, it mainly serves as a reminder that courts will not hesitate to "pierce the corporate veil" in the interest of public policy.

Maritime updates. The last year has seen a number of significant developments in shipping. Hopes for an industry-wide recovery were frustrated by the approaching deadline for compliance with new environmental requirements and the escalating trade war between the United States and China.

Shipping struggled to prepare for the implementation of amendments to Annex VI to the International Convention for the Prevention of Pollution from Ships (MARPOL) designed to reduce sulfur oxide (SOx) emissions from ships by lowering the maximum sulfur content of fuel oil used on ships outside of designated emission control areas from 3.5% m/m (mass by mass) to 0.50% m/m beginning January 1, 2020.

Uncertainty about the future cost and availability of low-sulfur fuel oil, combined with the ability to satisfy the new requirements by using exhaust gas cleaning systems, more commonly referred to as "scrubbers," to reduce SOx emissions from burning high-sulphur fuel oil, prompted many shipowners to order scrubbers as a means of complying with the new requirements.

A number of important international ports then acted to ban the use of so-called "open-loop" scrubbers in which SOx and other pollutants removed from ship exhaust emissions are discharged overboard and this, combined with improved visibility into the future cost and availability of low-sulfur fuel oil and the difficulty of financing the installation of scrubbers on ships with existing mortgages, resulted in many shipowners abandoning their plans to install scrubbers and planning instead to comply with the new requirements by requiring charterers to purchase more expensive low-sulphur fuel oil.

On the trade front, the uncertainty surrounding the expanding application of tariffs by the United States and China also had a deleterious effect on shipping. Concerns that a prolonged trade war between the world's two largest economies could dramatically reduce the amount of goods transported by sea and slow worldwide economic growth dampened the prospects of any meaningful recovery in an industry still struggling to recover from

the effects of the financial crisis a decade earlier and the excessive ordering of newbuild vessels that followed.

Notes:

The authors would like to thank their colleague, John Imhof Jr., who contributed the maritime update in this article. Please note that the content of this article has been updated through September 9, 2019. In addition, the article represents the views of the authors only, and it does not necessarily represent the views or professional advice of Vedder Price P.C.

1 *Notice of Policy Clarification for Acceptance of Documents with Digital Signatures by the Federal Aviation Administration Aircraft Registry*, 81 FR 23348 (April 20, 2016).
2 *See e.g., The Electronic Signatures in Global and National Commerce Act*, 15 U.S.C. 96; Uniform Electronic Transactions Act (2009) ("UETA") (enacted in 47 states); New York Electronic Signatures and Records Act, N.Y. Technology Law, Art. 3.
3 The UCC, like the UETA, is a model state statute, the provisions of which have been adopted in almost all material respects by all fifty states in the US. The "uniform" nature of these commercial laws relating to, among other things, sales, payment instruments, suretyships, consignments, leases and security interests (including the sale of various payment rights), have made it easier for parties in a particular state to transact with parties in other states. The version of the UCC adopted in New York is often relied upon by parties in cross-border transactions (even if not involving US parties) to address most of the fundamental commercial issues relating to New York law governed documents. The UCC also serves as the model for many of the correlative provisions of the Cape Town Convention and its related mobile asset-specific Protocols.
4 UCC § 9-102(70).
5 UCC § 9-102(31).
6 *FAA Reauthorization Act of 2018*, Pub. L. No. 115-254, 132 Stat. 3186 (2018).
7 *Vreeland v. Ferrer*, 71 So.3d 70 (Fl. 2011).
8 49 U.S.C. § 44112 (emphasis added).
9 *FAA Modernization and Reform Act of 2012*, Pub. L. No. 112-95, 126 Stat. 11 (2012).
10 *FAA Plans to Modernize Its Outdated Civil Aviation Registry Systems, but Key Decisions and Challenges Remain*, (OIG Report No. AV-2019-052), May 8, 2019.
11 https://www.faa.gov/news/press_releases/news_story.cfm?newsid=22874.
12 *United States of America v. The Hinman Company*, 1:18-cv-01140 (W. D. Mich. filed Oct. 4, 2018); this case appears to have been settled and terminated as of August 21, 2019.
13 598 B.R. 118 (Bankr. S.D.N.Y. Feb. 14, 2019).
14 The parties ultimately settled this case after the lessor filed its notice of appeal, perhaps indicating that the lessee realised that the decision could be vulnerable if appealed.
15 2019 WL 1004218 (S.D.N.Y. March 1, 2019).
16 756 Fed. Appx. 724 (9th Circ. 2019).
17 49 U.S.C. § 44112.

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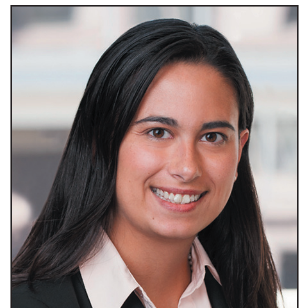

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