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Insights

ENGINE LEASING, THE FUNDAMENTALS - LEGAL RISKS AND THE CAPE TOWN CONVENTION

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SUMMARY

In our previous article Engine Leasing, the Fundamentals – What is the Attraction?, BCLP's global aviation team discussed the appeal of engine leasing to investors and the economic considerations which influence decisions made by investors in this asset class. In this, the second of a four part series focussing on engine leasing and financing, BCLP's global aviation finance team considers the legal risks associated with engine leasing and the mitigating impact that the Cape Town Convention has had on those risks.

Spare aircraft engines are highly mobile assets, leased for the sole purpose of coming off and going on aircraft, both within the immediate operator's fleet and (if permitted) to certain affiliates within their group (via pooling arrangements or subleasing) and/or other airlines via permitted subleasing arrangements. Ensuring contractual operation restrictions are tight is essential, as is monitoring the aircraft engine location to ensure that the lessor/owner protections afforded by the lease are being maintained. Below we explore common protections for aircraft engine lessors and financiers.

The risks

It is usually not possible to register or record ownership of an aircraft engine separately from the airframe on which it is installed. If available, such a registry can potentially assist with not only identifying ownership (separate from the airframe on which it is installed) but also assist in resolving the thorny legal point about whether or not an aircraft engine, when installed on an airframe, forms part of that airframe and by reason of its installation becomes the property of the owner of the airframe and subject to any mortgage granted over that airframe (this is the case under Dutch law, for example).

Under English law this argument follows the distinction made between fixtures and fittings in determining ownership rights and which depends largely on a determination of whether an object is

capable of being removed from the property on or in which it is installed, without doing significant harm to that property or the utility of that property (commonly known as the "doctrine of accession").

In the case of aircraft engines, which are, by their nature, routinely installed and taken off-wing across various airframes depending on operational requirements over their lifetime, and taking into account the independent cost of an engine and the ability to assess, separate to the airframe, the maintenance-adjusted value of an engine, you might think it appropriate that an aircraft engine – perhaps unlike a ship's engine – should be regarded as a "fitting" and therefore its ownership should remain separate from the ownership of the airframe on which it is installed at any given time. The aircraft financing and leasing market has not generally taken to adopting such separate ownership arrangements applying to aircraft engines, notwithstanding that lease agreements would customarily include provisions to allow (i) for title swapping, (ii) title tracking and (iii) recognition of rights arrangements as between the owners of airframes on which off-wing aircraft engines are installed.

This lack of certainty from one jurisdiction to another about aircraft engine ownership rights (and therefore any security taken over those rights), with the attendant risk of loss of priority for engine lessor/financiers against competing/superior claims to the engine under any relevant applicable national law, only added to the historic disparities in the ability of cross border lessor/financiers to enforce recovery rights (whether to engines or total loss proceeds) without obtaining prior consent of the court in the debtor airline's jurisdiction; a process that might be both expensive and time consuming.

Until the advent of the CTC (see below) the lack of easily identified and recognised ownership and security interests in engines (coupled with the uncertainties of title tracking/title accession regulations around the world) limited the ability of owners to use spare engines as collateral for loans. As we note below, this issue has been substantially mitigated in CTC member jurisdictions but investors and financiers of engines must factor in the risk that at the time of default the engine is located either (i) in a non-CTC State whose national laws reduce their priority or prevent the prompt exercise of their rights of possession by making it prohibitively expensive or impossible to pursue repossession or (ii) in a CTC State which does not fully implement the CTC principles of enforcement without local court sanction (as discussed in more detail in below).

Additional risks arise when an engine is in the possession of a maintenance, repair and overhaul facility ("MRO"). Should an owner/lessor seek to repossess the engine it will not only have to ascertain where the engine is but what condition it is in. MRO's will generally have possessory lien rights arising as a matter of law which allow them to retain possession for unpaid bills – and in some cases not just unpaid bills in relation to a specific engine but to all unpaid bills of the same owner/lessor or lessee. This is not, perhaps, any greater risk than an owner/lessor or lender faces with aircraft that are in the hands of an MRO. This risk has traditionally been mitigated by the requirement in leases for security deposits, maintenance reserve payments or in lieu of such cash

payments, standby letters of credit which can be applied or drawn on to meet the anticipated costs of scheduled maintenance visits. If security deposits or Letters of credit for maintenance reserves are not agreed leases will usually allow a lessor to pay the MRO itself, in order to release the lien, and then make a claim against the lessee under the lease's indemnity provisions.

Cape Town Convention

The Convention on International Interests in Mobile Equipment and the associated Protocol on Matters Specific to Aircraft Equipment, Cape Town 2001 (the "CTC") applies to certain types of engines. For the purposes of the CTC:

"aircraft engines" means aircraft engines (other than those used in military, customs or police services) powered by jet propulsion or turbine or piston technology and:
(i) in the case of jet propulsion aircraft engines, have at least 1750 lb of thrust or its equivalent; and
(ii) in the case of turbine-powered or piston-powered aircraft engines, have at least 550 rated take-off shaft horsepower or its equivalent,
(iii) together with all modules and other installed, incorporated or attached accessories, parts and equipment and all data, manuals and records relating thereto.

The CTC introduces a security-style interest registered as an international interest in aircraft engines (but note that the CTC does not create any property right in the aircraft engines to which it applies). Interests in those aircraft engines can be registered on the international registry under the CTC although the CTC will not apply to an aircraft engine if the only nexus to the CTC is registration of the aircraft on the national aviation registry of a contracting state. The connecting factor which will establish whether an international interest in an "aircraft engine" can be registered is whether the debtor (owner/lessee) of the engine is located in a Contracting State. The CTC establishes a legal regime which allows engine creditors (which would include financiers and lessors) to enforce certain remedies upon their defaulting debtors. To be so eligible a creditor has to register an 'international interest' in the engines pursuant to the CTC; and the way the relevant Contracting States respect international interests in their debtor's insolvency proceedings is how international interests are recognised and enforced.

Although the CTC should in practice assist in mitigating risks, its effectiveness can be stymied by national courts and aviation aircraft registration authorities unfamiliar with the content and scope of the CTC's jurisdictional rules. In addition practical issues, particularly access to location and condition/status of aircraft and aircraft engines and technical records will always be relevant to effective outcomes.

While the CTC is the best risk reduction/mitigant for all counterparties, practical experiences in Brazil, India, Nigeria and China reveal institutional bias in favour of pre-CTC national law and often places CTC States in violation of international law. The lack of an international authority to adjudicate disputes leaves interpretation and enforcement to local institutions that might continue to be unfamiliar with the CTC rules. We note however that the practical problems associated with

the implementation of the CTC and ascertaining the condition and status of the engines and technical records are equally applicable to aircraft leasing and financing so should not be regarded as problems peculiar to aircraft engine leasing and financing.

A compliance index has now been formulated to assist engine owner/investors in their appraisal reviews of engine users in CTC contracting states and can be found on the Aviation Working Group website.

Conclusion

Engine financiers and lessors need to navigate through the jurisdictional maze of engine title tracking, enforcement and repossession pathways. Engine financiers should conduct due diligence of applicable national laws in the multiple jurisdictions in which the asset may from time to time be based. Relevant jurisdictions may include jurisdictions where the engine is located when on-wing, on a shop visit or stored with an MRO or operator. Such due diligence should (i) consider what steps a financier or lessor must take with regard to protecting its priority and recovery interests, (ii) scrutinize any applicable CTC set of declarations and (iii) include obtaining relevant local legal opinions in key jurisdictions.

In CTC jurisdictions engine financing and leasing can now present less risks than those jurisdictions where financiers and lessors are wholly reliant for recognition and enforcement on national laws for remedies on default and insolvency.

In the next instalment of “Engine Leasing and Financing, the Fundamentals” BCLP’s global aviation finance team will consider additional steps and protections that can be implemented in order to mitigate the risks associated with engine leasing and financing.

RELATED PRACTICE AREAS

- Aviation Finance
- Transport & Asset Finance

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