

**QUEST FOR AIRCRAFT FINANCING: AN APPRAISAL  
AND EXPOSITION OF THE EMERGING LEGAL  
CHALLENGES AND LIMITATIONS IN THE CONTEXT  
OF KENYAN LAW**

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**DECLARATION**

**I, WILSON KAHORO MURAGE**, do hereby declare that this thesis is my original work and has not been submitted, and is not currently being submitted for a degree in any other University.

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DATE: .....

This thesis has been submitted for examination with my approval as University Supervisor

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## **DEDICATION**

*To my son Brian Murage – for his steady passion for aircraft*

## **ACKNOWLEDGEMENTS**

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To all those who have in one way or another supported me in this work, I say thank you and may God richly reward you.

Above all, I thank the Almighty God from whom all blessings flow.

To God be all the glory!

**LIST OF ABBREVIATIONS**

ASU-----	Aircraft Sector Understanding
CAA-----	Civil Aviation Act (No. 21 of 2013, Laws of Kenya)
ECA-----	Export Credit Agency
EETC-----	Enhanced Equipment Trust Certificate
ETC-----	Equipment Trust Certificate
IAS-----	International Accounting Standard
ICAO-----	International Civil Aviation Organization
IDERA-----	Irrevocable De-Registration and Export Authority
IATA-----	International Air Transport Association
KCAA-----	Kenya Civil Aviation Authority
LTV-----	Loan to Value Ratio
OECD-----	Organization for Economic Co-operation and Development
PDP-----	Pre-Delivery Payment
PTC-----	Pass-Through Certificate
UNCITRAL-----	United Nations Commission on International Trade Law
UNIDROIT-----	International Institute for the Unification of Private Law
US-----	United States of America



## **LIST OF INTERNATIONAL INSTRUMENTS**

1. Charter of the United Nations
2. Convention on International Civil Aviation (Chicago, 1944)
3. Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Cape Town, 2001)
4. Convention for the Unification of Certain Rules Relating to International Carriage By Air, Warsaw 1929
5. Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment and Regulations and Procedures for the International Registry
6. Rome Convention on the Law Applicable to Contractual Obligations, 1980
7. Vienna Convention on the Law of Treaties

## **LIST OF STATUTES AND LEGAL INSTRUMENTS**

1. Admiralty Act 1988 (Cth), Australia
2. Bills of Exchange Act, (Cap.27, Laws of Kenya)
3. Chattels Transfer Act (Cap. 28, Laws of Kenya)
4. Civil Aviation Act (No. 21 of 2013, Laws of Kenya)
5. Civil Aviation (Cape Town Convention and Other Matters) Amendment Act, 2010 New Zealand
6. Companies Act (Cap. 486, Laws of Kenya)
7. Constitution of Kenya, 2010
8. Customs and Excise Act (Cap. 472, Laws of Kenya)
9. German Mortgage Lending Act, 2009
10. Income Tax Act (Cap. 480, Laws of Kenya) and Income Tax (Leasing Rules) 2002
11. International Interests in Aircraft Equipment Act (No. 27 of 2013, Laws of Kenya)
12. International Interests in Mobile Equipment (Aircraft Equipment) Act, 2005, Canada
13. International Interests in Mobile Equipment (Cape Town Convention) Act 2005, Ireland
14. Sale of Goods Act (Cap. 31, Laws of Kenya)
15. United States Bankruptcy Code



## LIST OF CASES

1. *Amin Rasheed Shipping Corporation v Kuwait Insurance Company* (1984) AC 50.
2. *Blue Sky One Limited & Others v Mahan Air & Others* [2010] EWHC 631 (Comm)
3. *Celestial Aviation Trading 71 Limited v Paramount Airways Private Limited* [2010] EWHC 185 (Comm)
4. *Corocraft Ltd v Pan American Airways Inc* [1969] 1 QB 616.
5. *Foscolo, Mango & Co Ltd v Stage Line Ltd* (1932) AC 328.
6. *Fothergill v Monarch Airlines Ltd* [1981] AC 251.
7. *Fullerton Nominees Pty Ltd v Darmago* [2000] WASCA 4 (Unreported).
8. *Giella v Cassman Brown* [1973] E.A.359
9. *Howard v Shirlstar Container Transport Ltd* [1990] 3 All ER 366; [1990]1 WLR 1292 (CA).
10. *James Buchanan & Co Limited v Babco Forwarding & Shipping (UK) Ltd* (1978) AC 141.
11. *Kuwait Airways Corporation v Iraqi Airways Company and Others* [2002] UKHL 19.
12. *League* (1979) 143 CLR 190.
13. *Lemenda Trading Co Ltd v African Middle East Petroleum Co Ltd* [1988] QB 448.
14. *Miller v Cook* 1870 L.R. 10 Eq 641
15. *Minister for Foreign Affairs v Magno* (1992) 37 FCR 298 (FC).
16. *Oppenheimer v Cattermole (Inspector of Taxes)* [1976] AC 249.
17. *Owings v. Norwood's Lessee*, 9 U.S. (5 Cranch) 344, 348 (1809)
18. *R. v. International Trustee for the Protection of Bondholders A/G.* [1936] 3 All E.R. 407 (C.A).
19. *Re United Railways of Havanna* [1961] AC 1007.
20. *Re Anglo-African Steamship Co* (1886) 32 Ch 348.
21. *Santley v Wilde* [1899] 2 Ch.474
22. *SS Pharmaceutical v Qantas* [1991] Lloyds Rep 288.
23. *Scruttons v Midland Silicones Ltd* [1961] 2 Lloyd's Rep 365.
24. *Shipping Corporation of India Ltd v Gamlen Chemical Co A/Asia Pty Limited* (1980) 147 CLR 142.
25. *Slavenburg's Bank NV v International Natural Resources Limited* [1980] All ER 955; [1980] 1 WLR 1076)
26. *Sykes v Cleary* (1992) 176 CLR 77.
27. *The Bremen v Zapata Offshore Co* 407 US 1 (1972).
28. *The Hollandia* (1982) 1 QB 872 at 885.
29. *The Rose Mary* [1953] 1 WLR 246.
30. *Tzortzis v. Monark Line A/B,* [1968] 1 W.L.R. 406 (C.A.).
31. *Vita Food Products Inc. v. Unus Shipping Co. Ltd.,* [1939] A.C. 277 (P.C.).
32. *Whitworth Street Estates (Manchester) Ltd. v. James Miller & Partners Ltd.* [1970] A.C. 583.

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## CHAPTER ONE

### 1.0 LAYOUT AND DESIGN OF THE STUDY

#### 1.1 BACKGROUND OF THE STUDY

It is argued that Africa has the second oldest aircraft<sup>1</sup> fleet, behind the fleet in Russia and Central Asia and this fleet is in need of replacement<sup>2</sup>. Aircraft manufacturer Boeing's 20-year market forecast indicates that between 2008 and 2027, driven by economic growth of 5.1 annual average Gross Domestic Product growth and the need for replacing the old aircraft, African airlines will need 560 new aircraft valued at about United States Dollars 60 billion.<sup>3</sup>

In addition, aircraft manufacturer Airbus<sup>4</sup> postulates that increasing trade ties and an inflow of tourists from Europe, China, the Middle East and North America to Africa is expected to generate huge demands for new aircraft in the coming decades. Airbus forecasts that Africa will need 640 new aircraft in the next 20 years. Logically, Kenya will demand for its share in the acquisition of the new aircraft. Already Kenya Airways Limited in its fleet expansion plan has intimated the desire to acquire additional new and modern aircraft.<sup>5</sup>

The situation in Africa is changing. Countries such as Egypt, Nigeria and Morocco have deregulated their domestic market. As a result, many new operators are coming to the market and these new operators require new aircraft for their operations. Air Cemac<sup>6</sup>, Asky Airlines<sup>7</sup> and Star Equatorial<sup>8</sup> are some of the new regional carriers established in Africa. The

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<sup>1</sup> An aircraft is defined in section 2 (1) of the Kenyan Civil Aviation Act (No. 21 of 2013, Laws of Kenya) to mean “*any machine that can derive support in the atmosphere from the reactions of the air, other than reactions of the air against the earth’s surface, and includes all flying machines, aeroplanes, gliders, seaplanes, rotocrafts, airships, balloons, gyroplanes, helicopters, ornithopters and other similar machines but excludes state aircraft*”. State aircraft is defined by that Act as “*an aircraft used in military, customs and police services of Kenya or of any other state or any other civil registered aircraft at the time performing a state function and fully converted to offer services to heads of states, military service, customs or police or to any other states*”.

<sup>2</sup> See Kaleyesus Bekele reporting on the financial trend on Saturday, 9<sup>th</sup> January 2010 article entitled *Quest for aircraft financing in Africa* published in the Ethiopian Reporter:

[http://en.ethiopianreporter.com/index.php?option=com\\_content&task=view&id=2134&Itemid=1](http://en.ethiopianreporter.com/index.php?option=com_content&task=view&id=2134&Itemid=1)  
<accessed on 27<sup>th</sup> March, 2012>.

<sup>3</sup> *Ibid*

<sup>4</sup> Appendix I on key aircraft manufacturers and financiers.

<sup>5</sup> See press release by Kenya Airways on its website at [http://www.kenya-airways.com/contentdisplay\\_corporate.aspx?id=2740&nmi=84&LangType=1033&ekfxmen\\_noscript=1&ekfxmen\\_sel=e5782b6a3\\_33\\_34](http://www.kenya-airways.com/contentdisplay_corporate.aspx?id=2740&nmi=84&LangType=1033&ekfxmen_noscript=1&ekfxmen_sel=e5782b6a3_33_34) <accessed on 11<sup>th</sup> November, 2013>.

<sup>6</sup> Air Cemac is the Central African Economic and Monetary Community (CEMAC) joint airline. In 2001, the decision to create a sub-regional joint airline mainly privately held air transport company was taken following the conference of Head of States of the CEMAC held in Cameroon. Air Cemac was operationalized later 2008 as an initiative to facilitate mobility of people and goods within the community area of South Africa.

<sup>7</sup> Asky Airlines is a passenger airline with its head office in Lome, Togo. It was founded in 2008 by Ethiopian Airlines which held 40 per cent of the stake in the company.

<sup>8</sup> Star Equatorial is a recently established airline that is based in Equatorial Guinea.

economic situation in Africa is improving. Several African countries are registering significant economic growth. 4 of the top 20 world oil producing countries are found in Africa and the economic growth forecast is at 5.1 per cent. It is recorded that the political situation in Africa is improving and all these factors are positively contributing to the development of the airline industry.<sup>9</sup> Growth in passenger traffic, oil price hike and environmental regulations related to carbon emission has prompted the demand for new fleet.

In the aviation sector, forms of commercial financing include secured bank loans, operating leases, and public debt issues secured by aircraft (in particular, enhanced equipment trust certificates (EETC)). In addition to commercial financing, governmental export credit agencies (ECAs) provide export credit financing support either in the form of direct export credit loans or export credit guarantees that support commercial financing. In some cases manufacturers also provide financing.

Amidst the persistent demand for modern and cost effective aircraft, the question that has baffled many airlines is how to effectively finance the acquisition of new aircraft. The solution is quite often aircraft financing.<sup>10</sup> Essentially, the aircraft itself, along with the income it generates, is used as security against a loan advanced in respect of its acquisition.

## **1.2 STATEMENT OF THE PROBLEM**

A key component in the growth of the airline industry is the availability of capital to finance aircraft transactions. Airlines and businesses wishing to own or operate aircraft, as well as commercial operators, all require capital to purchase and/or lease aircraft. Aircraft are

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<sup>9</sup> As reported in Airfinance Journal in June 2012, the African aviation market is growing at a rapid rate. This looks set to continue for the foreseeable future with Boeing forecasting that Africa will need 710 new aircraft (worth about US\$80 billion) in the 20-year period to 2029 and Airbus suggesting a figure of 1,270 new aircraft for the same period. Growth is being led through demand for aircraft from both of these established players. Ethiopian Airlines, South African Airways and Kenya Airways are expanding and modernising their fleets, as well as more recently established airlines breaking into the market, such as Arik Air in Nigeria, Fly540 in Kenya and 1Time in South Africa. International banks, international leasing companies and regional African banks are all demonstrating an interest in investing in the aviation sector. Since traditional financing such as commercial debt or finance leases is increasingly difficult to access, much of the financing for these aircraft is by way of export credit agency financing, together with support from the development banks such as African Export Import Bank (Afrexim). Earlier in 2012, Afrexim announced its intention to underwrite aircraft acquisitions for African carriers in 2012.

<sup>10</sup> Simply defined, aircraft finance refers to financing provided to a person for the purchase and operation of an aircraft.

expensive assets<sup>11</sup> and airlines typically do have low margins. As a result not many airlines can afford to pay cash for the purchase of an aircraft. Airlines thus use one, or a combination, of various sources and techniques such as aircraft financing to finance the acquisition of the aircraft. Aircraft finance transactions are global in nature and more often involve more than one jurisdiction or country. As such, without an efficient and effective international private legal regime, this poses challenges to creditors and debtors in an aircraft finance transaction on enforcement of available remedies.

An aircraft is a highly mobile asset which traverses countries and continents fast and within a very short period of time. This possesses huge challenges to a lender who is financing or funding an airline or operator and the aircraft is the main collateral. Why? In the event a default arises, repossession of an internationally mobile asset has limitations and the situation is aggravated if a difficult debtor is involved. The problem in situations where an aircraft is the chief collateral are accelerated by the fact that an aircraft is a depreciating asset with a highly diminished resale value and highly prone to acts of terrorism. Moreover, the fact that an aircraft does not have title or a single ownership document brings about the problem of uncertainty of title which negatively impacts on securitization and security by deposit of title.

### **1.3 EMERGING ISSUES FOR THE STUDY**

There are various specific emerging legal challenges and issues of concern touching on aircraft financing which our study wishes to address. These are:

#### **1.3.1 Challenges in obtaining security over an internationally mobile asset/chattel**

One such issue is how a financier can obtain a valid security over an asset that is mobile, that is, an asset that moves from one country or jurisdiction to another within a very short time span. It is important to consider the best way to structure the transaction so as to minimize risk and maintain the value of the asset particularly where the aircraft may be registered in one jurisdiction but operate in another, while the owner and its business are registered in yet another jurisdiction. In the study we have considered the modalities of obtaining a valid security interest in a mobile asset and the challenges that relate to this.

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<sup>11</sup> See Boeing website where as at July 2013, a Boeing 777-300ER was priced at about 315 million United States Dollars.



### 1.3.2 Determination of applicable law and jurisdiction and the issue of political risk

Jurisdictional issues and the considerations for choosing the country in which to register the aircraft and interests over an aircraft is a concern in aircraft financing. The choice of the country on which to register an aircraft is particularly important because it is usually the laws of that country (or state) which govern recognition of ownership and mortgage interests in an aircraft in addition to its operational and maintenance requirements. In some countries, aircraft registers<sup>12</sup> are subject to political interference, and in others they can only be altered by a specific person(s) or organization<sup>13</sup>. In either case, it may be difficult to deregister an aircraft if the airline defaults on payment or if in certain cases there is need to de-register an aircraft.

The jurisdiction where an aircraft is registered is also an important aspect in aircraft financing due to the varying financial and legal structures from one country to another and whether the jurisdiction in which the aircraft is registered actually has an effect on the legal framework for registering a mortgage over an aircraft. The study has examined the issue of jurisdiction and how the same affects validity and enforcement of security interests over aircraft. The study has also examined the role of the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (the “Convention”) on this subject. The study has also

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<sup>12</sup> The Register of Aircrafts in Kenya contains the following particulars:

- (a) the number of the certificate of registration of the aircraft;
- (b) the nationality mark and registration mark assigned to the aircraft by the Director-General of KCAA;
- (c) the name of the manufacturer of the aircraft and its designation;
- (d) the serial number of the aircraft;
- (e) the name and address of every person who is entitled as owner to a legal, or beneficial, interest in the aircraft or a share therein; or, in the case of an aircraft which is the subject of demise charter or hire - purchase agreement, the name and address of the charterer or hirer; and
- (f) in the case of an aircraft registered in the name of an unqualified person or charterer, an indication that it is so registered.

Although not specifically mentioned in the CAA, in practice the KCAA also notes the following particulars in the Register: the weight of the aircraft; the number of engines on the aircraft and the expiry date of the Certificate of Airworthiness (once this has been issued).

<sup>13</sup> In Kenya, the Air Navigation Regulations under the repealed Civil Aviation Act (Cap. 394) provided that the KCAA may amend the Register of Aircrafts whenever it considers it necessary or appropriate for giving effect to the Regulations dealing with the registration and marking of aircraft or for bringing it up to date or to correct any registered particulars. The registered owner of the aircraft must inform the Director-General of:

- (a) any change in the registered particulars;
- (b) the destruction of the aircraft or its permanent withdrawal from use;
- (c) in the case of an aircraft chartered by demise, the termination of the demise charter;
- (d) in the case of an aircraft the subject of a hire-purchase agreement, the termination of the hire-purchase agreement.

It should be noted that the Register is updated yearly. However, the licensing office notes the daily changes in a Master Register.

exposed limitations and deficiencies under the Convention particularly where the security interest is created in a country that is not a contracting state under the Convention.

The question of which laws would be applicable is an important issue in determining the registration of interest over aircraft and security matters associated with the same. Financing of aircraft typically involves many different jurisdictions and so, the question of which law applies in which particular circumstance is often complex. In light of the complexity of aircraft financing transactions, there has been an increased necessity for lawyers and aviation industry stakeholders to understand the basic tenets and underlying challenges relating to such transactions most of which are multi-jurisdictional. The study has exposed the multi-jurisdictional challenges and discussed the place of law and the take of Convention in addressing such issues.

A further issue which aviation industry stakeholders and lawyers consider is political risk. The laws of a particular jurisdiction and/or the legal system could be changed arbitrarily during the life of a transaction thus disturbing or distorting the existing legal framework pursuant to which the structure of transaction was built upon. Additionally, in certain jurisdictions the aircraft may be confiscated by the state, the militia and/or insurgent groups or a defaulting aircraft operator may refuse to release the aircraft. In this regard, political stability is important particularly given the duration many aircraft financing transactions take to finalize.

### **1.3.3 Title to an aircraft and securitization**

Lack of title over an aircraft at the national and international level is an issue of concern to many financiers participating in aircraft financing.<sup>14</sup> At the local level, a lender advancing moneys on the security of a mortgage over an aircraft does not hold in its custody and possession any title documents relating to the aircraft or its engines. In addition, the Kenyan Companies Act does not allow for registration or noting of a security interest in relation of an aircraft mortgage over an aircraft created by a company which is not registered in the Register of Companies.<sup>15</sup> The study demonstrates that sufficient protection to lenders is missing

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<sup>14</sup> Different parts of an aircraft may be owned separately. See Appendix I on key parts of an airplane and their functions

<sup>15</sup> For example a foreign company may lease an aircraft to a Kenyan company. The aircraft may have been mortgaged by the foreign company to a foreign lender. The Registrar of Companies cannot note the security interest in respect of the aircraft against the Kenyan lessee which would serve as notice to third parties. More

particularly under the Civil Aviation Act<sup>16</sup> (No. 21 of 2013, Laws of Kenya) (the “CAA”) and the International Interests in Aircraft Equipment Act, 2013 (the “Interests Act”) and has proposed recommendations for reform.

### **1.3.4 Does the Convention (and the Protocol) foster real international business transactions between private parties?**

A key issue examined is what inspires confidence and reliance in the International Registry<sup>17</sup> in Dublin, Ireland and the authenticity of the information filed with the Registry.<sup>18</sup> The study has addressed these issues and has confirmed what anchors the provisions of the Convention and spurs confidence in the International Registry. This includes confidence on the authenticity and veracity of the information filed with the International Registry.

The other issue which the study has examined and considered is whether domestication of the provisions of the Convention and the Protocol in relation to the Convention (“Protocol”) alone in Kenya is sufficient in affording protection to lenders besides safeguarding their security interests and making Kenya a desired choice of forum for addressing matters relating to aircraft finance.

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often than not, like any other lender, foreign lenders who intend to extend financing to a Kenyan operator or aircraft owner would be more comfortable to lend in cases where the domestic laws have sufficient protection in relation to the lenders’ security interests in and over the aircraft. In addition, local laws affording a lender sufficient protection in the event the borrower or lessee defaulting would be favourable to a lender as this would undoubtedly reduce the hardships in repossessing the aircraft, de-registering the aircraft and eventually exporting the aircraft out of Kenya.

<sup>16</sup> The new CAA came into force and commenced on 25<sup>th</sup> January, 2013. The short title states that it is an Act of Parliament to repeal the Civil Aviation Act, to provide for the control, regulation and orderly development of civil aviation in Kenya and for connected purposes. Section 3 (1) of the CAA provides that the provisions of the CAA and of regulations made thereunder shall, except where expressly or by implication included, apply to all aircraft whilst in or over any part of Kenya and all Kenya aircraft, the crew and other persons on board wherever they may be and all aerodromes and service providers within aerodromes.

<sup>17</sup> The international registry is supervised by the International Civil Aviation Organization and is operated out of Dublin, Ireland by Aviareto, a joint venture between SITA, an air transport IT service provider and the Irish government. The international registry is a web and notice-based electronic registry system, requiring no physical documentary filing, and operating 24 hours a day, 7 days a week. The registry is an “object-specific” registry, meaning that registrations are made against and searched by criteria such as manufacturer, model, and serial number of an aircraft object. The rationale behind the international registry is reduction of risks associated with financing aircraft, allowing greater certainty to creditors and aircraft manufacturers and resulting in larger amounts of credit being made available to airlines and aircraft owners at lower costs, which in turn generates increased airline profits and spin-offs to the broader economy. Specifically, with the registry in place, it is anticipated that this will reduce the risks of purchasing and financing aircraft by allowing individuals and organizations to electronically register interests in aircraft on a “first-to-file” priority basis, allowing individuals and organizations to search the registry to ensure the priority of their interests and allowing for various remedies for individuals and organizations in the case of default of registered interests, including de-registration, re-possession, sale, lease and export of aircraft.

<sup>18</sup> What would bar a fraudulent person from filing fictitious and fraudulent information? As will be discussed later, the Registrar is not liable for any inaccurate information.

In conclusion, against the gaps and deficiencies highlighted above, the study has found that it is still considered that if there existed a strong private international system that supports international business transactions between private parties, aircraft financing could be greatly enhanced. In addition, if the security agreement and the debtor satisfied the requirements for the applicability of the Convention and Protocol<sup>19</sup>, the enforcement rights of creditors and debtors in such country will be greatly enhanced. The creditors may, in the event of default, and if the applicable agreements and applicable domestic law provide, obtain de-registration of aircraft, take possession or control of aircraft<sup>20</sup>, sell or grant a lease of aircraft, collect or receive any income or profits arising from aircraft, terminate applicable agreements or apply for court orders to enforce applicable agreements particularly in non-hostile defaults and environments.

#### **1.4 OBJECTIVES OF THE STUDY**

As a main objective, this study has provided an in depth analysis of aircraft financing. By doing this, this study becomes a comprehensive thesis on the subject. The study has analysed and addressed the key underlying issues in aircraft finance globally and in Kenya with an aim of making those issues exhaustively and authoritatively understood and appreciated by aviation lawyers and key stakeholders in the aviation industry.

The study has critically exposed the challenges and limitations of aircraft financing globally and have detailed the implications of those challenges in funding airlines. The study has also highlighted the implications of lack of a solid legal and regulatory framework to promote aircraft financing. The study has critically examined the role of the CAA, the Interests Act and the Convention in facilitating aircraft financing in Kenya. In fulfilling its objectives, the study has found out that the existing framework is indeed ineffective and inefficient in supporting aircraft financing. Moreover, the study has given a critical commentary of the successes and

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<sup>19</sup> As stated elsewhere in this study, the Convention and Protocol do not replace applicable domestic law such as that relating to debtor property rights and obligations or liability in tort. It also does not override governmental regulations such as those relating to safety.

<sup>20</sup> Although aircraft lessors and financiers prefer to structure and close new deals than to terminate and enforce old ones, they are occasionally confronted with the unavoidable need to declare a default and repossess the equipment. The process of repossession encompasses many complex decisions, several of which can have far-reaching consequences, and some of which can expose the lessor or financier to practical difficulties or even legal liability if not properly handled. Most cases involving repossession of aircraft arise from the lessee's failure to pay rent and/or maintenance reserves under the applicable lease or financing agreement or upon occurrence of an event of default under the finance documents, although normally the breach by the lessee of any undertaking will ultimately constitute a default and entitle the lessor to repossess the aircraft equipment.

failures of such a regime. To this end, the study has endeavoured in its Chapter 6 to suggest the necessary legal reforms that should be put in place to address the challenges and limitations.

The study has also fulfilled its objective in establishing the benefits that will accrue/apply to debtors and creditors by creating an enabling international legal and regulatory framework to govern and promote aircraft financing globally, and particularly in enforcing the provisions of the Convention and the Protocol.

## **1.5 RESEARCH QUESTIONS**

The study has been based upon and guided by the following key research questions:

- (i) What are the key legal challenges and limitations that face modern aircraft financing? How can these challenges be overcome?
- (ii) How can the challenge of lack of an effective and efficient legal regime that support the creation and enforcement of security interests in an aircraft finance transaction be addressed?

The CAA provides for, among other things, the licensing and regulation of aircraft in Kenya through the Kenya Civil Aviation Authority (“KCAA”).<sup>21</sup>

## **1.6 METHODOLOGY OF THE STUDY**

The study is derived from primary research including a critical review of the relevant Kenyan statutes (primarily the CAA, the Interests Act, the Companies Act and the Chattels Transfer Act) in light of aircraft finance, analytical review of the provisions of the Convention and the Protocol, telephonic interviews with the KCAA officials (the transport and licensing department) and other research sources such as published books, articles, journals, law reviews and legal commentaries and reviews.

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<sup>21</sup> Kenya Civil Aviation Authority (KCAA) is established under section 4 of the CAA with 27 primary functions set out in section 7(1) of the CAA.

The internet has formed part of a substantial source for the study and research especially as regards articles and electronic publications on aircraft financing. Workshop papers and presentations by scholars and professional writers were utilized towards making this paper a fine piece of work and at each point giving them a critical analysis.

The author's main involvement within these linked methodologies is that of a legal researcher, although this also called for the author's involvement in different roles. The author was, for example, involved in activities ranging from interviewing and collation of information. However, during the course of the study there was maintenance of a consistent focus on how to improve the use of legal and collaborative approaches in managing the research.

As regards the type of research and the type of method used in this study, the study has utilized exploratory, descriptive and explanatory methods of legal research. As the study explored, it was explaining the issues and critically analyzing the phenomena and the various situations.

The study has also adopted the qualitative study approach and where necessary has undertaken a comparative study with a jurisdiction that has developed an effective and efficient aircraft financing system.

## **1.7 JUSTIFICATION OF THE STUDY**

The study is justified on various grounds. We have noted in the course of our research that there is no single and consolidated paper that comprehensively addresses the problems, the challenges and the limitations of aircraft financing particularly from a Kenyan perspective. The articles and contributions we have come across are not case specific. The study has filled that gap by providing a single and consolidated paper on the legal challenges and limitations of aircraft financing using Kenya as the base.

Financing of aircraft typically involves many different jurisdictions and so, the question of which law and jurisdiction is relevant and in which particular circumstance is often a complex subject. In light of the complexity of aircraft financing transactions, there has been an increased necessity for lawyers and aviation industry stakeholders to understand the tenets and challenges relating to such transactions. Despite this need, we have noted that there are limited published works on this subject which provide an in depth analysis to the problems and

limitations facing aircraft financing. To this end, our study provides a comprehensive exposition on the topic of aircraft financing and analysed the conflict of laws aspect with the aim that it provides a one-stop shop knowledge reservoir on the key issues relating to and touching on aircraft financing in Kenya.

Our study provides an in-depth analysis into the various shortcomings of the legislative framework in relation to aircraft financing with a sharp focus on Kenya. In particular, it provides a critique of the CAA, the Companies Act framework and the Interests Act regime and exposes the inadequacy of these statutes in the provision of appropriate legal and regulatory framework to facilitate aircraft financing in Kenya.

Our study also provides an objective analysis of present legislation, exposes the weaknesses of the CAA and the Interests Act particularly as relates to aircraft financing, and using this as the basis, discusses the legal and regulatory challenges in aircraft financing. The study has also analyzed the limitations of the provisions of the Convention and the Protocol and critically analyzed their relevance and commercial advantages in aircraft financing. However, the study has suggested solutions and legal reforms.

Our study also provides valuable recommendations in order to deepen and revamp aircraft financing globally.

## 1.8 THEORETICAL FRAMEWORK

To facilitate economic and commercial activity, Professor Sir Roy Goode argues<sup>22</sup> that the national and international business communities requires a legal system which is efficient, certain and predictable - a system that will give effect to its transactions and give legal recognition to trade customs and market practices. Such a system must be flexible in order to accommodate new practices and development in business<sup>23</sup> and the market and should be in a position to offer an efficient dispute resolution mechanism to deal with ensuing disputes.<sup>24</sup>

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<sup>22</sup> See Roy Goode, Herbert Kronke, Ewan McKendrick, and Jeffrey Wool on *Transnational Commercial Law, International Instruments and Commentary*, Second Edition.

<sup>23</sup> The business world attaches high importance to the predictability of judicial decisions on legal issues. The commercial community values legal certainty because it allows for planning and anticipation of liability. Businesses need to know that courts will reliably and consistently interpret commercial transactions.

<sup>24</sup> Roy Goode, *The Nature and Source of Commercial Law*, Chapter 1, Commercial Law, Penguin Books, Third Edition, 2004, page 3.

Efficiency of transnational and commercial laws epitomizes Sir Goode's philosophy and is in turn the hallmark and thrust of this study.<sup>25</sup>

Schmidtchen argues that a conflict of law system is efficient if it provides sufficient assurance to the parties involved in an international transaction in that, the contract will be honoured thus fostering mutually beneficial transaction.<sup>26</sup> The efficiency of laws in relation to the markets is best understood in the paradoxical relationship between law and economics. The law and economics movement applies economic theory and method to the practice of law.<sup>27</sup> It asserts that the tools of economic reasoning offer the best possibility for justified and consistent legal practice.<sup>28</sup> It is arguably one of the dominant theories of jurisprudence. The law and economics movement offers a general theory of law as well as conceptual tools for the clarification and improvement of its practices.<sup>29</sup> The general theory is that law is best viewed as a social tool that promotes economic efficiency and, that economic analysis and efficiency as an ideal can guide legal practice.<sup>30</sup> It also considers how legislation should be used to improve market conditions in return. Law and economics offers a framework with which to model legal outcomes, and common objectives with which to unify disparate areas of legal activity.<sup>31</sup>

Instead of looking for the unique and defining features of law, the practitioner of law and economics looks at law as a social tool and tries to evaluate it functionally.<sup>32</sup> What is emphasized is not its uniqueness as an institution, but its place within the general and common economic structure of society. The descriptive claim most often associated with law and economics is that legal practices are best characterized as tools for encouraging economically

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<sup>25</sup> Our study is based on the fact that an efficient and effective international private legal regime is significant in boosting and deepening global private business transactions.

<sup>26</sup> See Dieter Schmidtchen, Roland Kirstein and Alexander Neunzig in "*Conflict of Law Rules and International Trade: A Transaction Costs Approach*" page 4.

<sup>27</sup> See article on law and economics published on <http://www.iep.utm.edu/law-econ/>.

<sup>28</sup> Cotter, Thomas F., "*Legal Pragmatism and the Law and Economics Movement*," 84 *Georgetown Law Journal* 2071 (1996).

<sup>29</sup> *Ibid.*

<sup>30</sup> Paul H. Rubin in "*Law and Economic*" 2<sup>nd</sup> Edition argues that law and economics," also known as the economic analysis of law, differs from other forms of legal analysis in two main ways. First, the theoretical analysis focuses on efficiency. There are two distinct theories of legal efficiency, and law and economics scholars support arguments based on both. The positive theory of legal efficiency states that common law is efficient, while the normative theory is that the law *should be* efficient. It is important that the two theories remain separate. Most economists accept both. According to Rubin, law and economics stresses that markets are more efficient than courts. When possible, the legal system, according to the positive theory, will force a transaction into the market. When this is impossible, the legal system attempts to "mimic a market" and guess at what the parties would have desired if markets had been feasible.

<sup>31</sup> See Katz, Avery Weiner, *Foundations of the Economic Approach to Law* (Oxford: Oxford University Press, 1998).

<sup>32</sup> See Polinsky, A. Mitchell, *An Introduction to Law and Economics* (Boston: Little, Brown & Company, 1989).



efficient social relations. Normally what is aimed at through economic reasoning is the improvement of efficiency.<sup>33</sup>

The law and economics movement claims that law is best understood as a tool to promote economic efficiency.<sup>34</sup> But how can the institution of law help encourage efficient transactions? Legal systems can be used to ensure economically efficient transactions through effective enforcement of valid contracts. By ensuring compliance with contractual terms courts can give parties to a contract confidence that the other party will fulfill the agreed-to obligations. This becomes especially important in international contracts and transactions. It may be no real surprise that law often is used to encourage efficient transactions.<sup>35</sup> But it seems a stretch to claim that law as an institution is best completely described in economic terms. It seems counter-intuitive to view all law as based upon market principles. What the economic analysis of law manages, though, is to see such disparate areas as contract, tort and criminal law as all based upon economic aims, therefore giving law a more coherent basis than other theories can offer.<sup>36</sup> It may be argued that an economic explanation of law fails on two counts. Firstly, as a descriptive analysis it does not do justice to everyday legal conceptions. Secondly, as an analytical analysis of the necessary conditions for the practice of law, it fails to account for the internal point of view which Hart thought so central to a proper understanding of law. More analytical approaches to economic explanation of law have considered this a fatal flaw.<sup>37</sup> But whether or not law and economics is an accurate or even conceptually necessary description of law as a social institution, and whether or not it suffices as a complete analysis of law, it could be argued that law should in any case adopt economic efficiency as the central aim guiding judicial decision-making.<sup>38</sup>

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<sup>33</sup> *Ibid.*

<sup>34</sup> See article on law and economics published on <http://www.iep.utm.edu/law-econ/>.

<sup>35</sup> *Ibid.*

<sup>36</sup> See Miceli, Thomas J., *Economics of the Law: Torts, Contracts, Property, Litigation* (1997). In his article, Richard Posner argues that tort cases – those involving private harm – can be seen as contractual by looking for the hypothetical terms that the parties to an accident would have agreed to in advance in order to bring about the accident voluntarily. Also that criminals are deterred by the threat of punishment only if the likelihood of punishment multiplied by the quantity of punishment exceeds the gain offered by the criminal act.

<sup>37</sup> See Coleman, Jules, *The Practice of Principle: In Defense of a Pragmatist Approach to Legal Theory* (Oxford: Oxford University Press, 2001).

<sup>38</sup> In *Market, Morals and the Law* (Cambridge: Cambridge University Press, 1988), Coleman Jules argues against the efficiency theory on nonnative grounds. He evidently argues that consent provides a better normative basis for law than does efficiency and he uses consent agreements to attack recommendations from scholars in law and economics. His own chief contribution, however, is to law and economics rather than to any alternative theory.

Closely related to efficiency under law and economics is the legal theory of finance (LTF) advanced recently by Katharina Pistor.<sup>39</sup> LTF asserts that “finance is legally constructed; it does not stand outside the law”.<sup>40</sup> LTF’s critical contribution is to emphasize that the legal structure of finance is of first order importance for explaining and predicting the behaviour of market participants as well as market-wide outcomes.<sup>41</sup> As an inductive theory, Pistor’s legal theory of finance proposes an alternative mode of analysis from traditional theories on how markets work.<sup>42</sup> Notably, neo-classical economic theories use deductive “top-down” reasoning to apply principles of supply and demand to our understanding of how markets function. These theories emphasize economic freedom as a precondition to the functioning of the market, and so tend to view government intervention as a manipulation of a Pareto efficient outcome. The supply and demand model, however, is static in time, and so assumes that a particular set of market conditions already exist. What Pistor’s legal theory of finance does, essentially, is to look under the hood of that static economic model and examine the structural components of the market in a dynamic fashion.<sup>43</sup>

Whether through regulatory law, contractual law or judicial interpretation, law serves as a reference point and an interpretive backstop for all contracts constructed within its jurisdiction (and often in today’s market, outside of its jurisdiction as well). Pistor remarks that finance and markets do not exist outside rules but are constituted by them and that the more a financial system moves from relational finance to entities and ultimately markets, the more it depends on a formal legal system with the capacity to authoritatively vindicate the rights and obligations of contractual parties or to lend its coercive powers to the enforcement of such claims. The credibility and value of fungible financial contracts depends on such backing. We argue that this is why aircraft financing requires a cogent international backing so as to enhance and broaden access to finance under the Convention auspices.

## 1.9 LITERATURE REVIEW

Literature is not lacking on this subject. There are various writings that have been made by various scholars and researchers alike touching on issues covered by our thesis. However, the

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<sup>39</sup> See Katharina Pistor, “A Legal Theory of Finance”, Columbia Law School, May 2013.

<sup>40</sup> *Ibid* at page 2.

<sup>41</sup> *Ibid* at page 3.

<sup>42</sup> See Richard Shamos on *Free Markets and the Legal Theory of Finance* July 2013 published on <http://clsbluesky.law.columbia.edu/2013/07/30/free-markets-and-the-legal-theory-of-finance/>

<sup>43</sup> A central thesis to Pistor’s theory is the notion that financial assets are legally constructed, and so the financial systems they create “comprise a complex interdependent web of contractual obligations.”

study has examined and reviewed the writings which relate to and are relevant to our research objectives. These include the issues relating to aircraft financing. We wish to point out at this stage that we have not come across any writing in Kenya that specifically deals with and devotes to aircraft finance and discusses the issues we intend to deal with or uses the perspective this study has adopted.

We have reviewed various writings. A volume entitled *Aircraft Finance: Registration Security and Enforcement (2012 Edition)* which volume is compiled by Thomson Sweet and Maxwell with Graham McBain as the General Editor contains answers to general uniform questions being contributions by law firms around the world in respect of registration of aircraft, creation and enforcement of security over aircraft. The volume contains briefly answered questionnaire covering issues to do registration of aircraft, creation of security and enforcement of security in Kenya<sup>44</sup>. We note that the questionnaire only answers questions of a general nature in relation to registration of aircraft, creation of security and enforcement of security in Kenya but does not delve into a critical or an in depth analysis of aircraft financing in Kenya. Our study has addressed all tenets of aircraft financing in Kenya in detail whilst using a different perspective.

Thomson Sweet and Maxwell has also published a volume on *Aircraft Liens & Detention Rights (2012 Edition)*. The volume contains briefly answered questionnaires from law firms around the world relating to general uniform questions on matters relating to creation of liens and rights to detain aircraft. The volume also contains an answered questionnaire covering creation of liens and rights to detain aircraft in Kenya<sup>45</sup>. We note that the questionnaire only answers questions of a general nature in relation to the stated topics but does not delve into a critical or an in depth analysis of aircraft financing in Kenya. Our study has delved into this issue in detail.

We have also reviewed an article entitled *Aircraft Financing - Aviation Finance: An Overview* by Elizabeth D. Mann<sup>46</sup>. In her article, Elizabeth provides an overview on issues relating to aircraft financing in the United Kingdom. Firstly, we note that the article only provides an overview of aircraft financing from the United Kingdom perspective. Secondly, we note that

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<sup>44</sup> The Article on Kenya was prepared by Anjarwalla & Khanna Advocates with assistance of the author in the study.

<sup>45</sup> The Article on Kenya was prepared by Anjarwalla & Khanna Advocates with assistance of the author of the study.

<sup>46</sup> Journal of Structured Finance: 2009 Vol. 15, Num. 1, pp. 109-117.

matters relating to aircraft financing are more developed and settled in the United Kingdom as compared to Kenya. In this regard, the study has endeavoured to provide a comparative analysis by borrowing some aspects and concepts from the United Kingdom and using them to recommend reforms on Kenyan financing regime.

Greg Reigel of Reigel Law Firm Limited in his article entitled *The Basics of Aircraft Finance*<sup>47</sup> discusses the basic steps in the process of aircraft financing from the point of view of the laws of Minnesota, United States of America. Our study has critically analysed Greg's work and analysed the process of aircraft finance in much greater detail from a Kenyan perspective.

The study has additionally examined and reviewed other writings and legal commentaries which relate to and are relevant to our research.

#### **1.10 ASSUMPTIONS**

Our study has assumed that the remedies and benefits accruing under the Convention and the Protocol do not accrue to non-Contracting States.

In addition, we assume that lack of sound legal provisions anchoring aircraft financing in Kenya coupled with inadequate and wanting legal and regulatory regime poses a big challenge to the success of aviation finance in Kenya. The upshot of this, we assume, will be an erstwhile reluctance among the lenders to aggressively pursue aircraft financing. Our study has thus formulated and championed a strong case for legal and regulatory reform in order to sufficiently enshrine and accommodate the tenets of aviation finance in the Kenyan systems and structures.

#### **1.11 SCOPE AND LIMITATION OF THE STUDY**

The study is limited to an exposition of the limitations of the legal and other challenges relating to aircraft financing and security agreement under the CAA, the Interests Act and the

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<sup>47</sup> Published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx>.

Convention and its accompanying Protocol. The study has laid more emphasis on the limitations of the remedies available under the Convention and the Protocol and local statutes.

The study has addressed the provisions of the Convention particularly those touching on registering a security interest, declarations by Contracting States, deregistration and export of the aircraft and remedies and protections afforded to creditors and also on the benefits to be derived by lessors, creditors and debtors under the Convention regime.

## **1.12 CHAPTER BREAKDOWN**

**Chapter One** of our study provides the layout/basis and the plan of the study and our research. It constitutes an overview of the problem and the background of the study, the statement of the problem, the emerging issues for study, the justification of the study, research objectives, the hypotheses, literature review of the study, theoretical framework with focus on law and economics, research methodology, assumptions and the limitations of the study.

**Chapter Two** discusses aircraft financing generally. It demonstrates the need and necessity for aircraft financing in Kenya, Africa and globally by interrogating the question why airlines and aircraft operators borrow funds from finance providers. The Chapter also deals with aircraft financing transactions, the principal considerations in an aircraft financing transaction and the features and various forms of aircraft financing. The Chapter discusses the relevance and challenges of export credit guarantees in international finance, the challenges to ECA financing and the guarantee framework under the new ASU dispensation. The use of pre-delivery payment financing in aircraft financing is analysed and recent financial innovations and new sources of aircraft finance disclosed.

**Chapter Three** delves into the question of how title to an aircraft is acquired and analyses the effect of want of certainty and guarantee to title on aircraft finance and securitization.

**Chapter Four** discusses the law of financing. The Chapter discusses the current law on mortgaging and enforcement of security interests over an aircraft. It exposes the problems and challenges of financing an internationally mobile asset/chattel. The Chapter also discusses the relevance of aircraft insurance and the problem of terrorist threat. The Chapter highlights in detail the aspect of conflict of laws and determination of applicable law and jurisdiction.

**Chapter Five** deals with the realization of security interest. It discusses events of default and enforcement. It deals with enforcement mechanisms pursuant to security agreements. Challenges and limitation in enforcing the financier's remedies and protections are also discussed. It criticizes the Convention and the Protocol, the remedies under CAA, the Interests Act and aircraft mortgage. The significance of key declarations made by Contracting States is examined and key declarations made by Kenya detailed.

**Chapter Six** is the concluding chapter. It sets out the summary of the study and conclusions. The Chapter also provides suggestions and recommendations for policy and legislative reforms. These include recommendation for amendment of the CAA and the Interests Act, recommendation for reforms at the Companies Registry, recommendation for reforms under the Stamp Duty Act and recommendation for the amendment of Convention and the Protocol.

## CHAPTER TWO

### 2.0 AIRCRAFT FINANCING

#### 2.1 Necessity for aircraft financing in Kenya and globally

The airline industry is a debt intensive industry due to the significant amounts of debt incurred in the financing of an aircraft and the costs necessary for its operations. It is argued that the African airline industry is struggling for lack of resources and that aircraft financing is one of the major problems facing the industry<sup>48</sup>. Financiers and lessors rate the credit risk of African carriers high because of the political instability and low profitability of the carriers. It is noted that the airline industry in Africa is hampered by various challenges including poor safety record, inadequate qualified aircrew and pilots, inadequate financial resources, and other problems related to market access. There are several barriers stifling the growth of the African airline industry. The dearth of financial resource seems to be the most critical challenge.

In many instances, most national airlines in Africa are highly indebted and their capital base is weak and minimal. African governments are unable to provide support to their airlines because they have limited financial resources and they have to prioritize urgent social and economic needs such as health, agriculture and development. These governments are also pressured not to invest their money in their airlines by donors and development partners. Foreign investment is also not forthcoming, with rare exceptions, due the lack of a favourable regulatory environment and restrictions placed which quote often hinder foreign investment. There have been increased lamentations that there lacks adequate national private capital for investing in airlines. Even if capital could be raised locally<sup>49</sup> many countries do not have the

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<sup>48</sup> Kaleyesus Bekele reporting on the financial trend on Saturday, 9<sup>th</sup> January 2010 article on Quest for Aircraft Financing published in the Ethiopian Reporter and published at [http://en.ethiopianreporter.com/index.php?option=com\\_content&task=view&id=2134&Itemid=1](http://en.ethiopianreporter.com/index.php?option=com_content&task=view&id=2134&Itemid=1) accessed on 27<sup>th</sup> March, 2012.

<sup>49</sup> On 17<sup>th</sup> October, 2011, Kenya Airways Limited announced that its board of directors having considered and approved its funding requirements for its future expansion plans and had approved that part of such funding be raised by way of a rights issue to the existing shareholders of the company. It was announced in mid March 2012 that Kenya Airways intend to raise Kenya Shillings 20,680,373,686/=, before expenses, by way of a renounceable rights issue of 1,477,169,549 new ordinary shares at a price of Kenya Shillings 14.00 per ordinary share. This is a 250 million United States dollars rights issue which the Capital Markets Authority has approved and the funding is intended to enable Kenya Airways meet its additional capital requirements related to acquisition of additional aircrafts. The Capital Markets Authority welcomed the move by Kenya Airways Limited for electing financing through the capital markets to meet its current and future infrastructure development initiatives. The national carrier's expansion is partly a plan to counter the growing penetration of cash-rich Middle East airlines into the African market. It has been reported by airline experts that competition from Middle East airlines in Africa and also on other global routes is growing because they do not have much

stock exchange<sup>50</sup> required to enable private individuals to invest. The dearth of financial resource thwarting the African airlines can be evidenced by, among others, the aging aircraft they operate. Of course, there are several airlines which have recorded exceptionally astounding results over time. However, in general terms obtaining aircraft financing has for long been the biggest problem. Additionally, the credit crunch that is still biting and instigating a global financial crisis is making access to financing even harder for African airlines. International Air Transport Association<sup>51</sup> (IATA) predicted net losses of 700 million United States dollars in Africa during the course of 2009.

In 2005, Ethiopian Airlines became the first African carrier to place an order for 10 Dream liner aircraft (B787-8) valued at 1.3 billion United States dollars<sup>52</sup>. Ex-Im Bank<sup>53</sup> has

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trouble raising money. Kenya Airways is among the dominant airlines in the continent competing with other continental leaders like South Africa Airways, Egypt Air and Ethiopia Airlines. Kenya Airways intends to expand its operations through acquisition of new fleets, in line with its ten-year plan. If realized, the money will enable it to fund the ambitious plans to double its fleet by 2015 and become Africa's premier carrier with a footprint in every nation in Africa in the coming ten years. Kenya Airways is set to acquire 9 new Boeing 787 Dream liners over the next few years to enable it effectively operate long haul flights to regions such as Far East, North Asia, and Southern America. In the new agreement, the first Boeing 787 Dream liner is due to be delivered by the fourth quarter of 2013. The Dream liners will come in at a time that the airline predicts a momentous growth in passenger and cargo demand and rapidly expanding route network. The Dream liners will use 20 per cent less fuel than other aircrafts of its class with up to 45 per cent more cargo revenue capacity. This will help to leverage the Kenya Airways' escalating fuel bill in addition to diversifying its revenue base which is heavily reliant on passengers. The B787-8s will be used to replace the ageing B767 aircraft as well as open up new long range routes. The B787 is a family of aircrafts carrying between 200 to 300 passengers on routes between 3500 and 8500 nautical miles. Kenya Airways plans to raise part of the funds to finance the order from investment options available from the Nairobi Securities Exchange with a target of raising 250 million United States dollars, with the rest coming from other financing institutions and internal sources.

<sup>50</sup> However, this is not always the case. In Kenya and Tanzania, Kenya Airways and Precision Air Services Limited have turned to stock markets to raise capital. For instance, starting October 7, 2011, Precision Air Services Limited, started selling 31.2 per cent of its shares on the Dar es Salaam Stock Exchange in a bid to raise 17 million United States dollars to fund expansion. Kenya Airways is also considering a rights issue.

<sup>51</sup> See [www.iata.org](http://www.iata.org). Information accessed on 29<sup>th</sup> March, 2012 at IATA website confirms that IATA is an international trade body, created over 60 years ago by a group of airlines and it currently represents some 240 airlines comprising 84 per cent of total air traffic. The organization also represents, leads and serves the airline industry in general. Formal IATA membership only applies to airlines but other industry partners can participate in different IATA programs and benefit from a wealth of resources to carry out their operations:

- (i) Airlines: IATA membership is open to both scheduled and non-scheduled airlines.
- (ii) Travel Agencies and other Travel and Tourism intermediaries: travel and tourism accreditation and code services simplify the business relationship between agents and airlines as well as other tourism service providers.
- (iii) Freight Forwarders: IATA accreditation provides industry recognition for cargo agents.
- (iv) Industry Suppliers: IATA Strategic Partnerships program allows suppliers and service providers to interact with IATA and its member airlines in the development of industry solutions.

<sup>52</sup> By August 2012, Ethiopian Airlines had become the first African country to acquire a Dreamliner aircraft. The purchase price for a Dreamliner is high. Kenya Airways has confirmed that the offer price given for its Boeing 787-8 Dream liner was United States Dollars 185.2 million. This means the total confirmed order will amount to about United States Dollars 1.67 billion.

<sup>53</sup> Kaleyesus Bekele in the article entitled "*Quest for Financing African Aviation Industry*" published on the Ethiopian Reporter on 22<sup>nd</sup> November 2008 has commented that Ex-Im Bank is the largest financier of new United States manufactured commercial aircraft in the world. According to the said article, during the period of 15 years from 2008, Ex-Im Bank provided almost 60 billion dollars of aircraft financings to the world's airlines and leasing companies to support their acquisition of over 1,000 Boeing aircraft (an average of approximately 70



guaranteed 85 per cent of the loan fund for the purchase of the aircraft. Aircraft experts argue that in 2010 the cost of purchasing a new aircraft on average was between 65 and 100 million United States dollars. Clearly, very few airlines in Africa have an equity of 100 million United States dollars. This therefore means that if an airline took all its equity and working capital it would only buy 1 aircraft and, of course, there is no airline that can work on one foot. If an airline wishes to do business with 4 or 5 aircraft, it will definitely have a financial challenge. It is clear that there is a persistent demand for modern and cost effective aircraft in Kenya and Africa as a whole. However, an aircraft being an expensive asset, it means that the purchaser has to solicit and raise moneys to purchase an aircraft from its sources although there is an option by a person wishing to acquire an aircraft to resort to taking a loan from a lender in what is commonly known as aircraft financing.

## **2.2 Aircraft finance transactions**

An aircraft is an expensive asset.<sup>54</sup> An aircraft purchaser has an option of soliciting and raising moneys to purchase an aircraft from its own sources or resort to other forms of financing so as to acquire an aircraft. A purchaser may, for instance, opt to take a loan from a financier/lender. “Financing” has been defined from a business perspective as the act of providing money for a project<sup>55</sup> and it is stated that financing is one way to find the monetary resources needed to achieve a specified project<sup>56</sup>. The project may be the acquisition of an aircraft or financing the operations of an aircraft owner/operator.

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aircraft per year, although it has ranged from less than 15 aircraft per year to more than 120 aircraft per year) and Ex-Im Bank’s existing aircraft finance portfolio includes more than 27 billion dollars of guarantees and loans for approximately 700 U.S. Boeing aircraft. Ex-Im Bank’s aircraft finance portfolio is the largest part of Ex-Im Bank’s total portfolio, almost 50 percent of the world total portfolio. The article is published on: [http://en.ethiopianreporter.com/index.php?option=com\\_content&task=view&id=291&Itemid=5](http://en.ethiopianreporter.com/index.php?option=com_content&task=view&id=291&Itemid=5) and was accessed on 29<sup>th</sup> March 2012.

<sup>54</sup> Kaleyesus Bekele reporting on the financial trend on Saturday, 9<sup>th</sup> January 2010 article on Quest for Aircraft Financing estimated that in 2010 the cost of purchasing a new aircraft on average was between 65 and 100 million United States dollars. Kenya Airways in early 2012 committed to acquiring each Boeing 787-8 Dream liner at the cost of about 185 million United States Dollars. On 25<sup>th</sup> June, 2012, Kenya Airways Limited announced that it had approved the award of the mandate to arrange for the purchase of 9 new Boeing 787-800s Dreamliners, 1 Boeing 777-300ER and 10 Embraer 190 aircraft to the African Export-Import Bank. The financing package consists of a pre-delivery payments facility and an aircraft delivery finance facility to finance the acquisition. Kenya Airways raised Kenya Shillings 14.487 billion in its 2012 Rights Issue. The proceeds will be utilised towards financing pre-delivery payments for 9 new Boeing 787-800s Dreamliners. This Chapter shall discuss pre-delivery payments.

<sup>55</sup> See <http://www.businessdictionary.com/definition/financing.html> <Accessed on 11<sup>th</sup> July, 2012>

<sup>56</sup> See <http://www.businessdictionary.com/answers/2485/what-is-the-meaning-of-financing/> <Accessed on 11<sup>th</sup> July, 2012>.

Our study has adopted an operational definition of aircraft financing as substantially international financing of the operation or acquisition of an aircraft using the aircraft as security. In this regard, the aircraft and the income it generates are used as security against a loan advanced in respect of its acquisition and/or operation under the secured loan financing arrangement. There are a number of ways aircraft financing can be arranged and structured. The common arrangement involves structuring the aircraft financing on a project basis which means that the loan repayment is made based on the value of the aircraft itself, its earnings and the proceeds from its sale.

### **2.2.1 Principal considerations in an aircraft financing transaction**

A loan will work well if an operator uses the aircraft for commercial use and hopes to take advantage of the tax depreciation. In addition, a loan will work well if the owner plans on keeping the aircraft more than about 7 years. Some institutions get creative with long term loans that have balloon payments due at the end making the typical loan payment less than the short term lease payment.

As discussed above, the purchaser of a new or used aircraft has a number of options available to him for financing this purchase. There are a number of considerations that go into a final decision on the form of financing, but the most prominent considerations are tax and financial consequences. As discussed above, there are certain tax advantages that a purchaser can take into account. Our study only highlights these issues in a more general manner and emphasizes the need for a purchaser to seek advice from tax, financial and accounting experts prior to embarking on a financing transaction. However, the decision to lease or purchase is not determined solely by considering tax and financial consequences. The purchaser must also consider the regulatory requirements associated with aircraft ownership and operation.

In Kenya for instance, KCAA is properly obsessed with safe operation of civil aircraft. Accordingly, the KCAA's primary involvement in ownership structures is to make certain that the entity or person responsible for the safe operation of the aircraft is disclosed; and that this aircraft operator is capable of fulfilling its regulatory obligations to maintain and safely operate the aircraft. The legal owner of a Kenyan registered aircraft will always appear on public record because the KCAA issues a Certificate of Registration after that person or entity files a bill of sale, as well as a registration application. If the owner transfers operational

control to another party (through operating lease), then that lease must be approved by and filed with the KCAA.

A further issue which aviation industry stakeholders and lawyers consider is political risk. The laws of a particular jurisdiction and/or the legal system could be changed arbitrarily during the life of a transaction thus disturbing or distorting the existing legal framework pursuant to which the structure of transaction was built upon. Additionally, in certain jurisdictions the aircraft may be confiscated by the state, the militia and/or insurgent groups or a defaulting aircraft operator may refuse to release the aircraft. In this regard, political stability is important particularly given the duration many aircraft financing transactions take to finalize. To guard against the political risk, most international aircraft financing transactions entities choose to have their principal documentations expressed to be governed by the laws of jurisdictions such as England which are considered as politically stable jurisdictions. However, there may be an issue where the jurisdictions which are considered stable are not Contracting States under the Convention as the remedies available under the Convention may not accrue readily.

### **2.2.2 Features of commercial financing**

As stated in Chapter 1, commercial financing in the aviation industry include secured bank loans<sup>57</sup>, operating leases, and public debt issues secured by aircraft<sup>58</sup>. In addition to commercial financing, governmental export credit agencies provide export credit financing support either in the form of direct export credit loans or export credit guarantees that support commercial financing. In some cases manufacturers also provide financing.

Our study will discuss in detail the common forms of commercial aircraft financing namely, secured loan financing, operating leases and enhanced equipment trust certificates. We shall also discuss the role of export credit guarantees which support commercial financing.

The common forms of commercial aircraft financing are discussed below.

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<sup>57</sup> According to research by Steven Golbeck and Vadim Linetsky *Asset Financing with Credit Risk*, January 8, 2012, Department of Industrial Engineering and Management Sciences, McCormick School of Engineering and Applied Sciences, Northwestern University (see <http://users.iems.northwestern.edu/~linetsky>), a typical bank loan financing the purchase of a new commercial aircraft might have a 12 year, an initial loan-to-value of 85%, mortgage-style principal amortization and quarterly payment schedule.

<sup>58</sup> In particular, Enhanced Equipment Trust Certificate (EETC).

### 2.2.2.1 Secured loan financing

A person (being a company, firm, individual, entity or business) who has made the decision to purchase an aircraft may not necessarily have the moneys required to purchase an aircraft. Or, if the person does have the moneys available, tax or cash flow implications may hinder the person from paying cash towards the purchase of the aircraft.<sup>59</sup> As a result, these persons may decide to purchase an aircraft using financing provided by a third-party. There are financing companies that specialize in aircraft financing, as well as banks that will finance aircraft on an occasional basis, often at the request of a high-net-worth client.<sup>60</sup> The ultimate decision of a purchaser/borrower is usually based on the loan terms. Most aircraft acquisition loans are secured by the aircraft itself which is pledged as collateral by way of an aircraft mortgage. The mortgage is specialized to aircraft assets, dealing with the details of aircraft maintenance, aircraft registration and aviation insurance. As we shall discuss later in this Chapter, under the Kenyan laws, the interest pursuant to a mortgage over an aircraft registered in Kenya will be filed with the Civil Aircraft Registry managed by the KCAA<sup>61</sup> and noted on the Certificate of Registration.

We shall now discuss the steps and processes to complete a secured loan financing transaction. Although the processes and procedures involved in an aircraft finance transaction are similar to other finance transactions, an aircraft finance transaction involves many nuances and unique aspects. Having a general understanding of the nuances associated with an aircraft finance transaction can significantly aid assist a borrower and a lender in successfully closing an aircraft finance transaction.

It should be noted that as the size of the aircraft and the amount being financed increase, the structure, processes and procedures for obtaining aircraft financing become more complicated.

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<sup>59</sup> See article by Greg Reigel of Reigel Law Firm Limited entitled *The Basics of Aircraft Finance* April 2006, published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx> <accessed on 11th July, 2012>.

<sup>60</sup> *Ibid.* Greg notes that the aircraft finance marketplace includes a wide variety of financial institutions and lenders that will finance aircraft and that not all of these lenders are experienced with aircraft finance. As a result, Greg notes that some of the lenders are unable to process aircraft financing transactions as efficiently or economically as lenders with more aircraft finance experience. He recommends that individuals and businesses interested in financing the purchase of an aircraft should survey the marketplace and contact a number of lenders to locate a lender with experience who understands the borrower's needs and goals.

<sup>61</sup> Similarly, by Federal law, the mortgage on a U.S. registered aircraft will be filed with the FAA Civil Aircraft Registry in Oklahoma City, Oklahoma (much like a home mortgage is filed in local land records). Aircraft registered in other nations will benefit from similar national lien registries if the nation is a party to international conventions on the recognition of security interests. The "non-aircraft" assets associated with the aircraft (such as records, warranties and loose equipment) is taken as security with typical lien filings in local jurisdictions. See Greg referenced below.

In this Chapter, we shall provide a general overview in respect of a basic aircraft finance transaction and will not address the nuances and variations that may be associated with more complex transactions.

### ***Application for financing***

In general terms, the majority of lenders, who are international lenders, handle applications for aircraft financing similarly. The lender will require the borrower to submit information regarding the aircraft including its make, model, year of manufacture, registration details and the proposed purchase price. The borrower<sup>62</sup> will also be required to provide financial information and account statements and, if the borrower or the entity purchasing the aircraft is a corporation or limited liability company, the lender will require copies of its certificate of registration/incorporation, Memorandum and Articles of Association and other constitutional documents. Further, if the financing will include personal or corporate guarantees, the lender will require similar financial and organizational documentation from each guarantor.<sup>63</sup>

### ***Aircraft appraisal***

If a certain lender does not have a great deal of experience in aircraft financing, or if the transaction involves a larger aircraft, the lender will likely require an appraisal of the aircraft. The appraisal will allow the lender to ensure that the value of the aircraft is consistent with and supports the lender's loan to equity ratio for the particular transaction. For traditional financial institutions, it also provides back-up for the loan file to satisfy a bank examiner, who may have no aircraft finance experience, that the value of the aircraft meets the financier's lending criteria and authority.<sup>64</sup> On the other hand, for an experienced financier, an appraisal may not necessarily be required for transactions involving small single-engine aircraft up to larger twin-engine aircraft. An experienced aircraft financier will quite often have a good sense of the market value of the various types of aircraft based upon similar transactions processed by the financier in the past. These financiers are typically not traditional financial

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<sup>62</sup> If the borrower is a business or a partnership, the underlying registration and constitutional documents will be required. A borrower who is a natural person would be required to avail personal identification documents.

<sup>63</sup> See article by Greg Reigel of Reigel Law Firm Limited entitled *The Basics of Aircraft Finance* April 2006, published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx> <accessed on 11th July, 2012>.

<sup>64</sup> *Ibid.*

institutions such as banks and, as a result, do not have the same file documentation considerations with bank examiners, as a traditional bank.<sup>65</sup>

From the borrower's perspective, the appraisal does not usually impact on the purchase transaction. Although a purchase agreement may be drafted to include a contingency that the aircraft should be appraised at or above a certain value, usually the borrower will have agreed upon the purchase price for the aircraft prior to applying for its financing and the appraisal merely reconfirms whether the borrower negotiated a good purchase price.

### ***Search on ownership***

The lender will obtain searches on the aircraft to confirm ownership and obtain confirmations whether any security interests, liens or other encumbrances has been recorded and registered against the aircraft. In Kenya, a search with the KCAA is made by way of a formal application to the Director-General of the KCAA. The Director-General of the KCAA then writes back to the applicant confirming the aircraft details. If an aircraft is subject to a registration under the Convention<sup>66</sup>, a search with the International Registry in Ireland will be necessary.<sup>67</sup>

After the necessary search or searches has been completed and obtained, a title report is prepared, usually by the lender's lawyers, and addressed to the lender disclosing the current status of the aircraft's title. If any liens, encumbrances or other title defects are disclosed in the title report, the lender will require that any issues are released or otherwise resolved to the lender's satisfaction prior to closing. The lender will also perform name and judgment searches to ensure that the aircraft seller has capacity to convey clean title to the borrower. Although the lender will expect that the borrower resolve title issues prior to closing, ultimately, curing

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<sup>65</sup> *Ibid*

<sup>66</sup> See provisions of the Convention. Aircraft and equipment subject to the Convention include:

- (a) Airframes, that when appropriate aircraft engines are installed thereon, are type certified by the competent aviation authority to transport at least 8 persons including crew; or goods in excess of 2750 kilograms (6,062 pounds);
- (b) Helicopters, heavier-than-air machines, supported in flight chiefly by the reactions of the air on 1 or more power-driven rotors on substantially vertical axes and which are type certified by the competent aviation authority to transport at least five (5) persons including crew; or goods in excess of 450 kilograms; and
- (c) Aircraft engines, 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.

<sup>67</sup> We have discussed in detail the process of undertaking a search with the International Registry in Chapter 4 of our study.

title defects and passing clean title to the aircraft is the seller's responsibility in an aircraft transaction.<sup>68</sup>

### ***Aircraft title insurance***

In jurisdictions such as the United States of America, a financier will often purchase title insurance to insure the financier's security interest in the aircraft. The aircraft title insurer will ensure that the registration documentation such as the bill of sale, application for registration and other documents are accurate and that all documents, including the lender's aircraft security agreement, are filed in a timely manner. It will also require that any title defects disclosed by the title search are cured at or before the closing. Then, if any adverse issues relating to the title arise after the transaction closes, the title insurer will be responsible for protecting the lender's interest in the aircraft and resolving any title defects covered by the insurance.<sup>69</sup>

### ***Loan documentation***

The loan documents typically associated with a basic aircraft finance transaction include a loan or facility agreement<sup>70</sup>, aircraft security agreement<sup>71</sup>, guarantee/pledge and authorization. A facility agreement and the aircraft security agreement contains the terms of the loan and the borrower's promise to repay the loan according to those terms. It also provides the lender with remedies if the borrower does not fulfil its obligations under the facility agreement.<sup>72</sup>

The aircraft security agreement (or an aircraft mortgage (as the case may be)) pledges the aircraft as security for the loan or the promissory note. If the borrower fails to repay the loan or fails to honour the promissory note (or the terms of the facility or loan agreement), the lender will have the right to take possession of the aircraft. Once the lender has regained possession, the lender may be, subject to other matters discussed in this study, in a position to sell or otherwise dispose of the aircraft to recover as much of the outstanding loan balance as

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<sup>68</sup> See article by Greg Reigel of Reigel Law Firm Limited entitled *The Basics of Aircraft Finance* April 2006, published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx> <accessed on 11th July, 2012>.

<sup>69</sup> *Ibid.*

<sup>70</sup> In some jurisdictions such as the United States of America, the promissory note will be the underlying loan documentation.

<sup>71</sup> This is the case in the United States. In Kenya, an aircraft mortgage will be created over an aircraft.

<sup>72</sup> See article by Greg Reigel of Reigel Law Firm Limited entitled *The Basics of Aircraft Finance* April 2006, published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx> <accessed on 11th July, 2012>.

possible. If the lender sells the aircraft for more than is owed, the excess is paid to the borrower. However, after the lender offsets the amount received from sale against the outstanding balance and the lender's costs/fees incurred in repossessing and selling the aircraft, it is unusual for an excess balance to exist.<sup>73</sup>

For transactions in which the loan is being guaranteed by someone other than the borrower, that individual or business will need to execute a guarantee that obligates the guarantor to repay the loan in the event that the borrower defaults. If the borrower or any guarantor is a corporation or limited liability company, the lender will require that the guarantee is executed in accordance with the provisions in the constitutive documents or an appropriate official of the entity execute an authorization (or power of attorney) representing that the person executing the documents on behalf of the entity is authorized to sign and bind that entity.<sup>74</sup>

Most lenders will have standard or form documents they use in aircraft finance transactions. However, depending upon the lender, the financial position of the borrower, the relationship of the borrower with the lender and the amount of the loan, many of the terms in the loan documents may be negotiable.<sup>75</sup>

### ***Closing***

Either the lender or an experienced aviation lawyer<sup>76</sup> on behalf of the lender will handle the closing of the loan transaction. Prior to disbursing any funds, the lender will require the parties to execute the loan documentation and also ensure that any other requirements of the title insurer are satisfied. The lawyer will ensure the appropriate documents are received, completed, and confirm that the documentation is accurate and filed in a timely manner. This is to ensure perfection and priority of the lender's interest in the aircraft.<sup>77</sup> In the absence of an experienced aviation lawyer processing the transaction, a lender may utilize a title company to close the transaction on its behalf.<sup>78</sup>

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<sup>73</sup> *Ibid.*

<sup>74</sup> *Ibid* at 22.

<sup>75</sup> *Ibid* at 22

<sup>76</sup> In the United States of America, an entity known as the title company will besides undertaking the title searches described above handle the closing.

<sup>77</sup> We shall discuss the registration and creation of security interest over an aircraft in much detail later in Chapter 4.

<sup>78</sup> See article by Greg Reigel of Reigel Law Firm Limited entitled *The Basics of Aircraft Finance* April 2006, published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx> <accessed on 11th July, 2012>.



## **Costs**

The borrower is usually responsible for the costs incurred by the lender in processing and closing the aircraft finance transaction. The costs include application fees, title search fees, appraisal fee, title insurance premium and recording/registration fees.<sup>79</sup> However, depending upon its financial condition and its relationship with the lender, the borrower could negotiate the allocation of costs between the borrower and the lender.<sup>80</sup>

## **Secured loan and aircraft lease distinguished**

In simple terms, a loan provides the borrower with ownership of the aircraft from the start. The borrower/purchaser borrows money and provides either the aircraft as collateral, or some other tangible assets. In a lease, the owner (or lessor) allows another person the use of an aircraft for a fixed period of time or at will under an operating lease. There are 2 major differences between a lease and a loan.<sup>81</sup>

With a loan, the owner/borrower assumes the full residual value risk of the aircraft. With a lease, the lessor assumes that risk.<sup>82</sup> With a lease, the lessor owns the aircraft and can therefore take advantage of tax depreciation. With a loan, there may be tax advantages if the aircraft is for business use, but personal use and mixed use may severely limit or eliminate any tax advantages. If tax depreciation is not needed, a lease may be the way to go. Leasing may be less capital intensive than a loan. Down-payments for loans are generally greater than the upfront costs associated with a lease. This may be especially true for new models, but deals can be made.

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<sup>79</sup> In Kenya, a borrower would be responsible for legal fees of the lender's lawyers and will meet the stamp duty costs in relation to an aircraft mortgage and other security documents.

<sup>80</sup> See article by Greg Reigel of Reigel Law Firm Limited entitled *The Basics of Aircraft Finance* April 2006, published in <http://blog.globalair.com/post/The-Basics-of-Aircraft-Finance.aspx> <accessed on 11th July, 2012>.

<sup>81</sup> Kaleyesus Bekele reporting on the financial trend on Saturday, 9<sup>th</sup> January 2010 article on Quest for Aircraft Financing argues that financiers are reluctant to lend loans for weak airlines. Even if they want to lease, lessors would be reluctant to lease a 100 million dollars aircraft to a small airline.

<sup>82</sup> See article by David Wyndham of Conklin & De Decker July 2007 entitled *Lease versus Loan: the Things You Should Know* published on <http://blog.globalair.com/post/Lease-vs-Loan-the-Things-You-Should-Know.aspx> <accessed on 11<sup>th</sup> July, 2012>. Wyndham reported that aircraft owners who tried to sell their aircraft in the period from 2001 to 2003 saw a significant loss in value over what they anticipated. Wyndham also reported that as at 2007, sellers of popular late model turbine aircraft were likely to see some appreciation in value compared to a few years before 2007.

With a loan, the owner/borrower may, with the written consent of a financier, sell the aircraft before the loan repayment is completed. There are rarely penalties in such a case except that the borrower must pay off any remaining balance of the loan. Early exits from a lease can be costly as the contract may require the lessee to pay the remaining lease payments. Leases have return conditions. When returning an aircraft from a lease, the lessee will be required to return it in some pre-agreed state of condition. The lessee will, often, be required to pay the lessee a certain determined amount for returning the aircraft in less than the agreed contracted condition of return. The lender in a loan transaction will require that the aircraft is maintained in an airworthy condition and good state of repair but the owner assumes the risk of the aircraft being worth less than the balance of the loan amount.<sup>83</sup>

In general, leases work well for operators who do not need tax advantages, want minimal down payments, and plan on turning their aircraft over for new ones every few years.<sup>84</sup> With leases longer than about 7 years, the owner/borrower will most likely pay more than if the owner or borrower had taken a loan. On the other hand, lease terms may be more favourable for a new aircraft as many manufacturers offer lease (and finance) programs for their new models.<sup>85</sup>

### **2.2.2.2 Operating lease**

Another form of aircraft financing is an operating lease.<sup>86</sup> An operating lease is defined in the Income Tax (Leasing Rules), 2002<sup>87</sup> as a contract under which the lessor agrees to lease assets to the lessee for specified periodical payments where the title to the assets and the risks and rewards associated with ownership substantially remain with the lessor.<sup>88</sup> However, under the

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<sup>83</sup> *Ibid.*

<sup>84</sup> *Ibid* at page 32.

<sup>85</sup> *Ibid* at page 32.

<sup>86</sup> See *Aircraft Financing*, Third Edition (Paperback) Edited by Andrew Littlejohns, Stephen McGairl (1998) published by Euromoney Publications PLC, Neston House, Playhouse Yard, London EC4V5EX at page 470. Littlejohns and McGairl assert that operating leases are typically arranged by aircraft manufacturers or specialized lessors who are obliged to take back the aircraft at the end of the lease term. Operating leases provide airlines with enhanced flexibility but are usually more expensive than alternative methods of financing. An operating lease is a lease whose term is short compared to the useful life of the asset. For example, an aircraft which has an economic life of 30 years or more may be leased to an operator for 5 years on an operating lease basis. One particular type of operating lease is the wet lease, in which the aircraft is leased together with its crew. A related concept to the operating lease is the leaseback, in which the operator sells its own aircraft for cash, and then leases the same aircraft back from the purchaser for a periodic payment.

<sup>87</sup> These are rules promulgated under and pursuant to the Income Tax Act (Chapter 480, Laws of Kenya).

<sup>88</sup> The Income Tax (Leasing Rules) 2002 distinguishes between operating and finance leases and hire purchase agreements. The rules note that in both operating and finance leases, the legal title to the aircraft remains with the lessor and the lessee merely has a right of possession during the lease term. As regards the hire purchase

International Accounting Standard (IAS) 17, which is applicable in Kenya, an operating lease<sup>89</sup> “is a lease other than a finance lease”.<sup>90</sup>

As a form of financing, often an aircraft purchaser will place itself into a lease structure by bringing a third party to act as purchaser/lessor.<sup>91</sup> In this structure, the third party takes title to the aircraft and leases it to the original buyer. This may allow the financier/lessor to take advantage of tax benefits that the lessee was unable to utilize.<sup>92</sup> According to Greg<sup>93</sup>, usually

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agreements, the rules note that it is the intention of the parties that ownership is transferred on the expiry of the lease. The definition of hire purchase under the aforesaid rules includes conditional sale agreements and credit agreements. This legal distinction has tax consequences.

<sup>89</sup> Finance leasing is attractive to the lessee because the lessee may claim depreciation deductions over the aircraft's useful life, which offset the profits from the lease for tax purposes, and deduct interest paid to those creditors who financed the purchase. This has made aircraft a popular form of tax shelter for investors, and has also made finance leasing a cheaper alternative to operating leases or secured purchasing for many operators. Under American and British accounting rules, a finance lease is generally defined as one in which the lessor receives substantially all rights of ownership, or in which the present value of the minimum lease payments for the duration of the lease exceeds 90% of the fair market value of the aircraft. If a lease is defined as a finance lease, it must be accounted as an asset of the company, in contrast to an operating lease which only impacts the company's cash flow.

<sup>90</sup> The Income Tax (Leasing Rules), 2002 defines a finance lease as a contract pursuant to which the lessor agrees to lease assets to the lessee for a specified period of time where the risks and rewards associated with ownership of the assets are substantially transferred from the lessor and to the lessee, but with the title to the assets always remaining with the lessor. The definition under the International Accounting Standard (IAS) 17 (which is applicable in Kenya) is different. A finance lease is defined in IAS 17 as the one that transfers to the lessee substantially all the risks and rewards incident to the ownership of an asset. IAS 17 does not provide a quantitative test. Instead, it sets out various indicators to facilitate the classification process which are:

- (a) The lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- (c) The lease term is for a major part of the economic life of the asset even if title is not transferred.
- (d) At the inception of the lease the present value of the minimum lease payments amounts to, at least, substantially all of the fair value of the leased asset.
- (e) The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.
- (f) If the lessee can cancel the lease, the losses associated with cancellation are borne by the lessee.
- (g) Gains and losses from the fluctuation in the fair value of the residual value fall to the lessee.
- (h) The lessee has the ability to continue to lease the asset at a rent substantially lower than the market rent.

There is no detailed statutory definition of an operating lease under Kenya law. Unlike a finance lease, the rent received during the lease term is generally insufficient to amortise the capital outlay; the intention being that the asset be leased more than once and that the lessor recovers the costs of acquisition as well as a profit from re-leasing the asset and/or its residual value on its eventual sale. It has been stated that the following features are characteristics (though not invariably so) of an operating lease:

- (a) the lessor will expect to lease the asset many times to different lessees during its working life;
- (b) either the lease will be for a relatively short period, or else the lessee will be able to terminate it at any time, or at stipulated intervals, without further charge;
- (c) the lessee will deal with and bear the cost of matters such as repairs, maintenance and insurance;
- (d) the risks of ownership such as malfunction, loss or destruction and obsolescence will lie with the lessor;
- (e) the lessor will normally have acquired the asset without reference to (and before being approached by) the lessee, and will often have specialist technical knowledge about it;
- (f) the benefit of the residual value of the asset (which will normally be substantial) at the end of the leasing period will be for the lessor.

<sup>91</sup> See article by Greg Cirillo entitled *Business Aircraft Finance Options*, October 2009 published in <http://www.avbuyer.com/articles/detail.asp?Id=87> <accessed on 16<sup>th</sup> July, 2012>.

<sup>92</sup> *Ibid.*

an operating lease is structured in such a way that the aircraft owner/lessor<sup>94</sup> will have to primarily consider 2 issues. These are cash flow in the form of rent coming in together with financing payments due to a financier of the aircraft and the residual value of the aircraft at the end of the lease.

By isolating these 2 elements, the owner/lessor can substantially control its risk, and offer very competitive pricing. Cash flow will include the use of depreciation by the owner or lessor, which in turn will allow the cost to the lessee to be lower. As with any other financing, the lessor of an aircraft will require that the lessee meet strict standards on maintenance, insurance and record keeping. In order to protect the lessor's asset, the lessee may be asked to maintain a reserve of funds (often held by the lessor) to fund on-going maintenance costs. The purpose of these reserves is to ensure that a neglected or abandoned aircraft does not become an expensive asset as regards overdue maintenance and repairs. For similar reasons, a lessor will strongly prefer that the lessee place engines and other components under a pre-paid, or pay-as-you-go maintenance program.<sup>95</sup> The lease will also include other key terms.<sup>96</sup>

In Kenya, aircraft leases are reviewed and approved by the KCAA as a matter of practice.<sup>97</sup> In their review of aircraft leases the KCAA looks at elements such as the duration of the lease,

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<sup>93</sup> *Ibid* at 41.

<sup>94</sup> A commercial aircraft is often leased through a Commercial Aircraft Sales and Leasing (CASL) company, the two largest of which are International Lease Finance Corporation (ILFC) and GE Commercial Aviation Services (GECAS).

<sup>95</sup> See article by Greg Cirillo entitled *Business Aircraft Finance Options*, October 2009 published in <http://www.avbuyer.com/articles/detail.asp?Id=87> <accessed on 16<sup>th</sup> July, 2012>.

<sup>96</sup> These are:

- (a) a full description of the aircraft and the engines attached thereto including their type, serial and registration numbers. Details of any spare parts (including engines) will also be required if it is intended that they also constitute part of the leased property.
- (b) The agreement should stipulate when the lease term shall commence usually on the delivery date and for what period it should remain in operation. As mentioned, one of the indicators of a finance lease is that the lease term is for a major part of the economic life of the asset even if title is not transferred.
- (c) The amount, place and method of payment must be stipulated. As indicated, one of the indicators of a finance lease is that at the inception of the lease the present value of the minimum lease payments amounts to, at least, substantially all of the fair value of the aircraft.
- (d) Covenants of the Lessee which invariably include the following:
  - (i) to service, repair, maintain, overhaul, test or cause the same to be done to the aircraft so as to keep it in good operating condition;
  - (ii) to pay all taxes levied upon it and to indemnify and hold the lessor harmless from any default on the lessee's part;
  - (iii) to permit the lessor or its agent to visit and inspect the aircraft, its condition, use and operation, as well as records maintained in connection therewith;
  - (iv) not to assign or create a sub-lease of the aircraft without the written consent of the lessor; and
  - (v) to bear all risks of loss of or damage to the aircraft.

<sup>97</sup> According to informal confirmations obtained from the KCAA's air transport department in January 2013, generally it takes 5 days to approval a lease in respect of an aircraft. The lease must be accompanied by a letter of introduction from the lessee briefly explaining the lease (that is if the lease of an aircraft is dry – that is involving the aircraft only or wet – that is involving the aircraft and the crew) and requesting for the lease to be approved,

the operational control of the aircraft and maintenance and insurance obligations. A full description of the aircraft and the engines should be attached thereto including the type, manufacturer's serial number and the registration number. Details of any spare parts (including engines) are also required if it is intended that they constitute part of the leased property. Details supplied must include a description of the parts, with sufficient particulars for identification, their number and location. The agreement should stipulate when the lease term shall commence and for what period it should remain in operation. In addition, the amount, place and method of payment must be stipulated.

#### **2.2.2.2.1 *Equitable relief from forfeiture and repossession of an aircraft***

As discussed in Chapter 4, the issue of repossession of an aircraft in the event the lessee/borrower who is in physical possession of an aircraft defaults, is a matter that requires careful consideration. In most cases, an aggrieved lessee/borrower will seek court intervention to challenge repossession of an aircraft by a lessor/financier.

In a recent case where the defaulting lessee sought relief from forfeiture and repossession, the court determined whether a court had jurisdiction to grant relief from forfeiture<sup>98</sup> in relation to an aircraft operating lease of the type and on the terms of those before the court and if so, whether it was appropriate for the court, in the exercise of its discretion, to grant such relief. In *Celestial Aviation Trading 71 Limited v Paramount Airways Private Limited*,<sup>99</sup> Celestial Aviation Trading 71 Limited ("Celestial") had leased 3 Embrair aircraft (with a useful life of at least 20 years) to Paramount Airways Private Limited ("Paramount") under 8 year operating leases. Paramount consistently failed to pay on time the rent and supplemental rent due. Celestial eventually terminated the leases and sued Paramount for monies due under the leases and sought delivery up of the aircraft. Paramount sought the equitable remedy of relief from forfeiture in respect of the aircraft, on the basis that the only default leading to termination was

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the lessee must show that the aircraft subject of the lease is not leased to another person. The requirements as to airworthiness of an aircraft and air operator's licences must be satisfied, the current (year 2012) fee for approving an aircraft lease agreement is 120 United States Dollars per aircraft. The lease must be properly executed and witnessed.

<sup>98</sup> Simply stated, forfeiture is early termination of a lease due to a breach of covenant of the lessee, such as failure to pay the rent. If the lessee breaches the terms of the lease then the landlord has the right to forfeit the lease – which means bring it to an end. Relief against forfeiture is an equitable remedy available in limited cases and like other equitable remedies it is discretionary. It allows a lessee a further opportunity to perform his contractual obligations. The relief can be granted in cases of hardship and if granted it would compel the lessor to continue with the aircraft lease agreements.

<sup>99</sup> Neutral Citation Number: [2010] EWHC 185 (Comm).

failure to pay monies due.<sup>100</sup> The lessor's application for delivery up was refused on the basis that the lessee had a realistic prospect of establishing at trial that the court had discretion to grant relief against forfeiture. Therefore, the lessor was only entitled to the sums claimed and not delivery up of the aircraft. At the summary judgment hearing in 2009, Mr. Justice Teare gave judgment for the unpaid rent, but surprisingly sent to trial<sup>101</sup> the issue of whether the defaulting lessee was entitled to relief against forfeiture.

The trial Court concluded that it had no jurisdiction to grant relief in relation to operating leases of this nature. Justice Hamblen noted that there would be real prejudice to Celestial in granting relief from forfeiture, which would compel Celestial to continue with the aircraft lease agreements.<sup>102</sup> It is not clear how a Kenyan court would determine issues relating to the equitable remedy of relief from forfeiture. However, it should be noted that English courts have persuasive authority.

From the *Celestial* case, our study alludes that aircraft lessors can be assured of their position in the case of an operating lease for a term less than the useful life of the aircraft and where the lessor retains most of the risks and rewards of ownership. The practical lesson from this case is that aircraft leases should be drafted carefully and the lessor's right to forfeit the lease and repossess the aircraft should be clearly spelt out and so is the obligation by lessee to return an aircraft.

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<sup>100</sup> Under the leases, failure to pay rent was an event of default the occurrence of which entitled the lessor by notice to Paramount and with immediate effect terminate the leasing or the aircraft and/or proceed by appropriate action to enforce the performance of the lease or to recover damages for breach of lease and/or either take possession of the aircraft and by serving notice require Paramount to redeliver the aircraft to Celestial at the redelivery location or such other location.

<sup>101</sup> At trial, the court reaffirmed that it had jurisdiction to grant relief where the contract involves the transfer of proprietary or possessory rights, the right to forfeit has been inserted in the contract essentially to secure the payment of monies or a particular result that was the primary object of the bargain and policy supports the existence of the jurisdiction. Mr Justice Hamblen accepted that the operating leases in this case transferred possessory rights to the lessee. Paramount only had a right to possess the aircraft for a proportion of its economic life and the lease contained no purchase option and had detailed terms of return and redelivery of the aircraft. He considered that Celestial, as lessor, retained a very real interest in the aircraft themselves, including their proper maintenance, the extent of their use, condition, and their rental and retail value, and therefore retained many of the risks and rewards of ownership. Mr Justice Hamblen therefore considered that this continuing interest in the aircraft themselves, and not just the payment of rent, meant that it could not be said that the essential purpose of the lease's termination provisions was as "security" for the payment of rent. Rather, the purpose of these provisions was to secure Celestial's ability to be released from the leases and to have the aircraft returned if Paramount was in default. As to policy, Mr Justice Hamblen was not prepared to hold that clauses making time of the essence in making payments necessarily excluded the relief jurisdiction. However, he did conclude that the need for certainty in commercial contracts for valuable assets, such as aircraft, pointed strongly against the court having power to relieve against forfeiture.

<sup>102</sup> Further, the Court noted that even if it had jurisdiction, Mr Justice Hamblen would not have granted relief in this case, where significant sums were due in respect of each aircraft and Paramount had given no proper explanation as to how and why the defaults had occurred, notwithstanding the length of time the sums had been outstanding and the warnings which had been given.

To help improve the position of the owner in the event it wishes to repossess an aircraft, our study proposes that as a matter of good practice an aircraft lease agreement should be drafted in such a way that the owner retains the risks and rewards of ownership regarding the aircraft<sup>103</sup> and in doing so the owner should confirm that the leasing of the aircraft does not in any way amount to or to be interpreted as a transfer of proprietary or possessory rights and the lessee should expressly agree to repossession in the event of a default. The owner should reserve the right to repossess an aircraft at any stage during the term.<sup>104</sup> In addition, leasing of the aircraft and the option to purchase should be coupled with an express provision to the effect that no right (including, without limitation, refusing repossession of an aircraft), title or interest in and to the aircraft shall vest with the lessee until the lessee has paid the purchase price in full for the aircraft and all other payments required to be made by the lessee and should be made subject to the certain reserved rights. These include the fact that upon the occurrence of any event of default under the security documents or any other terminating event, the owner will demand that the lessee immediately moves the aircraft to an airport designated by owner and lessee should unconditionally accept the obligation to immediately comply with such request. The lessee should also provide the owner unlimited access to the aircraft and require that the lessee provides the owner, within a specified time from the occurrence of an event of default or terminating event, with either the originals of the aircraft documentation or with certified copies and thereof and lessee should accept the obligation to comply with such request.

The agreement should also provide that if an event of default has occurred and is continuing, the owner may take all steps necessary to deregister the aircraft in the state of registration and export the aircraft from the state of registration, the base or the country where the aircraft is actually based and the lessee should irrevocably and by way of security for its obligations under the agreement appoint the owner as its attorney to execute and deliver any documentation and to do any act or thing required in connection with the foregoing.

The contractual position in Kenya is that, unless a contrary intention is expressed, on termination of the aircraft lease agreement (whether on expiry or otherwise) as contemplated

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<sup>103</sup> Examples of indicative elements relating to retention of risks and rewards include the obligation to insure, repair, maintain, inspect from time to time.

<sup>104</sup> The owner should reserve a right to take possession of the aircraft or serve notice requiring the lessee to return the aircraft to the owner at the location specified by the owner. The owner should be expressly authorized to instruct and direct the pilots of the lessee or other pilots to fly the aircraft to an airport designated by the owner and the owner will have all the powers and authorizations necessary for taking that action.

in that lease, the lessor would be entitled to repossess the aircraft and to deregister an aircraft from the register of the KCAA and to export the aircraft from Kenya.<sup>105</sup>

### 2.2.2.3 Enhanced equipment trust certificates

Other than operating leases, aircraft financing can be obtained through finance leases.<sup>106</sup> There are various forms of finance leases but our study will discuss the enhanced equipment trust certificates as a form of aircraft financing structure. We wish to highlight at this early stage of the study that this is a complex aircraft financing structure which has not received acceptance in developing jurisdictions such as Kenya. It is actually a form of financing in advanced jurisdictions, for example, the United States of America (“US”).

Aircraft are expensive.<sup>107</sup> With the limited ability of the traditional bank market to absorb the massive financing requirements of these capital expenditures, the airlines, aided by their investment bank advisors, have been able to turn to the capital markets to satisfy their financing needs.<sup>108</sup> While the capital markets have been tapped for some time to finance aircraft (and rail) equipment, largely in the form of publicly issued equipment notes, the security commonly known as the enhanced equipment trust certificate (EETC) has become the mainstay for the financing in the public markets of aircraft.

Under the traditional equipment trust certificate (ETC), a trustee issues equipment trust certificates to investors and uses the funds raised to buy an aircraft, which is then leased to the airline which ordered it. EETC is a modified version of ETC. Rather than selling one type of certificate or bond, the EETC divides these into different categories, each of which has a different risk/reward profile in terms of security and access to lease rental cash flows.<sup>109</sup>

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<sup>105</sup> The repossession and export of an aircraft is without requiring any further consents, approvals or licenses from any governmental or regulatory authority in Kenya provided that the exercise of such rights are subject to all fees and charges (such as air navigation charges) payable in respect of the aircraft having been paid to the relevant authorities and to any lien holders and is subject to obtaining a clearance certificate under the Customs and Excise Act (Chapter 472, Laws of Kenya).

<sup>106</sup> Finance leasing, also known as "capital leasing," is a longer-term arrangement in which the operator comes closer to effectively "owning" the aircraft. It involves a more complicated transaction in which a lessor, often a special purpose company or partnership, purchases the aircraft through a combination of debt and equity financing, and then leases it to the operator. The operator may have the option to purchase the aircraft at the expiration of the lease, or may automatically receive the aircraft at the expiration of the lease.

<sup>107</sup> See article entitled “EETCs In The Downturn: An Assessment” By Ronald Scheinberg which notes that aircraft can cost from 18 million United States Dollars for a 50-seat Canadair regional jet to over 150 million United States Dollars for a Boeing 777 aircraft.

<sup>108</sup> *Ibid.*

<sup>109</sup> See book entitled *Airline Finance*, Third Edition by Peter S. Morrell, 2007 at page 212.



Securitization of aircraft leases has become an important source of capital for US airlines as well as for US and non-US lessors.<sup>110</sup> Such financing provides access to the US and foreign capital markets, opening up a significant new source of capital for the aviation industry. There are 2 basic structures for securitizing aircraft leases namely, the EETC securitization and the portfolio securitization.<sup>111</sup> Our study will discuss EETC securitization.<sup>112</sup>

Since the first US EETC transactions in the 1990s<sup>113</sup>, EETCs have become the predominant capital markets vehicle for US airlines to finance aircraft - and they have generally withstood market ups and downs.<sup>114</sup> Securitizations of aircraft leases have achieved widespread acceptance as a means of financing for both airlines and lessors. For individual airlines that can make the necessary securities disclosures as well as lessors with groups of aircraft on lease to airlines that have sufficient publicly available financial information, EETCs will continue to provide a source of capital. Non-US airlines can also be expected to undertake EETC securitizations as the legal issue of "section 1110 equivalence"<sup>115</sup> is successfully addressed in other jurisdictions. In addition, more lessors can be expected to undertake portfolio securitizations as a means of accessing new sources of capital as the capital markets become more accustomed to the concept of the worldwide market for leased aircraft.<sup>116</sup>

An EETC securitization enhances the creditworthiness of traditional ETCs secured by lease receivables and the leased aircraft as follows. First, the issuer of the EETCs is bankruptcy remote (and insulated from a bankruptcy of the lessee) to the satisfaction of the rating agencies, second, the EETCs are tranching to take advantage of the expected residual value of the aircraft, that is, the lower the advance level, the higher the rating and third, a liquidity

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<sup>110</sup> See article by William C. Bowers entitled "*Aircraft Lease Securitizations*" published on <http://pages.stern.nyu.edu/~igiddy/ABS/bowers2.html> <accessed on 12<sup>th</sup> July, 2012>.

<sup>111</sup> For information about portfolio securitization see article by William C. Bowers entitled "*Aircraft Lease Securitizations*" published on <http://pages.stern.nyu.edu/~igiddy/ABS/bowers2.html> <accessed on 12<sup>th</sup> July, 2012>.

<sup>112</sup> For further reading and information on the structuring of EETC see article entitled "*EETCs In The Downturn: An Assessment*" By Ronald Scheinberg at [http://www.vedderprice.com/docs/pub/77ab0de9-8a54-4abf-b981-f919bfe3c622\\_document.pdf](http://www.vedderprice.com/docs/pub/77ab0de9-8a54-4abf-b981-f919bfe3c622_document.pdf) <accessed on 21st August, 2012>.

<sup>113</sup> *Ibid.* Scheinberg notes that the first issued in 1994, US airlines have issued in excess of 40 billion United States Dollars of EETCs to finance aircraft in their fleets.

<sup>114</sup> See also "*How The EETC Structure Has Changed*" in the May 2010 Airfinance Journal ([www.airfinancejournal.com](http://www.airfinancejournal.com)) published on [www.debevoise.com/.../HowEETCStructureHasChanged.pdf](http://www.debevoise.com/.../HowEETCStructureHasChanged.pdf).

<sup>115</sup> The rationale and significance of this US statutory provision is discussed in detail on our study.

<sup>116</sup> See William C. Bowers article on "*Aircraft Lease Securitizations*" published on <http://pages.stern.nyu.edu/~igiddy/ABS/bowers2.html> <accessed on 12<sup>th</sup> June, 2012>.

facility is provided to ensure the continued payment of interest on the EETCs during the remarketing period following a default by the lessee.<sup>117</sup>

In a traditional ETC, a trustee issues ETCs to investors and uses the proceeds to buy the aircraft, which is then leased to the airline.<sup>118</sup> Lease payments are then used to pay principal and interest on the certificates. The collateral of ETCs typically includes only one or two aircraft.<sup>119</sup> Increasing issuance costs led to the development of pass-through certificates (“PTCs”)<sup>120</sup>, which pooled a number of ETCs into a single security that was then backed by a pool of aircraft rather than just a single one. Although PTCs increased diversification and reduced exposure to a single aircraft, the airline industry downturn in the early 1990s led to downgrades of many ETCs and PTCs to below investment grade and subsequently to a narrowed investor base. During the mid-1990s, ETCs and PTCs were further modified into EETCs which soon became the leading source of external finance of aircraft.<sup>121</sup>

EETC<sup>122</sup> securitization has 3 main advantages compared to traditional ETCs and PTCs.<sup>123</sup> First, EETCs have larger collateral pools with more than 1 aircraft type, making them more diversified. Second, EETCs typically have several tranches with different seniority. Third, a liquidity facility, provided by a third party,<sup>124</sup> ensures the continued payment of interest on the certificates for a predetermined period following a default, typically for a period of up to 18 months. EETC securitization therefore enhances the creditworthiness of traditional ETCs and PTCs by reducing bankruptcy risk, tranching the cash flows, and providing temporary liquidity in the event of default. Because of the varying LTVs, credit ratings, and yields associated with different tranches of EETCs, they are purchased by both investment grade and

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<sup>117</sup> *Ibid*

<sup>118</sup> Efraim Benmelech and Nittai K. Bergman in *Bankruptcy and the Collateral Channel*, The Journal of Finance Vol. LXVI, No. 2 April 2011 at page 342.

<sup>119</sup> For example, on August 24, 1990, American Airlines issued an ETC (1990 ETCs, Series P) maturing on March 4, 2014. The certificates were issued to finance approximately 77% of the equipment cost of one Boeing 757-223 (serial number 24583) passenger aircraft, including engines (Rolls-Royce RB211-535E4B). The proceeds from the ETC issue were 35.5 million United States Dollars, with a serial interest rate of 10.36% and a credit rating of A (S&P) and A1 (Moody’s).

<sup>120</sup> See *Aircraft Financing*, Third Edition (Paperback) Edited by Andrew Littlejohns, Stephen McGairl (1998) published by Euromoney Publications PLC, Neston House, Playhouse Yard, London EC4V5EX at page 470. In the referenced article, it is argued that Pass Through Certificates (“PTC”) represent ownership of 2 or more ETCs created by pooling or bundling ETCs in a system where payment of principal and interest on the ETC is passed through a PTC holder via a trust structure. The Pass Through structure is created as a means of diversifying the aircraft pool and/or increasing the size of the total offering.

<sup>121</sup> Efraim Benmelech and Nittai K. Bergman in *Bankruptcy and the Collateral Channel*, The Journal of Finance Vol. LXVI, No. 2<sup>nd</sup> April 2011 at page 343.

<sup>122</sup> *Ibid* at page 343.

<sup>123</sup> See *Aircraft Financing*, Third Edition (Paperback) Edited by Andrew Littlejohns, Stephen McGairl (1998) published by Euromoney Publications PLC, Neston House, Playhouse Yard, London EC4V5EX at page 470.

<sup>124</sup> An example being Morgan Stanley Capital Services of the United States.

high yield institutional investors. These include insurance companies, pension funds, mutual funds, hedge funds, and money managers. Although the market for EETCs is not as liquid as that for corporate bonds, it is more liquid than the market for bank loans.<sup>125</sup>

The term of the liquidity facility in an EETC securitization relies on the ability of a lessor to repossess an aircraft from a bankrupt lessee under section 1110, if the lessee does not elect to perform. The principal issue in doing an EETC securitization with a non-US airline will be the availability of "section 1110 equivalent" repossession rights, that is, the ability to repossess and remarket the leased aircraft in a time frame comparable to that allowed by section 1110. The foregoing enhancements to traditional ETCs allow EETCs to have credit ratings significantly higher than the corporate credit rating of the lessee, particularly at lower advance levels. Thus, a sub-investment grade borrower can issue investment grade debt, and an investment grade borrower also can reduce its borrowing costs with the lower pricing for higher grades of debt.<sup>126</sup>

As mentioned in Chapter 1, Section 1110 of the US Bankruptcy Code has played a pivotal role in allowing US airlines to access capital markets through the issuance of EETCs. The section is unique among national insolvency laws around the world in giving secured creditors with interests in the aircraft the automatic ability to repossess after a fixed 60 day delay, thus removing any potential uncertainty in the handling of the creditor's rights by the courts.<sup>127</sup> As a result, while the US airlines have enjoyed access to capital markets due to Section 1110,

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<sup>125</sup> Efraim Benmelech and Nittai K. Bergman in *Bankruptcy and the Collateral Channel*, The Journal of Finance Vol. LXVI, No. 2 April 2011 at page 343 borrowing from Mann, Elizabeth D., 2009, Aviation finance: An overview, *The Journal of Structured Finance* 15, 109–117.

<sup>126</sup> For information about portfolio securitization see article by William C. Bowers entitled "Aircraft Lease Securitizations" published on <http://pages.stern.nyu.edu/~igiddy/ABS/bowers2.html> <accessed on 12<sup>th</sup> June, 2012>

<sup>127</sup> See page 14 of the Research by Steven Golbeck and Vadim Linetsky *Asset Financing with Credit Risk*, January 8, 2012. Golbeck and Linetsky argue that the repossession delay and costs are important variables in the valuation of defaultable leases, as well as secured loans. The costs the lessor or secured lender may incur in the repossession process may include legal costs of the repossession process, costs of the physical repossession (for example, flying the aircraft to the desired destination), costs of repair and maintenance of the asset (can be substantial if the bankrupt lessee or borrower fails to properly maintain the asset, and no separate maintenance reserves have been provisioned in the lease or loan contract), costs of downtime (for example, storage fees and insurance premiums), costs of re-marketing the asset to find a new lessee or buyer, as well as possible super-priority liens, such as mechanics' liens or airport fees attached to the aircraft in the event the bankrupt lessee or borrower does not pay those obligations. Re-marketing costs may have fixed, as well as proportional components (for example, broker commissions). All other costs are generally fixed. The repossession delay depends on the type of asset and the legal jurisdiction of the lessee or borrower. If the bankruptcy results in a stay of repossession, the repossession delay can take many months or even years. During that period the asset continues to depreciate, lease or loan payments are not made, and the various costs continue to mount. As discussed, In the US, Section 1110 of the US Bankruptcy Code grants aircraft lessors and secured lenders exemption from the repossession stay and grants them the right to repossess aircraft 60 days after payment default on a lease or secured loan.

non-US airlines have so far been largely unable to issue any public debt securities collateralized by aircraft on competitive terms. The primary reason has been the reluctance of bond investors to accept the depreciating aircraft collateral in the face of potentially lengthy repossessions delays.<sup>128</sup> While for many of the larger US airlines EETC issues have been the primary source of aircraft financing, the primary sources of financing for non-US airlines have been bank loans, leases, and export credit financing. The reasons why private market financiers, such as banks and operating lessors, are more willing to lend against aircraft collateral in the face of possible repossession delays is their specialized expertise in the aircraft markets and their on-going relationships with the airlines that may give them higher confidence in their ability to repossess swiftly, while EETC trusts are stand-alone financing vehicles managed by the trustee on behalf of bond holders that may lack the specialized expertise of a large bank or lessor extensively involved in aircraft finance on an on-going basis.

The positive impact of Section 1110 on US airlines' aircraft financing, including the airlines' access to capital markets via EETC issues, lead to the desire by many aircraft market participants to replicate the success of Section 1110 globally. The Convention and the Protocol were intended to standardize aircraft financing transactions and harmonize diverse national insolvency laws. In particular, the OECD qualifying declarations with the Protocol in Article XI with a maximum repossession delay period of 60 days essentially replicate Section 1110 internationally among the jurisdictions ratifying the Convention. A number of jurisdictions around the world have already ratified the Convention, with a significant number currently considering ratification.<sup>129</sup>

According to industry sources, the actual repossession experiences in various non-Convention jurisdictions around the world have varied greatly, from 60 days or less to as long as 2 years, depending on the jurisdiction's legal system, national insolvency laws, court expediency, and the circumstances of each case.

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<sup>128</sup> See page 27 and 28 of the Research by Steven Golbeck and Vadim Linetsky *Asset Financing with Credit Risk*, January 8, 2012.

<sup>129</sup> *Ibid*

## **2.3 Importance and challenges of export credit guarantees in commercial financing and the aspect of pre-delivery payment financing**

### **2.3.1 Export credit guarantees**

Whether in secured loan financing or under operating leases, the export of aircraft can be covered under an export credit guarantee. In view of credit amounts which may run into hundreds of millions of United States Dollars, protection against bad debt losses is of great importance. Long credit periods for the financing schemes adds to the uncertainty for financiers and other lenders. Aircraft are usually exported within the framework of leasing transactions in which a financier is involved. The airline company wishing to purchase an aircraft would usually look for a financier to fund its aircraft purchase transaction. The appointed financier then applies for an export credit guarantee from an export credit agency (“ECA”) which guarantee protects the financier against potential bad debt losses. An export credit guarantee is essentially a pure insurance cover contract.<sup>130</sup> In the event of default, the ECA takes over the defaulted loan from the commercial financier and pays off the outstanding loan balance and the accrued interest to the financier. The financier is thus relieved from the cost and delay of having to repossess<sup>131</sup> the aircraft and the risk of any shortfall in the event the recovered value of the repossessed aircraft net of all costs is less than the outstanding loan balance plus accrued interest. The ECA charges an upfront exposure fee expressed as percentage of the loan principal amount.<sup>132</sup> The exposure fee is paid by the borrower.

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<sup>130</sup> Export credit guarantee is some form of insurance which is advantageous for the parties involved. Financiers are protected from the risk of bad debt losses against the payment of a premium and it becomes easier for them to refinance themselves on the capital market with an export credit guarantee. Aircraft are usually financed over a period of 12 years. During this time the aircraft generates monies for the payment of interest and principal through its operation. In the event that the airline gets into financial difficulties during this period, the export credit guarantee becomes effective. In such a case efforts are made to stabilize the transaction by means of extending the credit period. In most cases the combination of restructuring and indemnification of the lender by instalments helps to keep the project afloat - though over a longer period of time than originally planned. See additional information on <http://www.agaportal.de/en/portal/presse/hintergrund/pm-flugzeuge.html> <accessed on 16<sup>th</sup> July, 2012>.

<sup>131</sup> For instance section 1110 of the United States Bankruptcy Code provides a secured lender the ability to repossess the aircraft within 60 days after a bankruptcy filing unless the airline cures all defaults. The right of the lender to take possession of the aircraft is not hampered by the automatic stay provisions of the US Bankruptcy Code.

<sup>132</sup> See article published on Saturday, 9<sup>th</sup> January 2010 in the Ethiopian Reporter: <[http://en.ethiopianreporter.com/index.php?option=com\\_content&task=view&id=2134&Itemid=1](http://en.ethiopianreporter.com/index.php?option=com_content&task=view&id=2134&Itemid=1)> accessed on 17<sup>th</sup> July, 2012 where it is argued that the Convention provides financiers with a number of key rights with respect to an aircraft financed for an airline of a country that has ratified the convention and protocol. As a result, the lender can offer lower financing. Ex-IM Bank offers eligible foreign buyers to receive an exposure fee of as low as 2%, a one-third reduction of the minimum 3% exposure fee on large aircraft financing. The referenced article has indicated that for the 15 year-period prior to 2010, Ex-IM Bank has collected over 100 million United States Dollars in exposure fees.

To help support exports of equipment, such as aircraft, railroad equipment, ships, and certain other assets, ECAs<sup>133</sup> such as the Export-Import Bank of the United States (“Ex-IM Bank”), under certain conditions provide export credit guarantees to financiers/lenders for loans conforming to the export credit eligibility requirements.<sup>134</sup> It is reported<sup>135</sup> that Ex-IM Bank, during past 15 year-period before 2010, provided almost 4 billion United States Dollars of aircraft financings to Africa’s airlines and leasing companies. During the similar period, Ex-IM Bank financed over 100 Boeing aircraft to airlines and leasing companies in Algeria, Angola, Ethiopia, Kenya, Morocco, Namibia, Nigeria, Malawi, Senegal, South Africa and Tunisia.<sup>136</sup> Ex-IM Bank is the largest financier of new United States manufactured commercial aircraft in the world. Ex-IM Bank’s existing aircraft finance portfolio includes more than 27 billion United States Dollars of guarantees and loans for approximately 700 US Boeing aircraft.

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<sup>133</sup> *The key agencies involved with aircraft financing are: Export-Import Bank of the United States (ExIm) -the bank assists in financing the export of US goods and services to international markets, filling the financing gaps that the private sector is unwilling to accept. ExIm is different from the other ECAs as it can provide funding if required.*

*Export Credits Guarantee Department (UK)- UK Export Finance is a government department that provides government assistance to UK exporters and investors, principally in the form of insurance policies and guarantees on bank loans.*

*Federal Export Credit Guarantees (Germany)- Euler Hermes helps to promote German exports by offering guarantees that protect German companies in the event of non-payment by foreign debtors. The German export credit scheme is managed on behalf of the Federal Government by Euler Hermes and PwC Germany.*

*Compagnie Française d’Assurance pour le Commerce Extérieur (Coface)- the Coface Group is a trade risk and credit insurance expert, offering credit insurance to companies, regardless of their size, sector or country.*

*Export Development Canada-Canada’s Export Credit Agency is self-financed and works to support and develop Canada’s export trade by helping Canadian companies respond to international business opportunities.*

*Brazil Development Bank- the BNDES is a Brazilian federal company aiming to provide long-term financing to Brazilian companies of all sizes. Its key goals are the strengthening of capital structures of private companies as well as the development of capital markets.*

<sup>134</sup> For instance, the export credit agencies of Germany, Great Britain (ECGD) and France (COFACE) recently agreed a close cooperation to provide joint cover for the export of Airbus aircraft. Each of the 3 agencies involved therefore insures the respective national share in the production. The 3 export credit agencies jointly developed an insurance model which takes the specific situation of the aircraft industry into account and makes 100% cover possible.

See <http://www.agaportal.de/en/portal/presse/hintergrund/pm-flugzeuge.html> <accessed on 16<sup>th</sup> July, 2012>.

<sup>135</sup> See Research by Steven Golbeck and Vadim Linetsky *Asset Financing with Credit Risk*, January 8, 2012, Department of Industrial Engineering and Management Sciences, McCormick School of Engineering and Applied Sciences, Northwestern University ([http://users.iems.northwestern.edu/\\_linetsky/](http://users.iems.northwestern.edu/_linetsky/)).

<sup>136</sup> See article entitled *Quest for Aircraft Financing in Africa* published on: <[http://en.ethiopianreporter.com/index.php?option=com\\_content&task=view&id=2134&Itemid=1](http://en.ethiopianreporter.com/index.php?option=com_content&task=view&id=2134&Itemid=1)> accessed on 17<sup>th</sup> July, 2012. The article notes that Ex-IM Bank’s existing African aircraft finance portfolio as at 2010 was almost 2 billion United States Dollars of guarantees and loans (approximately 7.5 percent of total current aircraft finance exposure) for approximately 70 Boeing aircraft (approximately 10% of the total number of aircraft). In addition, during the 15 year-period before 2010, Ex-IM Bank provided almost 60 billion United States Dollars of aircraft financings to the world’s airlines and leasing companies to support their acquisition of over 1,000 Boeing aircraft (an average of approximately 70 aircraft per year, although it has ranged from less than 15 aircraft per year to more than 120 aircraft per year).

In the aircraft sector, the Organization for Economic Cooperation and Development (“OECD”) Sector Understanding on Export Credits for Civil Aircraft (the OECD Aircraft Sector Understanding (“ASU”))<sup>137</sup> governs the terms and conditions of ECA support for aircraft. Some of the current terms and conditions under the new ASU that came into force in 2011 are that the maximum term for the guaranteed loan is 12 years, the maximum loan to value ratio (“LTV”)<sup>138</sup> of the loan is 85% of the net purchase price of the aircraft and the principal amortization schedule is mortgage-style with quarterly payments.

Furthermore, according to the credit rating of the borrower, certain risk mitigation measures are applied to the basic terms and conditions, such as the reduction in LTV, shortening loan maturity to 10 years, and/or replacing the mortgage-style principal amortization profile with the level principal amortization. The purpose of risk mitigation measures is to reduce the risk of the loan thereby reducing the exposure to the ECA guaranteeing it.<sup>139</sup>

### 2.3.2 Challenges to ECA financing

The role of ECAs has been under the spotlight in recent years because the ‘home airlines’ are barred from utilizing this type of financing.<sup>140</sup>

The issue is that airlines from around the world, some of which are highly profitable, have benefited from using ECAs as a reliable and relatively cheaper source of borrowing, which some argue gives them an unfair advantage. The situation has been particularly severe in the US where the Air Transport Association of America representing a number of key ‘home

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<sup>137</sup> The OECD "Aircraft Sector Understanding" (ASU) is an international agreement which establishes rules and minimum requirements for the financing of aircraft transactions through state export credit agencies. In tough negotiations at the OECD in which Brazil also took part, this agreement was revised in the course of the year 2010 and adapted to the changes in the environment in which the international aircraft industry operates. The new ASU entered into force on 1 February 2011. As from 2011 the premium which already used to be risk-based will mirror the market situation even better through a surcharge which will be fixed on a quarterly basis. The agreement is a Sector Understanding under the OECD Consensus, which establishes rules for state export credits and has been regarded as a cornerstone of fair world trade for a long time.

<sup>138</sup> See *Aircraft Financing*, Third Edition (Paperback) Edited by Andrew Littlejohns, Stephen McGairl (1998) published by Euromoney Publications PLC, Neston House, Playhouse Yard, London EC4V5EX at page 468. Littlejohns and McGairl argue that LTV is the ratio reflecting the percentage of an aircraft’s appraised market value that the loan represents. Accordingly, the writers postulate that the increase in LTV is the collateral coverage ratio or the number of times that an aircraft’s market value covers the loan. For example, an LTV of 40% implies a loan coverage of 2.5 times and that this number is valuable as a security measure, especially in light of the Section 1110 of the Bankruptcy Code protection in the US that allows an EETC holder to take possession of an aircraft upon the occurrence of an event of default.

<sup>139</sup> See page 18 and 19 of the Research by Steven Golbeck and Vadim Linetsky *Asset Financing with Credit Risk*, January 8, 2012, Department of Industrial Engineering and Management Sciences, McCormick School of Engineering and Applied Sciences, Northwestern University (see <http://users.iems.northwestern.edu/linetsky>).

<sup>140</sup> There are some limited exceptions e.g. at present AF KLM, Lufthansa and BA each have the option to finance two A380s supported by ECAs.

operators', recently sued the Ex-IM bank for providing a financing solution to Air India for its 787 deliveries which they argue will provide an uneven playing field to a direct competitor.

### **2.3.3 Guarantees under the new ASU dispensation**

Historically, ECA in the key airframe and engine manufacturing countries, such as the US, United Kingdom, Germany, France, Canada and Brazil, have recognized the importance of aircraft manufacturing to the national economies so supported the export of their aircraft by offering guarantees to cover the losses of commercial banks that were lending to relatively risky airlines. While traditionally, this type of guarantee-based funding has been used as a backup source, over the last four years ECA backed funding has become the funding source of choice and has been used by airlines with stronger credits.<sup>141</sup>

The key point about this source of funding is that commercial banks still provide the required funding, ECAs provide guarantees to make good any specific losses incurred by the funding bank in case of default. As a consequence, the credit risk for banks is not the airline anymore but the sovereign risk of the ECA giving the collateral. The cost of financing through ECA-backed guarantees has historically been lower than commercially available bank debt. But, with the implementation of the new Aircraft Sector Understanding<sup>142</sup>, the cost will increase from 2013 as premiums are more aligned with market ratios. The new ASU raises the export credit premium for all buyers and borrowers, whether airline or lessor, but the rise is steeper for those with a better credit rating. Higher-risk airlines will still pay more than they do now but not as much proportionally, making export credit less attractive to stronger airlines.

The new ASU directs each export credit agency to classify its buyers and borrowers into one of eight risk categories, based on their senior unsecured credit ratings. These rankings, valid for up to 12 months, will be recorded with the OECD Secretariat. An airline's risk rating affects several things, the main one being the amount of premium an ECA will charge for providing export credit. Export credit agencies will adjust their premiums prospectively. They

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<sup>141</sup>Aircraft Finance article by PWC, January, 2013, [http://www.pwc.com/en\\_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fastern-your-seat-belts-pdf.pdf](http://www.pwc.com/en_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fastern-your-seat-belts-pdf.pdf).

<sup>142</sup> The 2011 ASU applies to all new commercial aircraft, except regional jets and turboprops, delivered since the turn of the year. New regional aircraft come under the agreement on 1 January 2014. It applies to new aircraft from all manufacturers except those in China and Russia, which are not OECD members. Brazil is not an OECD member either but has accepted the new ASU. Aside from this difference in effective dates, the ASU eliminates all distinctions between aircraft type and sizes.



will set the new premiums each February and adjust them quarterly through surcharges. The purpose of these adjustments is to keep premiums in line with changing market conditions.

## 2.4 The aspect of pre-delivery payment financing

In aircraft financing, pre-delivery payment financing<sup>143</sup> refers to the financing of progress payments that a purchaser makes to a manufacturer while new aircraft are being built.<sup>144</sup> Pre-delivery payments are typically a percentage of the aircraft price. Considering that the price for a smaller aircraft from Airbus or Boeing is about 75 million United States Dollars, a purchaser will have to pay out 15 to 20 million United States Dollars over 2 or 3 years in advance of the aircraft delivery to the airline.<sup>145</sup> This could cover more than 30% of an aircraft's purchase price.<sup>146</sup>

Traditionally, short-term bank loans to a purchaser covering the pre-delivery payment would be paid off by the purchaser at the time of delivery of the aircraft. However, many financiers who had long offered special loans to cover pre-delivery payments are currently unwilling to do so and this has forced purchasers to arrange for this expense from their cash flow.<sup>147</sup> Michaels argues that arranging pre-delivery financing for the latest models of aircraft is also difficult because their resale values cannot be established with certainty. Financiers are more willing to finance on delivery because finished jetliners can be repossessed in a bankruptcy and are mobile assets with resale values well established in active used-plane markets. Pre-delivery loans have become unpopular as they fund unfinished assets. Financiers and manufacturers have argued over how to treat the loan if a borrowing airline defaults and the aircraft has not been delivered.<sup>148</sup> There has not been a concise agreement on how this should be done.

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<sup>143</sup> Also known as PDP financing.

<sup>144</sup> See Cameron A Gee article on *Aircraft Pre-Delivery Payment Financing Transactions* published at <http://www.ijournals.com/doi/abs/10.3905/JSF.2009.15.3.011>.

<sup>145</sup> See Special Report by IATA on *Aircraft Financing: Risk and Reward* August, 2010 published on <http://www.iata.org/pressroom/airlines-international/august-2010/pages/07.aspx> <accessed on 16th July, 2012>.

<sup>146</sup> According to an article by Daniel Michael (published on <http://online.wsj.com/article/SB124889252624990979.html> <accessed on 27th June, 2012>), a Dreamliner aircraft has a catalog price of about 180 million United States Dollars which would imply that pre-delivery prepayments would be about 60 million United States Dollars. See previous comment on foot note 54 on Kenya Airways Limited and the African Export-Import Bank arrangement for pre-delivery prepayment financing.

<sup>147</sup> See Article by Daniel Michael published on <http://online.wsj.com/article/SB124889252624990979.html> <accessed on 27th June, 2012>.

<sup>148</sup> *Ibid.*

## 2.5 Recent financial innovations and emerging new sources of aircraft finance

### 2.5.1 Financial innovations

As aircraft deliveries peak over the next few years,<sup>149</sup> at a time when long term United States Dollar financing becomes scarcer for major banks in Europe and other countries, there are significant challenges for the aviation industry as a whole to find finance for the new deliveries.<sup>150</sup> Pricewaterhouse Coopers (PwC)<sup>151</sup> reports that the cost of financing should be expected to increase further in the coming years as regulatory changes take shape, in particular Basel III and the implementation of the new Aircraft Sector Understanding (ASU) from 2013. The European banks who have traditionally dominated aircraft financing are continuing to opt out with the net effect that this will intensify the competition to obtain aircraft financing and the cost of financing will likely further increase.<sup>152</sup> PWC says that airlines and lessors will have to be more innovative in the structures they use to access new investors. All the major players in the aviation industry including manufacturers, financiers, airlines and lessors will therefore have to work harder to attract new investors to the industry.

The industry is already witnessing some creative financing solutions being introduced for example, the issued Nord LB aircraft mortgage covered bond and Doric Nimrod Alpha<sup>153</sup> issuance of EETC to finance A380s for Emirates.<sup>154</sup> Developing an EETC type product for leading airlines in various jurisdictions would help enlarge the pool of funds and bridge some of the funding gap. Doric Two (UK-listed company)<sup>155</sup> through the proceeds obtained by

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<sup>149</sup> Aircraft manufacturers Boeing and Airbus have predicted a peak in deliveries in the coming years.

<sup>150</sup> See article titled *Aircraft Finance: Fasten Your Seat Belts*, January 2013 by Pricewaterhouse Coopers (PwC), UK with electronic copy at [http://www.pwc.com/en\\_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fasten-your-seat-belts-pdf.pdf](http://www.pwc.com/en_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fasten-your-seat-belts-pdf.pdf).

<sup>151</sup> See article titled *Aircraft Finance: Fasten Your Seat Belts*, January 2013 by Pricewaterhouse Coopers (PwC), UK with electronic copy at [http://www.pwc.com/en\\_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fasten-your-seat-belts-pdf.pdf](http://www.pwc.com/en_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fasten-your-seat-belts-pdf.pdf).

<sup>152</sup> Banc of America Leasing is a leader in the corporate aircraft market, with a portfolio of over 750 clients and 7.25 billion US\$ in aircraft loans and leases. See <http://corp.bankofamerica.com/business/ci/aircraft-finance>.

<sup>153</sup> Doric Alpha is a wholly-owned subsidiary of Doric Nimrod Air Two Limited, an aircraft investment company listed on the London Stock Exchange. Doric now manages an asset portfolio totaling about 7 billion United States Dollars.

<sup>154</sup> The delivery of Doric's 18<sup>th</sup> Airbus A380 in December 2012 concluded the aircraft acquisitions for the Doric Alpha EETC transaction closed in June 2012.

<sup>155</sup> Doric Asset Finance and Nimrod Capital successfully listed an investment company, Doric Nimrod Air Two (DNA2), on the Specialist Fund Market of the London Stock Exchange on 14<sup>th</sup> July 2011 - a new company created to fund three A380s for lease to Emirates. In a press release on 3<sup>rd</sup> December, 2012, Doric Nimrod Air Finance Alpha Limited (Doric Alpha) announced that it took delivery of its fourth and final Airbus A380 bearing the manufacturer's serial number 110 on 30 November 2012 in Hamburg and it was noted that the eighth A380 has been financed in the capital markets. The first two A380s were delivered in October 2012 and the third superjumbo earlier in November 2012. All four aircraft are leased to Emirates for a period of 12 years. Upon

issuing an EETC and listing it, has purchased three A380s and lease them to Emirates each for 12 years.

On the other hand, Nord LB issued the German bond backed by an aircraft mortgage (a new product first used by Nord LB in July 2012). German banks are now able to refinance loans granted for aircraft on more favourable terms than previously as the federal government has issued aviation bonds to secure German banks' leading position on the market for the financing of aircraft.<sup>156</sup> The Law on Development of Bonds, passed by the Federal Cabinet in 2009, is intended to create a better framework for German bonds without relaxing the associated high collateral requirements set out under German law.<sup>157</sup> Lending through aviation bonds is limited to aircraft, so other types of air transport such as blimps or gliders cannot be considered. The loan value of an aircraft will be determined by an appraiser and may not exceed the value that results from a careful evaluation of its future ability to sell, taking into account any alternate use. The loan is limited to the first 60% of the aircraft value and to the first 20 years of its useful life. The law clearly states that any claims held by the mortgage lending institution that are based on the aircraft's economic substance are part of the recorded insurance cover.

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leasing of the first three aircraft, DNA2 aimed to pay a dividend of GBP 4.5 pence per share per quarter, equivalent to an annual dividend of 9% per GBP 200 pence share. In addition to the regular yield of 9%, once the lease has expired, the aircraft are likely to be sold and investors paid out from a residual value. Under the terms of the lease, Emirates is responsible for insurance and all other service, maintenance and repair cost. DNA2 is a limited liability company whose investment objective is to obtain income returns and a capital return for its Shareholders by acquiring, leasing and then selling aircraft.

<sup>156</sup> Sections 29 and 30 of the German Mortgage Lending Act assume a separation of assets in the event of bankruptcy and forced sale of assets. The mortgage lending bank, with its regular assets, is subject to the general regulations on execution levied on part or all assets under the Code of Civil Procedure and the Insolvency Code. However, the mortgage lending bank is liable only to the bondholders and remains the solvent legal owner, provided that the cover is sufficient for the bondholders. In spite of the insolvency of its general assets as a whole, the mortgage lending bank remains the legal owner of solvent special assets in the form of the cover. However, in this respect the representative and managerial body of the bank is no longer the managing board, but rather the trustee. Otherwise, the mortgage lending bank is subject to the law on liens as well as the general civil law, and in this respect is not subject to the insolvency law regime. The delineation of covers takes place in a purely formal sense after entry in the mortgage register. Thus, in the event of insolvency, the line of separation can be drawn quickly and neatly. As a result, what matters is not the entitlement to make an entry in the mortgage register, but solely the fact the entry was made.

<sup>157</sup> The new aviation bond is of particular interest because, over the five year period (2012-2017), the annual volume of new business is expected to reach €45 billion. In addition to the financing already provided by banks, there is sufficient demand for large volumes of aviation bonds to be issued. The opportunity to refinance using an aviation bond will strengthen the ability of German credit institutions to compete on the competitive international aircraft financing market.

## 2.5.2 New emerging sources of finance

Sovereign wealth funds (SWFs), private equity and Far Eastern banks<sup>158</sup> are amongst those demonstrating interest in investing in the aviation finance sector as growing sources of finance.<sup>159</sup> This is not surprising given the access these entities have to US dollar funding, longer term investment horizon and their insatiable appetite for deploying larger amounts of capital efficiently.

In addition, PwC states that they have recently witnessed a number of financial investors backing leasing businesses with recent ventures such as Cinven, CVC, GIC<sup>160</sup> and Oak Hill's investment<sup>161</sup> in Avolon,<sup>162</sup> Carlyle's investment in RPK, Cerberus Capital's investment in AerCap, Oaktree's investment in Jackson Square Aviation and subsequent sale to Mitsubishi Corporation, Terra Firma's investment in AWAS, Onex acquisition of 50% stake in BBAM

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<sup>158</sup> In 2011 South African Airways' fleet modernization program was financed through debt financing arranged and provided by Sumitomo Mitsui Banking Corporation and supported by a guarantee from Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE), the French export credit agency.

<sup>159</sup> As PricewaterhouseCoopers (PwC UK) highlights in article titled *Aircraft Finance: Fasten Your Seat Belts*, January 2013 by PwC UK with electronic copy at [http://www.pwc.com/en\\_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fasten-your-seat-belts-pdf.pdf](http://www.pwc.com/en_GX/gx/aerospace-defence/publications/assets/pwc-aviation-finance-fasten-your-seat-belts-pdf.pdf). PwC UK alludes that they have seen a number of SWF-backed funds such as China, Singapore and UAE investing in the aircraft asset class.

<sup>160</sup> GIC is a global investment management company established in 1981 to manage Singapore's foreign reserves. With a network of nine offices around the world, GIC invests internationally in equities, fixed income, natural resources, treasury & currencies, real estate, private equity and infrastructure. GIC is about 1,200 in staff strength and manages well over US\$100 billion. GIC SI is the private equity arm of GIC, investing globally in private equity funds, infrastructure, and directly in companies on both minority equity and a structurally preferred basis.

<sup>161</sup> In 27 October 2011, Government of Singapore Investment Corporation (GIC), one of the world's leading sovereign wealth funds, invested 300 million United States dollars in Avolon, the international aircraft leasing group. During the same time, Avolon announces equity investment from leading sovereign wealth fund with total equity capital raised reaching 1.4 billion United States dollars. These include leading private equity firms Cinven, CVC Capital Partners and Oak Hill Capital Partners. The proceeds of this capital raising were to be used to accelerate Avolon's expansion; and, to fund the continued growth of its aircraft fleet. Avolon's objective is to reach a fleet size of 150 aircraft, valued at 6 billion United States dollars by 2014. The Asia-Pacific region, where 34% of the Avolon fleet is currently placed, is strategically important to Avolon. It is estimated that approximately half of the world's air traffic growth over the next two decades will be driven by travel to, from and within the Asia-Pacific region. To support this growth, it is estimated that airlines in the region will need over 11,000 new aircraft, worth 1.5 trillion United States dollars, over the next 20 years. Avolon is deploying significant resource towards the expansion of its business in the region; and, to becoming the leading provider of innovative financing solutions to help local airlines fund growing aircraft fleets. Strengthening and geographically diversifying Avolon's capital base - through a world-class equity capital partner in Asia-Pacific - advances Avolon's objective to be the aircraft lessor of choice for airlines in the Asia-Pacific region. Citigroup Global Markets Inc. acted as exclusive placement agent to Avolon in connection with the capital raise.

<sup>162</sup> Headquartered in Ireland, with offices in Stamford CT, Hong Kong and Shanghai, Avolon provides aircraft leasing and lease management services. Avolon's investors include three of the world's leading private equity firms Cinven, CVC Capital Partners and Oak Hill Capital Partners and one of the world's leading sovereign wealth funds, Government of Singapore Investment Corporation (GIC). Avolon has established itself as one of the leading global players in the aircraft leasing sector, leveraging off the strong financial backing of its owners and the extensive trading history and senior industry relationships of its management team. The primary asset focus of the business is on young fuel-efficient single-aisle aircraft such as the Airbus A320 family and Boeings 737NG family. In addition, Avolon also invests in best-in-class twin-aisle aircraft such as the Airbus A330 family and Boeing 777 family. Avolon has a committed fleet of 88 aircraft serving 25 customers in 18 countries. Avolon's fleet is also the youngest fleet in the world with an average aircraft age of 1.4 years.

and funding of Inception Aviation and Apollo Global Management investment in Merx Aviation Finance LLC (aviation leasing). Recently, Emirates, Aviation Capital, Latam and Ryanair in a bid to raise funds have issued bonds backed by Ex-Im Bank guaranty.<sup>163</sup> Other notable developments are the launch of Aeronautics Fund (hedge fund focused solely on acquiring jets for the part out market).

Banks from the Far East have also been at the forefront of some of the larger deals, for example, the acquisition of RBS Aviation by Japanese Bank Sumitomo Mitsui<sup>164</sup>, the sale of DVB's 60 per cent share in TES to Development Bank of Japan and Mitsubishi Corporation and the recent acquisition of Jackson Square Aviation also by a Mitsubishi Corporation entity. Some Chinese banks may also be keen to expand into the aviation sector.

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<sup>163</sup> Airlines from Europe to Asia to South America, boosted by help from the US Government, are turning to the bond market and away from loans to finance aircraft acquisition as borrowing costs plunge. Emirates, based in Dubai, and Ireland's Ryanair Holdings Plc are leading carriers that have issued 2.3 billion United States of bonds in 2012 backed by the U.S. Export-Import Bank, a jump of more than six fold from a year earlier, according to data compiled by Bloomberg. Interest rates at record lows in 2012 and a new debt-guarantee program from the Ex-Im Bank are making it easier for non-U.S. airlines to access capital markets even as private-sector lending becomes more expensive and difficult to obtain. Boeing, the biggest U.S. exporter, stands to benefit while working through a jet backlog valued at 302 billion United States dollars.

<sup>164</sup> Europe's debt crisis is spurring banks to trim financing of plane purchases, pushing airlines to seek other options as they buy new jets. Royal Bank of Scotland Group Plc sold its aviation unit to Sumitomo Mitsui Financial Group Inc. in June for 7.3 billion United States dollars, while BNP Paribas SA and Societe Generale SA have retreated from dollar-linked aircraft financing after U.S. funding evaporated.

## CHAPTER THREE

### 3.0 AIRCRAFT, TITLE AND SECURITIZATION

#### 3.1 How do you acquire title to an aircraft?

Aircraft do not have physical titles. Because aircraft do not have certificates of title (as other chattels such as vehicles do), some people believe an aircraft's registration certificate provides proof of ownership. This is not the case according to Kenneth Mayfield, who served as vice president and general counsel of Aero Records & Title Company in Oklahoma City. Rather according to Mayfield it is the bill of sale that provides proof of ownership.

An aircraft's title/ownership is not as easy to establish as it is for a real property. There is no central register of 'aircraft title-holders' in Kenya or most countries in the world. Not even the International Registry has records of 'aircraft title-holders'. Considering that such large amounts of money are paid for aircraft, often as much as for other assets, it is surprising that many aircraft change hands without any formal ownership contract. As there is no sure and recognized way to register title to an aircraft in the same way that there is for real property, acquiring an aircraft obviously, and lending on its security, carries a higher degree of uncertainty to clear title. In fact, any country's aviation authority's civil aircraft register is not necessarily conclusive evidence of title.<sup>165</sup>

As mentioned above, an aircraft has many different components. In this regard, the engine, the airframe and any other part may be manufactured by different manufacturers and assembled together to make an aircraft. Worldwide, no aircraft manufacturer or competent entity issues title to an aircraft and no competent authority guarantees title to an aircraft. In addition, it is recommended that most piston aircraft engines be rebuilt every 1,800 to 2,000 or so hours<sup>166</sup> and as such the engine identity keeps changing over time.

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<sup>165</sup> As for insurance of an aircraft's title, there are aviation industry insurers who offer aircraft title policies that insure the validity and enforceability of aircraft interests and preserves the priority of that interest in the aircraft. 'Aircraft Title Insurance' has advanced protection guards against many problems that could imperil interest in an aircraft and include coverage not easily obtained under standard endorsements to ordinary aviation insurance policies.

<sup>166</sup> This to be overhauled (TBO) time is set by the engine manufacture.

It is an industry practice that the aircraft, its engine and components (such as propellers) are identified by the manufacturer, make, model, generic model, manufacturer's serial number, nationality and registration mark. Please see Appendix I for details on key parts of an aircraft and their functions.

An aircraft purchaser acquires ownership of an aircraft from the previous owner through a bill of sale.

### **3.2 No guarantee of title to an aircraft and impact on securitization**

#### **3.2.1 Introduction**

Chapter III of the Convention on International Civil Aviation also known as the Chicago Convention<sup>167</sup> governs registration and nationality of aircraft. Under the Chicago Convention regime, aircraft are not allowed to be registered in more than one state and registration is governed by the laws of the registering state. The registering state is required to provide a list of registered aircraft to the International Civil Aviation Council.<sup>168</sup>

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<sup>167</sup> In an article published in the website specified below, it has been argued that the tremendous development of aviation during World War II demonstrated the need for an international organization to assist and regulate international flight for peaceful purposes, covering all aspects of flying, including technical, economic, and legal problems. For these reasons, in early 1944, the United States conducted exploratory discussions with its World War II allies, on the basis of which invitations were sent to 55 allied and neutral states to meet in Chicago, United States in November 1944. In November and December 1944, delegates of 52 nations met at the International Civil Aviation Conference in Chicago to plan for international cooperation in the field of air navigation in the postwar era. It was this conference that framed the constitution of the International Civil Aviation Organization - the Convention on International Civil Aviation, also called the Chicago Convention. This Convention stipulated that ICAO would come into being after the convention was ratified by 26 nations. Pending ratification of the Convention on International Civil Aviation (also known as Chicago Convention) by 26 States, the Provisional International Civil Aviation Organization (PICA0) was established. It functioned from 6<sup>th</sup> June 1945 until 4<sup>th</sup> April 1947. By 5<sup>th</sup> March 1947 the 26<sup>th</sup> ratification was received. ICAO came into being on 4<sup>th</sup> April 1947. In October of the same year, ICAO became a specialized agency of the United Nations (linked to the Economic and Social Council (ECOSOC)) and charged the responsibility of coordinating and regulating international air travel. The Chicago Convention establishes rules of airspace, aircraft registration and safety, and details the rights of the signatories in relation to air travel and also exempts air fuels from tax. For more details see an article entitled *Creation - The International Civil Aviation Organization (ICAO) - problem, policy, The Chicago Conference of 1944* at <http://www.nationsencyclopedia.com/United-Nations-Related-Agencies/The-International-Civil-Aviation-Organization-ICAO-CREATION.html#ixzz1y4DIZilo>.

<sup>168</sup> According to the ICAO website ([www.icao.int](http://www.icao.int) <accessed on 25<sup>th</sup> July, 2012>), the Council, a governing body of ICAO, is a permanent body of ICAO responsible to the Assembly. It is composed of 36 Member States elected by the Assembly for a 3 year term. The Council has numerous functions, notable among which are to submit annual reports to the Assembly; carry out the directions of the Assembly; and discharge the duties and obligations which are laid on it by the *Convention on International Civil Aviation* (Chicago, 1944). It also administers the finances of ICAO; appoints and defines the duties of the Air Transport Committee, as well as the Committee on Joint Support of Air Navigation Services, the Finance Committee, the Committee on Unlawful Interference, the Technical Co-operation Committee and the Human Resources Committee. It appoints the Members of the Air Navigation Commission and it elects the members of the Edward Warner Award Committee and appoints the Secretary General. The Council elects its President for a term of three years, and he may be re-

Under the provisions of the Geneva Convention,<sup>169</sup> the Contracting States undertake to recognize rights of property in aircraft, rights to acquire aircraft by purchase coupled with possession of the aircraft, rights to possession of aircraft under leases of six months or more and mortgages, hypothèques and similar rights in aircraft which are contractually created as security for payment of an indebtedness,

provided that such rights have been constituted in accordance with the law of the Contracting State in which the aircraft was registered as to nationality at the time of their constitution and are regularly recorded in a public record of the Contracting State in which the aircraft is registered as to nationality. The regularity of successive recordings in different Contracting States, according to Geneva Convention, shall be determined in accordance with the law of the State where the aircraft was registered as to nationality at the time of each recording.

### **3.2.2 Evidence of ownership of an aircraft is required - US case**

The Federal Aviation Act, US requires the Federal Aviation Administration to maintain a recording system for aircraft bills of sale, security agreements, mortgages, and other liens. This is done at AFS-750, which also processes applications for, and issues, aircraft registration certificates. The two systems are linked together because one must prove ownership in order to be entitled to register an aircraft. “Clear title” is a term commonly used by aircraft title search companies to indicate there are no liens (such as chattel mortgage, security agreement, tax lien and artisan lien) in the FAA aircraft records. Title searches for the aviation public are not performed by AFS-750; however, the aircraft records contain all of the ownership and security documents that have been filed with the FAA.

In the United States, the Federal Aviation Regulations, Part 47, “Aircraft Registration”<sup>170</sup> provide that the owner of an aircraft must apply to the Aircraft Registration Branch, to obtain

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elected. The Council of ICAO elected Roberto Kobeh González (Mexico) as its President, effective 1<sup>st</sup> August 2006. He was re-elected on 19<sup>th</sup> November 2007 and again on 15<sup>th</sup> November 2010 for a second three-year term. Mr. Kobeh served 8 years as the Representative of Mexico on the Council, from 1998 until his election as Council President.

<sup>169</sup> Convention on the International Recognition of Rights in Aircraft, Signed at Geneva, on 19 June 1948 (Geneva Convention).

<sup>170</sup> See [http://www.faa.gov/licenses\\_certificates/aircraft\\_certification/aircraft\\_registry/media/8050-94.pdf](http://www.faa.gov/licenses_certificates/aircraft_certification/aircraft_registry/media/8050-94.pdf), Oklahoma City.



a certificate of registration.<sup>171</sup> The applicant must submit an Aircraft Registration Application, AC Form 8050-1, accompanied by evidence of ownership and registration fee. It should be noted that as regards ownership, the US Regulations require that the applicant must submit the required evidence of ownership and for the buyer in possession, the bailee, or the lessee of an aircraft under a contract of conditional sale, he must submit the contract conferring ownership.<sup>172</sup>

The regulations also state that registration of an aircraft is not evidence of ownership of aircraft in any proceeding in which ownership by a particular person is in issue and that FAA does not issue any certificate of ownership or endorse any information with respect to ownership on a Certificate of Aircraft Registration, AC Form 8050-3.<sup>173</sup>

### 3.2.3 Want of title and its effect on securitization

Under the Convention and Protocol, the security agreement must, among other things, describe the applicable aircraft object by manufacturer's serial number, name of manufacturer and generic model designation.

The Certificate of Registration<sup>174</sup> in respect of an aircraft which is a document issued by the Director-General of the KCAA is stated not to be evidence of ownership of an aircraft. In addition, there are no legal requirements for the bill of sale<sup>175</sup> to be stamped or registered in Kenya as a valid document conferring title to the aircraft the same way a transfer of immovable property is stamped and registered<sup>176</sup>. The logbooks in respect of an aircraft (or its

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<sup>171</sup> The FAA issues a Certificate of Aircraft Registration, AC Form 8050-3 to the person who appears to be the owner on the basis of the evidence of ownership submitted pursuant to the relevant regulation with the Aircraft Registration Application, or recorded at the Registry.

<sup>172</sup> The Federal Aviation Act, US requires the FAA to maintain a recording system for aircraft bills of sale, security agreements, mortgages, and other liens. This is done at AFS-750, which also processes applications for, and issues, aircraft registration certificates. The two systems are linked together because one must prove ownership in order to be entitled to register an aircraft. "Clear title" is a term commonly used by aircraft title search companies to indicate there are no liens (e.g., chattel mortgage, security agreement, tax lien, artisan lien) in the FAA aircraft records. Title searches for the aviation public are not performed by AFS-750; however, the aircraft records contain all of the ownership and security documents that have been filed with the FAA.

<sup>173</sup> A certificate of registration issued by the registering authority is conclusive evidence of the nationality of an aircraft for international purposes, but not conclusive evidence in a proceeding under the laws of the United States and not evidence of ownership of an aircraft in a proceeding in which ownership is or may be in issue.

<sup>174</sup> Note 1 on page 1 of the Certificate of Registration currently issued by KCAA states that "*This Certificate is not proof of Aircraft Ownership*".

<sup>175</sup> This is usually a document of transfer in respect of an aircraft and is usually signed by the transferor and the transferee of the aircraft.

<sup>176</sup> The laws relating to assets such as immovable property provide for registration and issuance of documents of title in respect of the same. For instance, section 23 (1) of the now repealed Registration of Titles Act (Chapter

engines and propellers) do not form part of the title documents. In this regard, it would appear that a lender in aircraft financing would not, under the Kenyan legal regime, hold any document of title pertaining to an aircraft. This notwithstanding the fact that the original Certificate of Registration and the logbooks are part of the documents which are required internationally to be carried on board the aircraft at all times.

The resultant effect of this is that these documents are incapable of being deposited with a lender as part of the lender's security documentation. In effect, a lender is unable to effectively create an equitable mortgage by deposit of title by the virtue of the fact that the lender is incapable of holding tangible documents of title which are capable of forming acceptable security to secure the extension of loan facilities in an aircraft financing transaction.

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281, Laws of Kenya) provided that the certificate of title issued by the registrar to a purchaser of land upon a transfer or transmission by a proprietor shall be taken by all courts as conclusive evidence that the person named therein is the absolute and indefeasible owner thereof. Having document of title has enabled lenders take security over land with ease and hold the document of title as the prime security.

## CHAPTER FOUR

### 4.0 LAW OF FINANCING

#### 4.1 Current Kenyan law on mortgaging and enforcement of security interests over an aircraft

Aircraft, including helicopters, are subject to national registration as a result of the Chicago Convention.<sup>177</sup> The provisions for registration of an aircraft in Kenya are set out in the CAA and KCAA is the relevant body for such registration.

##### 4.1.1 Registration of an aircraft mortgage

Where the mortgagor is a Kenyan company, registration at the Companies Registry in accordance with section 96 of the Companies Act is necessary in the case of a mortgage created by a company. Registration is applied for under Form 214 within 42 days of the creation of the mortgage. On registration, a certificate will be issued by the Registrar of Companies. It shall constitute conclusive evidence that the requirements as to registration have been complied with. In the case of a non-Kenyan mortgagor, the aircraft mortgage will not be registered at the Companies' Registry primarily because the provisions of section 96 (1) of the Companies Act apply to charges created by a company registered in Kenya and such mortgagor does not have an established place of business in Kenya. However, in light of the decision in *Slavenburg's Bank NV v International Natural Resources Limited*,<sup>178</sup> it is advisable to deliver the aircraft mortgage to the Registrar of Companies in Kenya for registration. In effect the Registrar would send the mortgage back stating that he cannot register the same as he has no record of the mortgagor. It was argued in *Slavenburg's case* that having done that the mortgagee will be protected as it is arguable that the mortgagee has done its duty.

The KCAA is also notified of the security interest created by the aircraft mortgage. As Kenya is yet to have a register of mortgages or rights over aircraft or a law that specifically governs the same, in practice, KCAA notes a mortgagee's interest in an aircraft if the original Certificate of Registration is lodged with the KCAA together with a copy of the aircraft mortgage and a written request that the mortgagee's interest be noted on the Certificate of

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<sup>177</sup> The Convention on International Civil Aviation opened for signature in Chicago on 7 December 1944.

<sup>178</sup> *Slavenburg's Bank NV v International Natural Resources Limited* [1980] All ER 955; [1980] 1 WLR 1076)

Registration. The KCAA will issue the mortgagor with a new Certificate of Registration with the mortgagee's interest noted thereon.

A mortgagee's interest which has been noted on the Certificate of Registration of an aircraft may be cancelled by lodging the Certificate of Registration with the KCAA together with a letter from the mortgagee requesting its interest to be cancelled. A charge or mortgage registered at the Companies Registry may be removed from the Register of Mortgages by the company filing Form 218 and lodging evidence that the mortgage has been discharged.

#### 4.1.2 Enforcement of security agreements over aircraft

Enforcement procedures in respect of mortgages taken over aircraft can be commenced upon the occurrence of an event of default under the underlying financing arrangement for which the aircraft is acting as security or a breach of the terms of the mortgage itself. Enforcement of mortgages under Kenyan law is not always straightforward. The principal difficulty with enforcement over an aircraft is that, by its nature, an aircraft can be located in any jurisdiction at any given time and enforcement procedures must be undertaken in the jurisdiction in which the asset is located. Enforcement procedures differ between states and a number of remedies set out in the mortgage may be unavailable in practice.<sup>179</sup> There is also a lack of clarity and predictability regarding enforcement of security in Kenya in two areas. Firstly, there is uncertainty in Kenyan law due to the application of the *lex situs* as to the law that governs security taken over aircraft. This position is not uniformly applied in foreign jurisdictions and thus it is not always easy to determine the validity of the security particularly after the recent *Blue Sky* case which would be persuasive in Kenya. Secondly, enforcement is difficult and

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<sup>179</sup> A number of issues may arise where aircraft are based or operated in jurisdictions outside of Kenya. It is important that a financier obtain a legal opinion in respect of each relevant jurisdiction when entering into a loan agreement. A legal opinion should typically address the following:

- a) the choice of law and jurisdiction clauses, and whether such clauses would be recognized by the relevant foreign court;
- b) the steps necessary to perfect security over an aircraft in the relevant jurisdiction;
- c) any particular issues of local law that may impact the enforceability and validity of a security (e.g. aircraft mortgages are not recognized as valid security in Austria and Belgium);
- d) the effectiveness of the deregistration power of attorney provided by the borrower to the financier;
- e) the recognition or otherwise of self-help remedies in the relevant jurisdiction;
- f) potential difficulties and procedures with respect to aircraft de-registration and export;
- g) the timeframe(s) involved in enforcement proceedings;
- h) any other risks, such as the likelihood of a local court allowing an aircraft owner to maintain possession and use of an aircraft subject to the owner meeting satisfying outstanding arrears; and
- i) all relevant documentation (and translations if relevant).

A financier should also consider the impact of any potential foreign insolvency procedures, international conventions (for example the Chicago Convention, the Geneva Convention, the Cape Town Convention) and any other jurisdictional requirements in order to successfully repossess the aircraft, engines and records.

will usually be delayed where the mortgagor is insolvent. If the mortgagor is in liquidation, it may not be possible for enforcement proceedings to be undertaken without the consent of the liquidator, who is not compelled to act within a specified timeframe.

## 4.2 Challenges in financing an internationally mobile asset/chattel

As discussed in Chapter 2, most secured loan financings in relation to aircraft acquisitions will be secured by the aircraft itself which is pledged as collateral pursuant to an aircraft mortgage. Aircraft financiers and lenders should be wary of the obvious risks associated with having the aircraft as collateral to the loan. According to Greg Cirillo<sup>180</sup>, aircraft move frequently and fast,<sup>181</sup> they lose value very quickly<sup>182</sup> if not properly maintained (with proper documentation of maintenance) and once repossessed, they can be difficult to sell, and the fair market value can be extremely volatile.<sup>183</sup> As a result, Greg recommends that financiers should often seek credit enhancements in the form of letters of credit, lower loan-to-value ratio, personal guarantees or corporate guarantees which are negotiable aspects of the loan transaction.<sup>184</sup>

### 4.2.1 Aircraft is a depreciating asset and the problem of repossession

In addition, an aircraft is a depreciating asset that has a typical useful economic life of between 30 and 35 years. During its economic life it generates a stochastic revenue stream for the airline owner-operator or a rent stream for the owner-lessor, while its economic value depreciates as the aircraft ages. At the end of its useful life the aircraft is salvaged for its scrap value. When forecasting used aircraft values, aviation stakeholders use the residual value<sup>185</sup> curve that represents an estimate of the expected economic value of a used aircraft as a

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<sup>180</sup> See article by Greg Cirillo entitled *Business Aircraft Finance Options*, October 2009 published in <http://www.avbuyer.com/articles/detail.asp?Id=87> <accessed on 16<sup>th</sup> July, 2012>.

<sup>181</sup> The very mobility of the aircraft makes collection in the case of default a significant problem. The plane, or part, can be moved in an attempt to evade collection or repossession in case of a default.

<sup>182</sup> The aircraft's residual value at the end of the lease is an important consideration for the owner. The owner may require that the aircraft be returned in the same maintenance condition as it was delivered, so as to expedite turnaround to the next operator. Like leases in other fields, a security deposit is often required.

<sup>183</sup> See article by Greg Cirillo entitled *Business Aircraft Finance Options*, October 2009 published in <http://www.avbuyer.com/articles/detail.asp?Id=87> <accessed on 16<sup>th</sup> July, 2012>.

<sup>184</sup> *Ibid.* Greg Cirillo notes that in a complex corporate structure, a financier will generally look for the supporting guaranty of a substantial parent or affiliate.

<sup>185</sup> Owning an aircraft requires an airline to take the residual risk. Assuming a typical depreciation policy that sees an aircraft being depreciated to 15% residual value over 25 years, a 75 million United States Dollars aircraft will be worth 11.25 million United States Dollars at the end of its useful life. Selling such an aircraft to another person may not be easy. See Special Report by IATA on *Aircraft Financing: Risk and Reward* August, 2010 published on <http://www.iata.org/pressroom/airlines-international/august-2010/pages/07.aspx> <accessed on 27<sup>th</sup> June, 2012>.

function of its age. However, market prices of used aircraft realized in secondary market transactions have substantial volatility around these expected residual values. The secondary market for used aircraft is an over-the-counter market with a reasonable amount of liquidity, at least for popular aircraft models with substantial market penetration and during non-distressed market conditions.<sup>186</sup> Thus, in addition to the expected economic depreciation,<sup>187</sup> the financier who repossesses a used aircraft in the event of default faces a significant risk due to secondary market volatility.<sup>188</sup>

Furthermore, the lender/lessor faces costs and delays in the repossession process. The expected economic depreciation, market volatility, as well as possible costs and delays associated with aircraft repossession and re-marketing, measured against the loan amortization, determine the lender's loss-given-default.<sup>189</sup> Golbeck and Linetsky<sup>190</sup> argue that the repossession delay and costs are important variables in the valuation of defaultable leases, as well as secured loans. The costs the lessor or secured lender may incur in the repossession process may include legal costs of the repossession process, costs of the physical repossession (for instance, flying the aircraft to the desired destination), costs of repair and maintenance of the asset (can be substantial if the bankrupt lessee or borrower fails to properly maintain the asset, and no separate maintenance reserves have been provisioned in the lease or loan contract), costs of downtime (for instance, storage fees and insurance premiums), costs of re-marketing the asset to find a new lessee or buyer, as well as possible super-priority liens, such as mechanics' liens or airport fees attached to the aircraft in the event the bankrupt lessee or borrower does not pay those obligations.<sup>191</sup> Re-marketing costs may have fixed, as well as proportional components (for instance, broker commissions). All other costs are generally fixed. The repossession delay depends on the type of asset and the legal jurisdiction of the lessee or borrower. If the bankruptcy results in a stay of repossession, the repossession delay can take many months or even years. During that period the asset continues to depreciate,

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<sup>186</sup> For example, Gavazza (2009) reports that, in the twelve months between May 2002 and April 2003, of the total world stock of 12,409 commercial aircraft used for passenger transportation that were at least 2 years of age, 720 traded. That represents a turnover of more than 5% of the total world commercial fleet in one year.

<sup>187</sup> See Special Report by IATA on *Aircraft Financing: Risk and Reward* August, 2010 published on <http://www.iata.org/pressroom/airlines-international/august-2010/pages/07.aspx> <accessed on 27th June, 2012> where it is recorded that depreciation is currently being worked out at the 16-20 year period rather than 25 years.

<sup>188</sup> In the event of default by the borrower, the secured lender repossesses the aircraft and sells it on the secondary market or leases it to another operator. In either case, the lender faces the risk of declining market prices or market lease rates in relation to a used aircraft.

<sup>189</sup> See Research by Steven Golbeck and Vadim Linetsky *Asset Financing with Credit Risk*, January 8, 2012, Department of Industrial Engineering and Management Sciences, McCormick School of Engineering and Applied Sciences, Northwestern University (<http://users.iems.northwestern.edu/linetsky>).

<sup>190</sup> *Ibid* at page 14.

<sup>191</sup> *Ibid*.

lease or loan payments are not made, and the various costs continue to mount.<sup>192</sup> As discussed above, in the United States, Section 1110 of the US Bankruptcy Code grants aircraft lessors and secured lenders exemption from the repossession stay and grants them the right to repossess aircraft 60 days after payment default on a lease or secured loan.

Deregistration and repossession of an aircraft is not easy. DVB Bank, Germany has filed a case against India's Director General of Civil Aviation (DGCA) for delayed deregistration of two Kingfisher Airlines aircraft, accusing the Indian administration of helping the owner of the struggling airline owner. The two Kingfisher aircraft in question at the time of filing the suit were located in Turkey and under the possession of DVB, but the bank was finding it impossible to deregister the aircraft from India and proceed with its sale. DVB took possession of the aircraft when it landed in Turkey in August 2012 for regular maintenance.<sup>193</sup>

#### **4.2.2 The Convention and Protocol have limitations**

The Convention and the Protocol provide standard remedies in the event of default by the debtor. The consequence of this is that creditors involved in aircraft financing are expected to have more confidence in the financing transactions while debtors are protected from unwarranted seizure of aircraft by creditors provided the debtors have performed their financial and contractual obligations.

The provisions of the Convention and the Protocol although they work, have limitations.

##### **4.2.2.1 Repossession and the import of “connecting factors”**

A domestic aircraft transaction as a national interest is registered at the national civil aviation registry. The interest is recognized within the borders of the registering state. Since aircraft are objects which move frequently and fast making their collection in the case of default a problem, under the Convention and Protocol regime, international investors in, or lessors of, mobile equipment do not now have to rely on differing national laws to protect their investments in aircraft. An internal transaction or national interest can also be registered at the

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<sup>192</sup> *Ibid.*

<sup>193</sup> The case was coming up for hearing on April 8, 2013. See [http://articles.economicstimes.indiatimes.com/2012-12-20/news/35933822\\_1\\_dvb-bank-aircraft-kingfisher-airlines](http://articles.economicstimes.indiatimes.com/2012-12-20/news/35933822_1_dvb-bank-aircraft-kingfisher-airlines).

international Registry and recognized globally in addition to international interests.<sup>194</sup> The Convention and the Protocol thus have a wider sphere of application. However, in order for a transaction to enjoy the protections afforded by the Convention and the Protocol, it should be ensured that the prerequisites (often referred to as “connecting factors”) are present. In the absence of a connecting factor, the Convention and the Protocol will not apply. For aircraft objects, there are 2 ways in which a transaction may satisfy the connecting factor requirements. The first involves the nature of the debtor (specifically, where it is “situated”) and the second, for certain aircraft objects, relates to its State of registration.<sup>195</sup> The Convention applies when, at the time of the “conclusion of the agreement”<sup>196</sup> creating or providing for an international interest in an aircraft object, the debtor<sup>197</sup> is situated in a Contracting State.<sup>198</sup> The fact that a creditor is situated in a non-Contracting State does not affect the applicability of the Convention.<sup>199</sup> Secondly, Article IV(1) of the Protocol provides that the Convention shall also apply in relation to an airframe or a helicopter, if such airframe or helicopter is, at the “time of conclusion” of the applicable agreement, registered or agreed to be registered in an aircraft registry of a Contracting State (and a subsequent re-registration

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<sup>194</sup> Please see Appendix II for a detailed analysis on registration of interest in the international registry and how to conduct searches.

<sup>195</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, published by the Legal Advisory Panel of the Aviation Working Group at page 29. The matter of the nationality of registration of an aircraft is considered a connecting factor.

<sup>196</sup> *Ibid* on footnote 81 where Goode argues that the relevant time for determining whether this requirement is satisfied is at the time the agreement is made. If the debtor is then situated in a Contracting State, the requirement is met, and the Convention does not cease to apply merely because the debtor moves to a non-Contracting State (and conversely, the Convention does not become applicable merely because the debtor becomes situated in a Contracting State after entering into the agreement). See also *Official Commentary, Revised Edition*, prepared by Professor Sir Roy Goode published in [www.unidroit.org](http://www.unidroit.org) at paragraph. 4.56 (Unidroit 2008).

<sup>197</sup> The Convention will only apply if the chargor (in the case of a security agreement), is “situated” in a Contracting State. According to *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, published by the Legal Advisory Panel of the Aviation Working Group at page 30, a debtor is deemed situated in a Contracting State if:

- (i) it is incorporated or formed under the laws of a Contracting State;
- (ii) its registered or statutory seat is located in a Contracting State;
- (iii) its center of administration is located in a Contracting State; or
- (iv) its principal place of business is located in a Contracting State (See Article 4 of the Convention).

The first two factors (set out in clauses (i) and (ii) above) are typically fairly easy to ascertain (usually, one only need look to the local authorities or governing bodies to determine whether an entity is duly formed and validly existing). The latter two factors can often be more difficult to determine with certainty, particularly when dealing with large, multinational corporations that have offices and carry on business in several distinct jurisdictions. The “centre of administration” of an entity typically corresponds to the place where the debtor conducts the administration of its interests on a regular basis. This factor, along with the factor in respect of the principal place of business of a debtor, are factually-based determinations and each requires a specific analysis of the particular debtor and its business operations.

<sup>198</sup> See Article 3(1) of the Convention.

<sup>199</sup> See Article 3(2) of the Convention.



from the original state of registry would not impact the continued effectiveness of such connecting factor).<sup>200</sup>

Another challenge is that not every country is a contracting state/member under the Convention.

#### **4.2.2.2 Gaps and challenges facing the International Registry**

It should be noted that neither the Convention, the Protocol, the Regulations for the International Registry nor the Procedures for the International Registry prescribe any offence for posting fraudulent or misrepresenting information or interfering with the information posted on the International Registry. How then is the veracity and authenticity of information posted at the International Registry assured and sustained?

There are a number of procedural and regulatory steps that have been put in place to guard the veracity of the information posted at the International Registry. As discussed above, the registration process contains restrictions and safeguards to ensure and enhance the sanctity of information provided to the International Registry. A key safeguard is the requirement for a party to first establish an account with the International Registry as a transacting user entity in order to register notice of an interest with the International Registry. The TUE must avail certain details and information as stated above and a registry official at the International Registry will verify the information about the existence of the entity and other information provided. Once vetting is successfully completed, the registry official approves the account and an email is automatically sent to the administrator containing a link to its digital certificate.

The use of a digital certificate in order to effect registrations on the International Registry is password protected but the International Registry does not have access to the password. In fact, to prevent unauthorised tampering with the registry information, no individual other than the administrator may effect, amend, discharge or consent to registrations with the

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<sup>200</sup> This alternative connecting factor does not apply to aircraft engines, for which there is no nationality registration. The consequence of this additional connecting factor (in respect of an airframe) is that there is a possibility that the Convention will apply to the international interest covering an airframe but not its related engines (unless, with respect to such engines, another connecting factor, such as the place of incorporation of the debtor, is available).

International Registry until he/she has been approved as a registry user.<sup>201</sup> Each registry user is required to notify his/her respective administrator of any of any security breach, of which he/she is aware, that is expected to result in unauthorised registrations, including unauthorised use, disclosure or compromise of his/her password or private key.<sup>202</sup> The administrator of a registry user entity is also required to notify the Registrar of any security breach to his account that is expected to result in unauthorised registrations.<sup>203</sup> The administrator is also required to take prompt action to block/disable the user account of any registry user representing his/her registry user entity where there has been a security breach.<sup>204</sup> On notification of a security breach, the Registrar is also empowered to block and/or disable any user account.<sup>205</sup>

As stated before, under Article 27 of the Convention and Article XVII (3) of the Protocol, the Supervisory Authority enjoys immunity from any legal or administrative action brought by any person who has suffered loss or damage as a result of the failure of the International Registry to perform the functions prescribed by the Convention and Protocol. However, this immunity does not extend to the Registrar. Incidentally, the Registrar is mandated/obligated to ensure the efficient operation of the International Registry. The Registrar is required to procure insurance or financial guarantee covering any liability that may arise in the performance of its functions. Under Article XX(5) of the Protocol, the amount of insurance or financial guarantee shall, in respect of each event, be not less than the maximum value of an aircraft object as determined by the Supervisory Authority.

Under Article 28 of the Convention, the Registrar is liable for damages for loss suffered by a person directly resulting from an error or omission of the Registrar and its officers and employees or from a malfunction of the International Registry system. However, the Registrar's liability does not include loss resulting from a malfunction caused by "an event of an inevitable and irresistible nature, which could not be prevented by using the best practices in current use in the field of electronic registry design and operation." In addition, the liability does not extend to factual inaccuracy of registration information received by Registrar or transmitted by the Registrar in the form in which it received that information. Similarly, Article 18(2) of the Convention provides that the Registrar is not under a duty to enquire whether consent for registration has in fact been given or is valid. Article 16(3) thereof

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<sup>201</sup> See section 6.1 of the Procedures under the Regulations and Procedures for the International Registry.

<sup>202</sup> See section 6.4 of the Procedures under the Regulations and Procedures for the International Registry.

<sup>203</sup> See section 5.11 of the Procedures under the Regulations and Procedures for the International Registry.

<sup>204</sup> See section 5.10 of the Procedures under the Regulations and Procedures for the International Registry.

<sup>205</sup> See section 5.13 of the Procedures under the Regulations and Procedures for the International Registry.

provides that the term “registration”, includes, where appropriate, an amendment, extension or discharge of a registration. Consequently, this exonerates the Registrar in cases where an apparent registration has been effected or registration has been amended or discharged without the authorization of the person legally entitled to consent to the measure. This may actually encourage fraudulent persons to tamper with the registry information. Article 28(3) of the Convention provides that the amount recovered from the Registrar “*may be reduced to the extent that the persons who suffered loss or damage caused or contributed to that damage.*”

In this regard, it is conceivable that a court would conclude that when an error or omission on the part of the International Registry was disclosed to a registrant in the confirmation, or information relating to a security breach was brought to the attention of a registry user entity, such a registry user entity failed to take any reasonable steps to mitigate the breach.

## **Conclusion**

As discussed, the Convention also allows a Contracting State to designate an entity or entities in its territory as the entry point through which the information required for registration shall or may be transmitted to the International Registry. In this regard, a Contracting State has the obligation of specifying the requirements to be satisfied before such information is transmitted to the International Registry. The process of registering an interest contains a raft of restrictions and safeguards to ensure or enhance the sanctity of information provided to the International Registry. In order to register the notice of an interest with the International Registry, each party to the interest must first establish an account with the International Registry as a transacting user entity which may be a legal entity or a natural person. Moreover, interests in aircraft objects are registered electronically on the International Registry only after consent of all the appropriate parties has been had and obtained. In addition, to prevent unauthorised tampering with the registry information, no individual other than the administrator may effect, amend, discharge or consent to registrations with the International Registry until he/she has been approved as a registry user. In addition, an International Registry official at the International Registry will verify, according to the standards set forth in the Regulations relating to the International Registry, that the entity exists and its contact details are accurate, the proposed administrator and back-up contact may be contacted at the email addresses and phone numbers provided by the administrator and the Certificate of

Entitlement to Act form nominates such individuals to act in these roles on behalf of the entity.

### **4.3 Conflict of laws and determination of applicable law and jurisdiction**

#### **4.3.1 Introduction**

Resolving disputes which arise under contracts can be complicated, particularly so, where the parties to the contract are based in different countries. It is important to establish what law will apply to a contract before the parties enter into any binding agreement. A governing law clause enables the parties to specify the system of law which will be used to interpret a contract and deal with any disputes which may arise under that contract. It is not a dispute resolution clause in the sense that it does not indicate how disputes will be resolved - rather, it determines the system of law which will be applied to decide what the parties' rights and obligations are.<sup>206</sup>

The choice of governing law should be considered before a contract is drafted. If English law is not used, a lawyer qualified in the relevant jurisdiction will need to advise on how the chosen governing law will apply to the contract. If there is no express choice of governing law provided in the contract then, in the event of a dispute, a court will decide which law is to apply in accordance with the relevant conflict of laws principles in that jurisdiction.

On the other hand, the choice of jurisdiction is an important element in an international contract. A common clause in most international contracts is the jurisdiction clause in which the parties to a contract agree at the outset of their contractual relationship which country's or countries' courts are to have legal authority ('jurisdiction') to hear disputes arising from that contract. If there is no jurisdiction clause, the courts which will be in a position to settle any dispute arising from the contract will be determined by the rules of private international law.

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<sup>206</sup> The signatories to a contract may choose the law applicable to the whole or part of the contract, and select the court that will have jurisdiction over disputes. By mutual agreement they may change the law applicable to the contract at any time (principle of freedom of choice). If the parties have not made an explicit choice of applicable law, the contract is governed by the law of the country with which it is most closely connected, according to the principle of the proper law (place of habitual residence or place of central administration of the party performing the contract, principal place of business or other place of business of the party responsible for performing the contract). However, specific rules apply in two cases: where the contract concerns immovable property, the law applicable by default is that of the country in which the property is situated and where the contract concerns the transport of goods, the applicable law is determined according to the place of loading or unloading, or the principal place of business of the consignor.

This can cause uncertainty and lead to additional costs and delay. In the United Kingdom and Europe, various instruments and conventions<sup>207</sup> have been enacted to determine the place or country where a case can be heard. The basic rule is that a party must be sued in the court in its own country, subject to various exceptions.

#### 4.3.2 Choice of applicable law – Express choice, implied choice and illegality

The legal system under which a contract is created and by which it is governed is known as the proper law of the contract. In *Amin Rasheed Shipping Corporation v Kuwait Insurance Co*<sup>208</sup> Lord Diplock described the proper law of a contract as: '*... the substantive law of the country which the parties have chosen as that by which their mutually legally enforceable rights are to be ascertained ...*'<sup>209</sup>

A significant feature of English law is the principle of party autonomy<sup>210</sup> that is, '*the proper law of the contract ... is the law which the parties intended to apply*' per Lord Atkin.<sup>211</sup> This would appear to be a manifestation of *consensus ad idem*, a subjectivist approach.<sup>212</sup> Either a subjectivist view or an objectivist view may be appropriate in determining the proper law of a contract. Both views were expressed in the *Amin Rasheed* case. Representing the subjectivist view is part of Lord Diplock's dictum in the *Amin Rasheed* case in which he said, with respect to a contract contained in an insurance policy, that:

'English conflict rules accord to the parties to a contract a wide liberty to choose the law by which their contract is to be governed. So the first step is to examine the policy in order to see whether the parties have, by its express terms, or by necessary implication from the language used, evinced a common intention as to the system of law by reference to which their mutual rights and obligations under it are to be ascertained.'

<sup>207</sup> For example the Rome Convention on the Law Applicable to Contractual Obligations, 1980.

<sup>208</sup> *Amin Rasheed Shipping Corporation v Kuwait Insurance Co*. [1983] AC 50; *Amin Rasheed Shipping Corporation v Kuwait Insurance Co* [1984] AC 50 per Lord Diplock.

<sup>209</sup> *Ibid* as per Lord Diplock.

<sup>210</sup> Party autonomy is a principle of contract law widely accepted around the world. According to the principle parties to a contract can choose the law that will govern their contract. This means that the contract will be interpreted according to that law, and if the parties have not regulated one or more issues in the contract, the court will do so according to that same law. However, currently there is much discussion about whether the parties to an international commercial contract can choose non-state law to govern their contract. It can be speculated that national courts are somewhat less reluctant in applying non-state law without reservations, whereas in an arbitral setting this seems to be possible.

<sup>211</sup> *R. v. International Trustee for the Protection of Bondholders A/G*. [1936] 3 All E.R. 407 (C.A.); [1937] A.C. 500 (H.L.).

<sup>212</sup> It should be noted that whereas the proper law governs most aspects of the contract, questions of capacity, formation, performance and illegality are not necessarily governed by the proper law.

From this, it would appear that a subjectivist view prevails where the parties have expressly chosen the law to govern their agreement, or, at least, the proper law can be inferred or implied. In contrast the objectivist view was expressed by Lord Wilberforce in the *Amin Rasheed* case where he said that, in the absence of a choice of law: '*... it is necessary to seek the system of law with which the contract has its closest and most real connection.*'

#### a) Express choice

Where the parties have expressly chosen a law to govern their agreement, it prevails. In *Vita Food Products Inc. v Unus Shipping Co. Limited*<sup>213</sup>, Lord Wright said that:

'provided the intention expressed is bona fide and legal, and provided there is no reason for avoiding the choice on grounds of public policy' the intention of the parties as to the choice of law prevails'<sup>214</sup>

Points to note with respect to the parties choice of law are that the parties can choose a law which has no obvious connection with the contract and still be bona fide and legal and if the choice of law was made for the 'specific purpose of avoiding the consequence of the illegality', then it is not bona fide and legal. However, there is no reported English case in which a choice of law clause has been struck down by the courts.

#### b) Where the parties have impliedly chosen the proper law

Case law has established that the parties to a contract may be deemed to have impliedly chosen the law to govern it perhaps by including a term relating to the resolution of a dispute by way of arbitration in a particular forum. Thus the tenuous connection with English law "as the proper law" in *Tzortzis v Monark Line A/B*<sup>215</sup> was due to the inclusion in the contract of an arbitration clause subjecting the parties to arbitration in London. Whereas '*the fact that the parties have agreed arbitration shall take place in England is an important factor and in many cases it may be a decisive factor ... it would ... be highly anomalous if our law required the*

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<sup>213</sup> *Vita Food Products Inc. v. Unus Shipping Co. Ltd.*, [1939] A.C. 277 (P.C.) per Lord Wright.

<sup>214</sup> That the parties to the contract 'are entitled to make such an agreement' was confirmed: by Lord Reid in *Whitworth Street Estates (Manchester) Ltd. v. James Miller & Partners Ltd.* [1970] A.C. 583.

<sup>215</sup> *Tzortzis v. Monark Line A/B*, [1968] 1 W.L.R. 406 (C.A.);

*mere fact of arbitration ... in England to be decisive as to the proper law of the contract'* per Lord Reid in Compagnie Tunisienne de Navigation SA v Compagnie d'Armement Maritime.<sup>216</sup>

The leading case on the impliedly chosen proper law is *Amin Rasheed* case. In *Amin Rasheed*, P, a Liberian company resident in Dubai, insured a ship with D, the Kuwait Insurance Company. When a claim made by P under this policy was rejected by D, P sought an order to serve a writ on D under RSC O.11 of Kuwait which could be granted, providing the contract 'by its terms, or by implication, was governed by English law.' There was no express choice of English law, nor was it clear as to what was the implied law: both Kuwaiti law and English law had claims to being the proper law of the contract. However, the surrounding circumstances as well as the terms of the contract itself '*point[ed] ineluctably to the conclusion that the intention of the parties was that their mutual rights and obligations under [the policy] should be determined in accordance with the English law of marine insurance'* per Lord Diplock.<sup>217</sup> A significant factor in reaching this conclusion was that at the time of making the contract, Kuwait had no law of marine insurance but the policy of insurance was based on the Lloyd Standard Form of Marine Insurance which is derived from England. So, from the *Amin Rasheed* case, it may be deduced that the contemporary approach to the resolution of what is the impliedly chosen proper law is to take into account 'the rest of the contract and relevant surrounding facts.'

### c) Illegality

In Mackender v Feldia (1966),<sup>218</sup> Diplock L.J. said that English courts will not enforce an agreement, whatever be its proper law, if it is contrary to English law, whether statute law or common law nor will they enforce it, even though it is not contrary to English law, if it is void for illegality under the proper law of the contract. Furthermore, subject to one exception,<sup>219</sup> the English courts will not enforce performance or give damages for non-performance of an act required to be done under a contract, whatever be the proper laws of the contract, if the act would be illegal in the country in which it is required to be performed.

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<sup>216</sup> *Compagnie d'Armement Maritime SA v. Compagnie Tunisienne de Navigation SA* (1971) AC 572-609 HL; *Compagnie Tunisienne de Navigation S.A. v. Compagnie D'Armement Maritime S.A.* [1969] 3 All E.R. 589 per Denning

<sup>217</sup> See *Amin Rasheed* case.

<sup>218</sup> *Mackender v. Feldia A.G.* [1967] 2 QB 590 CA

<sup>219</sup> The exception is where the illegality is a breach of a revenue or fiscal law of a foreign state.

A clear exception to Diplock LJ's proposition that English courts will not enforce performance or give damages for non-performance of an act required to be done under a contract in *Mackender v Feldia* is the decision in *Howard v Shirlstar Container Transport Limited*<sup>220</sup>. In the *Howard case*,<sup>221</sup> it was held that although the court would not normally enforce a contract which would enable a plaintiff to benefit from his criminal conduct, since to do so would be an affront to the public conscience, there were circumstances where it would be wrong to disqualify a plaintiff from recovery, even though his claim was derived from conduct which constituted a statutory offence. Here the conscience of the court would not be affronted by allowing the plaintiff to succeed since he had committed the illegal act to save his life and that of his wireless operator. H succeeded in his claim even though his conduct was illegal and contrary to English law.

#### 4.3.3 Intersection between private and public international law - the notion of domestic public policy<sup>222</sup>

There is now a settled principle that courts will not give effect to foreign laws or policies that are contrary to domestic public policy.<sup>223</sup> Thus, for example, a court may refuse to enforce a contract to pay bribes or secret commissions to foreign government officials, even if such payments are commonly (although unlawfully) made in the country of the payment.<sup>224</sup> More broadly, it has been held that domestic courts should refuse, on public policy grounds, to give effect to laws that offend against fundamental standards of justice, human rights and morality.

<sup>220</sup> *Howard v Shirlstar Container Transport Ltd* [1990] 3 All ER 366; [1990]1 WLR 1292 (CA).

<sup>221</sup> In this case, two aircraft had been leased from Shirlstar for private use in Nigeria. When the hire instalments became overdue, S was entitled to repossess the aircraft. They aimed to do this by engaging H a qualified pilot, to recover them under contracts which provided, inter alia, for the payment of £25,000 to H 'for successfully removing each aircraft ... from Nigerian airspace.' The contract provided for half the amount to be paid when the aircraft was removed from Nigerian air space and the other half on return of the aircraft to England. H went to Lagos, Nigeria, with a wireless operator where he found one of the aircraft parked at the airport. They prepared it for take-off with the assistance of two British engineers who were there. Then, when H was warned that 'powerful people wished to prevent them taking the aircraft', and that his life and that of his wireless operators was in danger, he took off in the aircraft without obtaining permission from air traffic control at the airport. The aircraft was flown to the Ivory Coast where it was seized by the Ivory Coast Government and subsequently returned to Nigeria. H and his wireless operator were allowed to come back to England where he sued for the second instalment because S refused to pay the full amount on the basis that the contract had been illegally performed in Nigeria i.e. H taking off without permission.

<sup>222</sup> See a case note by Martin Davies: *The Effect in Private International Law of a Breach of Public International Law by a State Actor*, Melbourne Journal of International Law [Vol 2], 2001.

<sup>223</sup> P E Nygh, *Conflict of Laws in Australia* (6<sup>th</sup> ed, 1995) 281–5

<sup>224</sup> See *Fullerton Nominees Pty Ltd v Darmago* [2000] WASCA 4 (Unreported, Kennedy, Ipp and Wallwork JJ, 21 January 2000) [27]–[32] (Ipp J; Kennedy and Wallwork JJ concurring); *Lemenda Trading Co Ltd v African Middle East Petroleum Co Ltd* [1988] QB 448, 456–61 (Phillips J).



<sup>225</sup> Beyond this category, and most controversially of all, it has been suggested that a civil court should deny recognition to acts done in breach of international law. Until 2000, there was very little authority for that proposition,<sup>226</sup> but it received strong approval from the English Court of Appeal in the case of *Kuwait Airways Corporation v Iraqi Airways Company and Others*<sup>227</sup>. The case nestles at the intersection between private and public international law. There are doctrines of private international law, to be applied in private civil litigation, but they depend very heavily on notions of authority, sovereignty and territoriality that are derived from public international law. Almost all of these doctrines were considered by the English Court of Appeal in the *Kuwait case*, it is not possible to analyze all of these issues in this study and we shall only consider the key conflict of law issues. We have provided detailed facts of the case and courts' decisions<sup>228</sup> but the emerging point as buttressed by Lord

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<sup>225</sup> For example the racially discriminatory Nazi laws that the House of Lords would have refused to recognise in *Oppenheimer v Cattermole (Inspector of Taxes)* [1976] AC 249, 278 (Lord Cross; Lord Hodson and Lord Salmon concurring) ('*Oppenheimer*'). See also the obiter comments in support of this principle in *Sykes v Cleary* (1992) 176 CLR 77, 112–13 (Brennan J), 135–6 (Gaudron J)

<sup>226</sup> The only authority was the oft-cited, but hardly authoritative, decision of the Supreme Court of Aden in *The Rose Mary* [1953] 1 WLR 246, 253–9 (Campbell J).

<sup>227</sup> *Kuwait Airways Corporation v Iraqi Airways Company and Others* [2002] UKHL 19.

<sup>228</sup> The plaintiff, Kuwait Airways Corporation ('KAC'), was the owner of ten aircraft that were situated at Kuwait International Airport at the time of the invasion of Kuwait by Iraqi military forces in 1990. The aircraft were seized by the Iraqi forces, and the Iraqi Government ordered them to be flown to Iraq. The Government, which is styled as the Revolutionary Command Council ('RCC'), then passed two resolutions proclaiming 'the sovereignty of Iraq over Kuwait and its annexation to Iraq' (see *Kuwait Airways* [2001] 1 Lloyd's Rep 161, [4] (Henry, Brooke and Rix LJ) citing *RCC Resolution 312* and *RCC Resolution 313*). Subsequent decrees issued by the President of Iraq also purported to make Kuwait a 'Governate' of Iraq, and appointed officials to administer the Governate on behalf of the central Iraqi Government). The planes were then flown to Basra, in Iraq proper. A later Iraqi Government resolution, *RCC Resolution 369*, purported to dissolve KAC and to vest all of its property throughout the world, including the ten planes in Iraq, in the defendant, Iraqi Airways Company ('IAC'). IAC had little use for the planes, but it did maintain them, register them with Iraqi serial numbers and paint some of them in its livery. The United Nations Security Council passed a series of resolutions condemning the Iraqi invasion of Kuwait, declaring the annexation of Kuwait to have no validity, and calling upon all states to take appropriate measures to protect assets of the legitimate government of Kuwait and its agencies. A later resolution set a deadline for the withdrawal of Iraqi forces from Kuwait. When Iraq did not meet the deadline, a coalition of UN member states used armed force to expel Iraqi troops from Kuwait. Iraq eventually acknowledged in principle its liability for any losses caused during the invasion, and its obligation to return Kuwaiti property, in *RCC Resolution 55*, which, among other things, retroactively repealed *RCC Resolution 369*. Four of the ten aircraft were removed to Mosul ('the Mosul Four'), in Northern Iraq, once the military offensive began, and were later destroyed by bombing. The other six were taken to Iran ('the Iran Six'), where they remained until hostilities were over. The Iran Six were subsequently returned to KAC, with a considerable bill (some US\$20 million) for storage, sheltering and maintenance costs. KAC also claimed to have suffered other losses as a result of being kept out of possession of the Iran Six (for example, the extra cost of leasing substitutes for them). KAC sued IAC and the Republic of Iraq in the Commercial Court of England and Wales, seeking damages for the loss of the Mosul Four and for losses suffered as a result of being deprived of possession of the Iran Six. The Republic of Iraq successfully challenged the validity of the service of the writ, and it took no further part in the proceedings in its own name (See *Kuwait Airways Corp v Iraqi Airways Co* [1995] 3 All ER 694, 702–4 (Lord Goff; Lord Jauncey, Lord Mustill, Lord Slynn and Lord Nicholls concurring). IAC, a state-owned and state-controlled entity, raised the defence of state immunity. The House of Lords eventually held that IAC was entitled to state immunity in relation to the acts of taking the aircraft and removing them from Kuwait to Iraq, which were exercises of governmental power by the Republic of Iraq. However, the House of Lords held that IAC was not entitled to immunity in relation to its retention and use of the aircraft after the proclamation of *RCC Resolution 369*, because acts done after that time were not done in the exercise of sovereign authority, but

Nicholls of Birkenhead is that under English conflict of laws principles the transfer of title to tangible movable property normally depends on the *lex situs* being the law of the country where the movable was situated at the time of the transfer. Likewise, governmental acts affecting proprietary rights will be recognized by an English court as valid if they would be recognized as valid by the law of the country where the property was situated when the law takes effect – in this case Iraq. Kuwait Airways Corporation did not dispute these propositions nor did it contend that the *lex situs* of the aircraft was the law of Kuwait as the place where, presumably, the aircraft were registered. KAC's response was that in the present case, as a matter of overriding public policy, an English court will altogether disregard RCC resolution 369. According to Lord Nicholls an English court will not regard this decree of Iraqi law as effective to divest KAC of its title to the ten aircraft.

#### 4.3.4 New jurisprudence on the proper law of a security interest

Reconciling the issue of jurisdiction and recognition of security interests poses legal challenges. In practice, regardless of where the aircraft is situated at the time the mortgage is created, a mortgage, valid according to the proper law of the transfer, will generally be upheld. It is, however, often considered to be a sensible precaution for the mortgagee to ensure that the aircraft is, at the time of the creation of the mortgage, located in the same place as that

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as a consequence of IAC's purported ownership of the aircraft. The proceedings thus continued against IAC alone in relation to its actions in the period after the proclamation of *RCC Resolution 369*, when all the aircraft were in Iraq, until the Iran Six were removed. There was a two-stage trial, separating issues of liability from those of the quantum of damages. Mance J considered the liability of IAC in what became known as the 'Stage 1 trial'. Because KAC was suing in England in relation to torts allegedly committed in Iraq, the choice of law rule in effect at the time required it to show that IAC's actions would have amounted to conversion if they had occurred in England and that they amounted to the Iraqi tort of usurpation. Mance J held that IAC was liable in relation to all ten aircraft, so the case moved on to the 'Stage 2 trial' before Aikens J. The Stage 2 trial raised the question of whether IAC's tortious acts were the cause of KAC's losses, or whether the disposition of the ten aircraft (and their eventual fate) would have been the same even if they had not been assimilated into the IAC fleet. Applying a simple 'but for' standard, Aikens J held that the disposition of the ten aircraft would have been exactly the same if there had been no usurpation or conversion of them by IAC and they had remained KAC aircraft under the disposition of Iraqi Government actors. The Mosul Four would have been flown to Mosul and destroyed there; the Iran Six would have been flown to Iran and detained there until their eventual return. Thus Aikens J held that none of KAC's losses flowed from IAC's tortious conduct. IAC appealed Mance J's decision on liability; KAC appealed Aikens J's decision on quantum. The Court of Appeal upheld Mance J's decision on liability and the part of Aikens J's decision that related to the Mosul Four. It allowed KAC's appeal against Aikens J's decision in relation to the Iran Six. In combination, these decisions resulted in IAC being held liable to pay KAC damages in relation to the Iran Six, but not the Mosul Four, which would have been destroyed by bombing even if there had been no tortious usurpation or conversion of them. The Court of Appeal remitted the action to the Commercial Court for an assessment of the damages flowing from the usurpation and conversion of the Iran Six.

stipulated as being the proper law of the transfer. This is a complex area of the conflict of laws which is yet to be fully and conclusively resolved. Furthermore, it is necessary to distinguish the law governing the validity of the mortgage from the jurisdiction that the parties select. In the case of *Blue Sky One Limited and Others v Mahan Air and Another*<sup>229</sup> which would have persuasive authority in Kenya, the English High Court confirmed that the validity of an English law aircraft mortgage is to be determined by the law of the place where the aircraft is situated (the *lex situs*) on the date the English law aircraft mortgage is executed. In addition, the Court held that in determining whether the mortgage was valid, one has to look at the domestic law of the *lex situs* rather than the contractually agreed governing law of the mortgage. Kenya recognises English law aircraft mortgage. The effect of the *Blue Sky Case* is that Kenyan law will be the law governing the validity of the mortgage if the aircraft is situated in Kenya at the time the aircraft mortgage is executed.<sup>230</sup> Kenyan courts will usually uphold a choice-of-law clause providing for the application of the laws of a foreign country unless its selection was made in bad faith, was illegal or was contrary to Kenyan public policy, for instance, if the parties' intention was to oust the jurisdiction of the court. The precise ambit of the exercise of discretion by the Kenyan courts, however, remains unclear unless the clause agreed upon by the parties is couched in mandatory terms, in which event no discretion may be exercised.

#### 4.3.5 Jurisdiction

A jurisdiction clause may take one of three forms namely, *non-exclusive jurisdiction clause* – this type of clause allows the parties to submit a dispute arising from an agreement to a particular country's courts, while leaving the parties free to commence proceedings in another country's courts, *exclusive jurisdiction clause* – this type of clause provides a more restrictive framework by stipulating that any dispute can only be submitted to an agreed country's courts

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<sup>229</sup> *Blue Sky One Limited and Others v Mahan Air and Another* [2010] EWHC 631 (Comm).

<sup>230</sup> Under English law, a mortgage is a conditional transfer of title (with an equitable right of redemption) and it is only effective if it is recognised as valid by the law of the jurisdiction where the property is situated. Accordingly, an English law mortgage over an aircraft or engines would only be valid if at the time of creation of the mortgage, the aircraft is situated in a jurisdiction which recognises the validity of an English law mortgage. In the *Blue Sky case* the claimant had sought to enforce an English law aircraft mortgage before the English courts. It was established that at the time of creation of the mortgage the aircraft was located in the Netherlands. The court held that in determining whether the mortgage was valid, one has to look at the domestic law of the *lex situs* (that is, the law of the jurisdiction in which the aircraft is located) rather than the contractually agreed governing law of the mortgage. It was held in this case that Dutch law did not recognise an English law mortgage and consequently the mortgage was held to be invalid as a matter of English law. England is presently not a signatory to the Convention. If England were presently a signatory to the Convention the concerns as to recognition of an English law mortgage would not arise provided all relevant registration criteria had been met and the mortgages had been registered at the international registry of aircraft interests established pursuant to the Convention.

and *one-way jurisdiction clause* – a less commonly used clause, this type of clause stipulates that one of the parties must always bring any claim in the courts of one particular country, whereas the other party retains flexibility to bring a claim in any courts it may choose (such a clause is predominantly seen in finance agreements in which the borrower is required to bring a claim in a particular forum whilst the bank retains the right to bring a claim in any forum, most likely where the borrower's assets are located).

The parties' choice of jurisdiction clause should be carefully considered before the parties enter into an agreement, in order to ensure that disputes will be decided in the courts which the parties prefer and have chosen. Simply designating the courts of one jurisdiction in a non-exclusive jurisdiction clause does not necessarily mean that the jurisdiction of those courts will be deemed to be the most appropriate to hear and determine a dispute. As the clause is non-exclusive, claims may also be heard in another country.

Whilst an exclusive jurisdiction clause provides the most contractual certainty, many parties to commercial contracts will nevertheless want to opt for a non-exclusive jurisdiction clause which provides parties with the freedom to bring proceedings in various jurisdictions, for example, one in which the counterparty has assets.

When bringing a claim subject to a non-exclusive jurisdiction clause, the presence and terms of that jurisdiction clause will constitute only one factor which the courts will take into account when considering which country's courts are the most suitable to hear a claim. Therefore, even if a non-exclusive jurisdiction clause specifies a forum other than Kenya, proceedings brought in Kenya will not be stayed if other factors do not prove that the other forum is "*clearly or distinctly*" more appropriate. It has, however, been established that 'non-exclusive' choice of jurisdiction leaves open the possibility that claims will be heard in some other courts. If a party wants to ensure that only one jurisdiction's courts can take jurisdiction over a claim, then this must be stated clearly in the contract, leaving no room to interpret the clause differently.

#### 4.3.6 **Interests Act - is Kenya positioning itself as an appropriate forum for undertaking and enforcing aircraft financing transactions?**

In 2013, Kenya enacted the International Interests in Aircraft Equipment Act, 2013 (“Interests Act”) which came into operation upon the announcement of the results of the 4<sup>th</sup> March, 2013 general elections. By doing so, is Kenya positioning itself as an appropriate forum for undertaking aircraft financing?

Section 3 of the Interests Act provides that the purpose and object of the Interests Act is to give effect and force of law to the provisions of the Convention and the Protocol. The application of the Interests Act is limited to the spheres of application of the Convention and the Protocol. We shall discuss in this study the relevance of the “connecting factors” but the point to be noted at this stage is that the applicability of the Convention and the Protocol to a particular transaction is limited if the debtor is not located in a Contracting State at the time of creating the interest. It should also be noted that the Interests Act exempts charges over aircraft objects from the provision of section 96(2) of the Companies Act and the provisions of the Chattels Transfer Act. The legal effect of the exemption is that a charge over an aircraft object does not require to be registered as required by both Statutes for the same to be valid against a liquidator or creditor. Prior to the Interests Act, the Registrar of Companies would confirm the validity of registered charges created over assets and properties of a company (or in the case of a charge created by an individual, the Registrar-General would confirm the validity of registration of a chattel mortgage). The Registrar-General or the Registrar of Companies (as the case may be) would maintain a register of instruments registered and upon request would give an official search certifying that a charge has been registered over a certain asset. By doing away with the registration requirements, the Interests Act poses a challenge on whether an interested party may be aware of the existence of an encumbrance over an aircraft object if the same is not registered in any registry or obtain an official search confirming the existence of an encumbrance over an aircraft object.<sup>231</sup>

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<sup>231</sup> It appears that this may complicate an already wanting matter. As the study has discussed elsewhere, an aircraft mortgage over an aircraft created by a company which is not incorporated or registered in Kenya is not registrable at the Companies Registry by virtue of the law. The Registrar of Companies does not establish a temporary register popularly known as ‘*Slavenburg*’ register as is the practice in jurisdictions such as the United Kingdom. As discussed elsewhere in the study, the United Kingdom’s Companies Office accepts charges created by companies not registered in the United Kingdom and notes them a temporary register. The relevance of a ‘*Slavenburg*’ register is that a person who conducts a search at the United Kingdom’s Companies Office would be in a position to know of the existence of a charge created by a company not registered in the United Kingdom.

It is the position of this study that the Interests Act does not fully strengthen and support aircraft financing in Kenya compared to similar statutes in other jurisdictions which provide for broader and extended provisions which strengthen aircraft financing. For example, in New Zealand, the Civil Aviation (Cape Town Convention and Other Matters) Amendment Act, 2010 amended the Civil Aviation Act, 1990 to give the Convention and Protocol the force of law in New Zealand, and to ensure these instruments prevail over any inconsistent domestic law and importantly to require the Director of Civil Aviation in New Zealand to de-register an aircraft when requested to do so by a creditor in accordance with the processes set out in the Protocol. The requirement on de-registration is a huge step towards bolstering aircraft finance. The New Zealand Act also made amendments to several other Acts to ensure that the special insolvency regime provided for in the Protocol prevails over any inconsistent domestic processes. Another example is Section 1110 of the US Bankruptcy Code which has played a pivotal role in allowing US airlines to access capital markets through the issuance of EETCs. Section 1110 protection is a crucial element of the EETC structure, due to the fact that the collateral is only as good as the ability of the creditor to access it in the event of default. Section 1110 of the US Bankruptcy Code is unique among national insolvency laws around the world in giving secured creditors with interests in the aircraft the automatic ability to repossess the aircraft after a fixed 60 day delay, thus removing any potential uncertainty in the handling of the creditor's rights by the courts. In addition, Canada's International Interests in Mobile Equipment (Aircraft Equipment) Act, 2005 which gives effect to the Convention and the Protocol introduces amendments to the federal Bank Act to remove large aircraft equipment from the Bank Act's application and to direct registrations to the international registry, and also amends the federal Bankruptcy and Insolvency Act, Companies' Creditors Arrangement Act and Winding-up and Restructuring Act to provide greater certainty for aviation creditors. We submit that the Interest Act should be amended to provide for similar measures.

#### **4.4 Relevance of aircraft insurance in aircraft finance**

An aircraft is an expensive asset and the risks associated with an accident involving an aircraft are enormous. In this regard, insuring an aircraft against all risks is a must for an aircraft owner, lessor, lessee, lender or borrower. A lender taking security over an aircraft must ensure that all appropriate insurance covers are obtained and maintained and if possible have the lender's interest noted in the insurance policy as first loss payee.

Assignment of insurance is also an important aspect in aircraft financing. Aviation insurance is divided into several types of insurance covers. These are all-risk insurance<sup>232</sup> including hull all risks insurance which shall include all flight and ground<sup>233</sup> risks, hull war risks insurance in respect of those risks which are currently enumerated in Lloyds Form AVN48B (war, hijacking and other perils exclusion clause (aviation)), all risks insurance including but not limited to riots, strikes, civil commotion and malicious damage with respect to the aircraft, any engine, parts or spares, rotors and all avionics and accessories and comprehensive airline liability insurance (including but not limited to aircraft third party liability<sup>234</sup> (bodily injury/property damage), passenger<sup>235</sup> (including passenger checked and unchecked baggage and personal effects) and cargo and mail (legal) liability insurance) for a combined single limit<sup>236</sup> of not less the agreed amount.<sup>237</sup>

Alongside insurance, the issue of re-insurance should be considered. There are options available to the financier or lender in order to obtain the benefit of any re-insurance contracts entered into by the insurer in respect of the insurance policies over the aircraft and engines. These are two. One option is obtaining an assignment of the re-insurance proceeds by way of a deed of assignment signed by the insurer in favour of the lender/financier. The assignment would require to be notified to the re-insurer and there should be a confirmation of no

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<sup>232</sup> See also Cunningham, Herb: *Understanding Aviation Insurance*, The COPA Guide to Buying an Aircraft, 34th Edition, pages 74-77, Canadian Owners and Pilots Association, May 2009.

<sup>233</sup> Ground risk hull insurance not in motion - This provides coverage for the insured aircraft against damage when it is on the ground and not in motion. This would provide protection for the aircraft for such events as fire, theft, vandalism, flood, mudslides, animal damage, wind or hailstorms, hangar collapse or for uninsured vehicles or aircraft striking the aircraft. There is also the ground risk hull insurance in motion (taxiing) - this coverage is similar to ground risk hull insurance not in motion, but provides coverage while the aircraft is taxiing, but not while taking off or landing. Normally coverage ceases at the start of the take-off roll and is in force only once the aircraft has completed its subsequent landing. Due to disputes between aircraft owners and insurance companies about whether the accident aircraft was in fact taxiing or attempting to take-off this coverage has been discontinued by many insurance companies.

<sup>234</sup> Public liability insurance, which is often referred to as *third party liability*, covers aircraft owners for damage that the aircraft may cause to third party property, such as houses, cars, crops, airport facilities and other aircraft struck in a collision. It does not provide coverage for damage to the insured aircraft itself or coverage for passengers injured on the insured aircraft. After an accident the insurance company will compensate victims for their losses, but if a settlement cannot be reached then the case is usually taken to court to decide liability and the amount of damages. Public liability insurance is mandatory in most countries.

<sup>235</sup> Passenger liability protects passengers on board an aircraft that is involved in an accident who are injured or killed. In many countries this coverage is mandatory only for commercial or large aircraft. Coverage is often sold on a "per-seat" basis, with a specified limit for each passenger seat.

<sup>236</sup> Combined Single Limit (CSL) coverage combines public liability and passenger liability coverage into a single coverage with a single overall limit per accident. This type of coverage provides more flexibility in paying claims for liability, especially if passengers are injured, but little damage is done to third party property on the ground.

<sup>237</sup> Another form of insurance is in-flight coverage which protects an insured aircraft against damage during all phases of flight and ground operation, including while parked or stored. Naturally it is more expensive than not-in-motion coverage since most aircraft are damaged while in motion.

objection to such assignment signed by the re-insurer. The alternative way in which this can be achieved is by way of what is known as a cut-through endorsement. A cut through endorsement is a reinsurance contract endorsement providing that, in the event of the insurer's insolvency or other inability to pay, the reinsurer will pay any loss covered by the reinsurance contract directly to the insured. It should be noted that in this case the endorsement is made to a reinsurance contract between the insurer and the re-insurer, and the insured is generally not made a party to such cut through endorsement. In view of the above, it would be important to ensure that the underlying re-insurance contract expressly recognises that there may be a third party interest in the contract and permits a third party who is not a party to the reinsurance contract to obtain the benefit of such contract and to enforce such contract. In this way the insured would be in a position to enforce the cut through endorsement as against the reinsurer. There are certain technical points to be borne in mind as regards the wording of the clause and the insolvency law which would be applicable to the insurer, which could impact the efficacy of the cut through clause in the event of insolvency of the insurer. Our understanding is that there are established forms of cut through endorsements used in the aviation insurance industry, developed by international aviation insurance industry bodies such as the Aviation Insurance Clauses Group (AICG). There are, of course, other industry standard form endorsements to the existing insurance policies in respect of the aircraft. It is always recommendable that advice is sought from insurance advisers on which method would best serve to protect the lender's/financier's interests.

#### **4.5 The problem of terrorist threat in the aviation industry**

12 years ago, al-Qa`ida utilized four US commercial airliners to destroy the World Trade Center's towers, damage the Pentagon, and kill close to 3,000 people.<sup>238</sup> The attempted 2009 Christmas Day attack on a Northwest Airlines flight from Amsterdam to the US by Umar Farouk Abdulmutallab who allegedly tried to detonate plastic explosives hidden in his underwear was another reminder that terrorists continue to look for opportunities to target international aviation.<sup>239</sup>

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<sup>238</sup> See *Terrorist Threats to Commercial Aviation: A Contemporary Assessment* by Ben Brandt, 2011: <http://www.ctc.usma.edu/posts/terrorist-threats-to-commercial-aviation-a-contemporary-assessment>.

<sup>239</sup> See article by the US Insurance Information Institute, titled *Terrorism Risk: A Re-Emergent Threat*, April, 2010: [http://insurancemarketreport.com/Portals/131/TerrorismThreat\\_042010.pdf](http://insurancemarketreport.com/Portals/131/TerrorismThreat_042010.pdf)



The fact that acts of terrorism<sup>240</sup> are intentional and that the frequency and severity of attacks cannot be reliably assessed makes terrorism risk extremely problematic from the insurance standpoint. Many insurers continue to question whether terrorism risk is insurable. Large segments of the economy and millions of workers are exposed to significant terrorism risk, but the ability to determine precisely where or when the next attack may occur is limited. At any given time, there are a range of viewpoints among industry analysts and national security experts on where the terrorist threat is highest and which country or location is most at risk. When it comes to estimating losses from potential terrorist attacks there also appears to be significant variability in outcomes, underscoring the degree of uncertainty associated with potential terrorist attacks. Despite the differing viewpoints, the overall consensus appears to be that terrorism risk is an on-going and in some cases growing threat.

Terrorism insurance provides coverage to individuals and businesses for potential losses due to acts of terrorism. Aviation insurance for terrorism risks continues to be an issue of concern for countries around the world. Airlines are required to have passenger and third-party liability insurance coverage to receive landing rights and as a condition for leases. The cancellation of insurance cover could affect the industry's ability to operate.

In the wake of September 11 attack in the US, there was a complete withdrawal of coverage for acts of war, terrorism and related perils. As a result a number of governments stepped in and established schemes to temporarily fill the coverage gap.<sup>241</sup> Since then, the private market has partially reinstated coverage, though at a significantly higher cost.

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<sup>240</sup> A sampling of some airline terrorist threats include the "shoe bomber" plot in December 2001, an attempt to shoot down an Israeli airliner in Kenya in 2002, the liquid explosives plot against transatlantic flights in 2006, the Christmas Day plot in 2009, and the cargo bomb plots in 2010. Other prominent operations attempted or executed by Islamist extremists during this period include a 2002 plot to hijack an airliner and crash it into Changi International Airport in Singapore, the 2002 El Al ticket counter shootings at Los Angeles International Airport, the 2004 bombings of two Russian airliners, the 2007 Glasgow airport attack, a 2007 plot against Frankfurt Airport by the Sauerland cell, a 2007 attempt by extremists to target fuel lines at JFK International Airport in New York, the 2011 suicide bombing at Moscow's Domodedovo International Airport, and the 2011 shootings of U.S. military personnel at Frankfurt International Airport.

<sup>241</sup> Some countries, like the U.S., assist airlines in insuring war risks. The Federal Aviation Administration (FAA) began issuing premium third party liability war risk insurance to US air carriers in the wake of 9/11. The Homeland Security Act of 2002 and subsequent legislation mandated the expansion of war risk insurance coverage to include hull loss and passenger liability and required continued provision of the insurance.

## **CHAPTER FIVE**

### **5.0 REALIZATION OF SECURITY INTEREST**

#### **5.1 Events of default**

Both the Convention and the Protocol provide remedies which may be exercised upon default by lessors, conditional sellers and secured parties in respect of international interests created in their favour and by assignees of international interests, all in their respective roles as creditors.<sup>242</sup>

Pursuant to Article 11 of the Convention, the debtor and creditor may at any time agree in writing as to the events that constitute a default or otherwise give rise to the rights and remedies specified in the Convention. Where no event of default is agreed upon by the parties, “default” means a default which substantially deprives the creditor of what it is entitled to expect under the security agreement<sup>243</sup>. For example, parties can agree that if the borrower removes the object/aircraft out of the creditor’s jurisdiction or reach, this shall be taken as an event of default.

#### **5.2 Enforcement of remedies pursuant to security agreements<sup>244</sup>**

This study will focus on the remedies available in financing transactions under security agreements. The Convention provides for the exercise of 4 remedies by the chargee upon default. In order to utilize any of the 4 remedies mentioned as extra-judicial remedies, the debtor must have provided its consent or agreement in writing at any time. No consent is required for the chargee to apply for a court<sup>245</sup> order. Each of the remedies is subject to any declaration that may be made by a Contracting State under Article 54 of the Convention, which permits remedies without leave of court.<sup>246</sup>

The Protocol provides for the remedies of deregistration of the aircraft and export/physical transfer of an aircraft object. Finally, Article 9 of the Convention provides, under certain

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<sup>243</sup> See Article 11 (2) of the Convention.

<sup>244</sup> See Article 1 (ii) of the Convention which defines a security agreement to mean an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure the performance of any existing or future obligation of the charger or a third person.

<sup>245</sup> Under Article 1 (h) of the Convention “court” means a court of law or an administrative or arbitral tribunal established by a Contracting State.

<sup>246</sup> See Article 8(1) of the Convention.

circumstances, that the ownership of any object covered by the security interest may vest in the chargee in or towards satisfaction of the secured obligations.

The remedies are discussed below:

***Possession or control.***

The chargee may take possession or control of any aircraft object charged to it or apply for a court order to authorize or direct such possession or control.<sup>247</sup>

***Sell aircraft object.***

The chargee may unless otherwise agreed between the parties, sell any aircraft object upon reasonable notice to applicable interested persons or apply for a court order to authorize or direct such a sale.<sup>248</sup> The Convention and Protocol do not require that the chargee have possession of an aircraft object before effecting its sale. Ten (10) or more working days' written notice is considered reasonable notice of sale, although the debtor and chargee may agree to a longer period.<sup>249</sup>

***Grant lease in the aircraft object.***

The chargee may grant a lease in any aircraft object or apply for a court order to authorize or direct such a lease.<sup>250</sup> The same notice provisions apply as with respect to a sale. This provision is subject to Article 54(1) of the Convention, which provides that a Contracting State may declare that while the charged object is situated within its territory the chargee shall not grant a lease of the aircraft object in that territory.<sup>251</sup> It should be noted that this restriction would no longer apply if the chargee took possession of the aircraft object and relocated it to a jurisdiction in which this limitation did not apply.

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<sup>247</sup> See Article 8(1)(a) and Article 8(2) of the Convention.

<sup>248</sup> See Article 8(1)(b), Article 8(2), and Article 8(4) of the Convention.

<sup>249</sup> See Article IX(4) of the Protocol.

<sup>250</sup> See Article 8(1)(b) and Article 8(2) of the Convention.

<sup>251</sup> See Article 54(1) of the Convention.

***Collect or receive income or profits.***

The chargee may collect or receive any income or profits arising from the management or use of the aircraft object or apply for a court order to authorize or direct the same.<sup>252</sup> The income or profits received by a chargee are required to be applied towards discharge of the amount of the secured obligation.<sup>253</sup> The chargee is obligated to distribute any remaining surplus among holders of subordinate interests which have been registered or of which the creditor has been given notice, in order of priority, and any remaining surplus must be paid to the debtor.<sup>254</sup>

**5.2.1 De-registration and export of the aircraft**

Similarly, Article IX (1) of the Protocol states that in addition to the remedies specified in the Convention, the creditor may, to the extent that the debtor has at any time so agreed and in the circumstances specified in the Convention, procure the deregistration of the aircraft and procure the export and physical transfer of the aircraft from the territory in which it is situated.

The creditor may procure the de-registration of the aircraft provided that certain conditions are met.<sup>255</sup> First, the debtor must have agreed, at any time, to permit deregistration of the aircraft. In cases where a Contracting State is the state of registry and has opted in to Article XIII of the Protocol,<sup>256</sup> the debtor may issue an authorization (the IDERA) agreeing to the exercise of this remedy in accordance with the terms of Article XIII. Second, the holder of a registered interest ranking in priority to that of the creditor must have provided consent in writing. The second condition may not be excluded by agreement.<sup>257</sup>

Article IX(1)(b) of the Protocol provides that the creditor may procure the export and physical transfer of the aircraft object from the territory in which it is situated. This is not a right to export to any particular jurisdiction, which jurisdiction may be prohibited by a contracting states export control restrictions. The same conditions applicable to de-registration of aircraft above are applicable here. The creditor may change the nationality of an aircraft and have the

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<sup>252</sup> See Article 8(1)(c) and Article 8(2) of the Convention.

<sup>253</sup> *Ibid.*

<sup>254</sup> See Article 8(6) of the Convention.

<sup>255</sup> See Article IX(1)(a) of the Protocol.

<sup>256</sup> Kenya has opted in.

<sup>257</sup> See Article IV(3) of the Protocol.

aircraft moved to the State of nationality or any other State subject to any applicable export control restrictions.

A chargee seeking to exercise the rights of deregistration, export and physical transfer referred to above must give reasonable prior notice thereof to interested persons specified in Article 1(m)(i) and Article 1(m)(ii) of the Convention and interested persons specified in Article 1(m)(iii) of the Convention who have given notice of their rights to the chargee within a reasonable time prior to the de-registration and export.<sup>258</sup> The perceived limitation of these remedies is that they are not automatic. An aggrieved interested party may seek court intervention and block the exercise of the remedies.

The registry authority in a Contracting State is required to honour the request for de-registration and export<sup>259</sup>. The applicable authorities are also required to expeditiously cooperate and assist the creditor in the exercise of such remedies (de-registration and export) in conformity with the applicable aviation safety laws and regulations.<sup>260</sup>

Moreover, Article X (6) of the Protocol specifies that the remedies of de-registration and export shall be made available by the registry authority and other administrative authorities, as applicable, in a Contracting State not later than 5 working days after the creditor notifies such authorities that the relief has been granted. Where the relief of de-registration or export has been granted by a foreign court, the court in a Contracting State is required to recognize the remedy and the creditor is entitled to procure those remedies in accordance with the Convention.<sup>261</sup>

### ***Significance of IDERA***

A provision relating to the de-registration and export of the aircraft, in the context of a default and the exercise of remedies, is included under the Convention. The Protocol sets out in an

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<sup>258</sup> See Article IX(6) of the Protocol which provides that where a chargee is seeking to procure the de-registration and export of an aircraft otherwise than pursuant to a court order, he/she shall give reasonable prior notice in writing of the proposed de-registration and export to:

- a) the debtor;
- b) any surety or guarantor of the debtor; or
- c) any other persons having rights in or over the object who have given notice of their rights to the chargee within a reasonable time prior to the de-registration and export.

<sup>259</sup> Article IX (5) of the Protocol.

<sup>260</sup> Article X (6) (b) of the Protocol.

<sup>261</sup> Article X (6) (a) of the Protocol.

annex thereto a form of irrevocable deregistration and export request authorization which is an authorization which gives a designated party the authority to seek deregistration and export of the aircraft object (also known as an “IDERA”). The debtor must complete this form and submit the completed form to the applicable civil authority for recordation.<sup>262</sup> By virtue of the debtor’s submission of the authorization, the person in whose favour the authorization has been issued (being the creditor) or its certified designee<sup>263</sup> becomes entitled to procure the de-registration and export of the aircraft in accordance with the terms of the authorization (subject to applicable safety laws and regulations).<sup>264</sup> An authorization, once given, may not be revoked by the debtor without the written consent of the authorized party. The relevant aviation authority is required to enforce the remedies of de-registration and export at the request of the authorized party, without the need for a court order, on the basis of the recorded authorization.<sup>265</sup> In addition, registry authority and other administrative authorities in the applicable Contracting State must expeditiously co-operate with and assist the authorized party in the exercise of remedies permitted by the Protocol, including application for relief pending final determination.<sup>266</sup>

These provisions are only applicable where a Contracting State has made a declaration to the effect that it wishes said provisions to be applicable. The failure of a Contracting State to make such a declaration does not mean that de-registration and export remedies are unavailable to creditors, but rather that the process for exercising such remedies will be determined by the procedural law of the state of registry rather than the Convention.<sup>267</sup>

It should be noted that an IDERA constitutes authorization by a debtor to export an aircraft from its state of registry not to any particular jurisdiction such as states that may be prohibited under that state of registry’s export control laws.

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<sup>262</sup> IDERA is to be filed for recordation with the applicable aviation authority where the aircraft is registered and not at the International Registry.

<sup>263</sup> An assignee of the creditor cannot exercise any rights under an IDERA unless such assignee is a certified designee of the creditor in respect of its rights thereunder (alternatively, and perhaps more typically, a new IDERA is executed in favour of such assignee).

<sup>264</sup> Article XIII(3) of the Protocol. Care should be taken to ensure the IDERA is provided by the party in whose name the applicable aircraft is registered. In jurisdictions like the United States, for example, where registration is made in the name of an owner, the issuance of an IDERA should be made by the owner of the applicable aircraft. Depending on the circumstances, the IDERA should not necessarily be issued by the operator of the applicable aircraft. Notwithstanding the issuance of an IDERA, as a condition to honouring any de-registration and export request, the authorized party must certify that all registered interests ranking in priority to that of the creditor in whose favour the IDERA has been issued have been discharged (or that the holders of such interests have consented to such deregistration and export). See Article IX(5) of the Protocol.

<sup>265</sup> See Article XIII(4) of the Protocol.

<sup>266</sup> *Ibid.*

<sup>267</sup> See Goode at para. 5.68 (Unidroit 2008).

## 5.2.2 Self-help remedies

The leave of court declaration under Article 54(2) of the Convention is the only declaration in the Convention that is mandatory. Whether a repossessing creditor or lessor may proceed against an aircraft object without permission of a court will depend on the local law where the aircraft object is located and, as stated, the declarations made by the Contracting State under Article 54(2) of the Convention.<sup>268</sup>

In other words, if the local law<sup>269</sup> would permit the use of self-help in seizing an aircraft, and the Contracting State did not change that law in its declarations when adopting the Convention, the Convention would permit the repossession and sale of an aircraft object without going to court for assistance. It is therefore important to always check the current declarations of the Contracting State shown on the UNIDROIT website before proceeding with a self-help remedy in a jurisdiction that would otherwise permit it.

As mentioned earlier in this study, seizing a commercial aircraft in most airports around the world without a court order may be quite challenging, and local administrative regulations must still be observed.<sup>270</sup> The creditor should proceed with good advice and extreme caution

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<sup>268</sup> Kenya has made this declaration requiring that leave of court is not required.

<sup>269</sup> Taking remedies as a non-judicial matter is a substantive right of the creditor. This distinction from the laws of procedure that must be followed as a mandatory principle is underscored by the way in which Article 14 requiring remedies to be exercised in conformity with local procedure begins with the phrase “subject to Article 54(2)”. The commentary by Goode at para. 4.114 (Unidroit 2008) provides that Article 14 “*is concerned with procedure, not with substantive law, and therefore does not affect the exercise of non-judicial remedies under Article 8 except in a contracting state which has made a declaration under Article 54(2) requiring leave of the court*”. Where a declaration is made permitting exercise of non-judicial remedies, the creditor cannot be required to go to a court to exercise its remedies. The commentary goes on to say that “other procedural law may be applicable, for example, a legal requirement that an administrative approval such as an airport authority must be obtained”.

<sup>270</sup> In Kenya, upon the occurrence of an event of default, the mortgagee may peacefully take possession of the aircraft and subsequently sell it provided that this is a stipulated term of the mortgage or the mortgagor has otherwise agreed. Often, however, there are good practical reasons for the mortgagee to proceed by way of court order in the case where the mortgagee resists re-possession. For example:

- (a) In the event of the wrongful taking of possession by the mortgagee, damages may be very high, especially those in relation to third parties such as lessees who incur loss as a result of such seizure.
- (b) The taking of possession may involve the mortgagee in the civil offence of trespass (though this possibility is often catered for in the mortgage by a provision that the mortgagor shall indemnify the mortgagee for any liabilities incurred in this respect).
- (c) The KCAA may refuse to grant to the mortgagee the requisite operating licences, airworthiness certificates and other permissions necessary for the continued operation of the aircraft.
- (d) A mortgagee in possession would be required to maintain the aircraft in necessary repair and be diligent in collecting revenues. It would be liable for sums lost through its own negligence and default. It would also be required to pay outgoings before applying the profits earned by the aircraft to discharge the debt owed to it by the mortgagor.
- (e) A private sale by the mortgagee of the aircraft may be challenged on grounds such as the authority of the mortgagee to pass good title, the right to sell, the lack of a sale at the best price and the infringement (or

in this regard and in all cases of repossession using self-help be sure not to act contrary to local law.<sup>271</sup> Exercising such remedies without breaching the peace while an aircraft is in storage or maintenance is also a possible avenue where self-help is available. The use of non-judicial remedies will be subject to the same requirements of commercial reasonableness as any other remedy under the Convention, and the text of the non-judicial remedy set forth in the remedy clauses can help support meeting this requirement where it is not manifestly unreasonable as provided in Article IX(3) of the Protocol.

### 5.2.3 Speedy relief

In addition to other available remedies, Article 13 of the Convention requires a Contracting State to ensure that a creditor who adduces evidence of default by the debtor is able to obtain “speedy relief” from a court pending final determination of its claim. The relief requires to have been agreed by the debtor beforehand.<sup>272</sup> The “speedy relief” described in Article 13(1) is said to be a Convention creation and is distinct from any “interim relief” that may also be available under the laws of the forum. Article 13(4) expressly states that “the availability of forms of interim relief other than those set out” in Article 13(1) are not limited by the Convention.<sup>273</sup>

Unless otherwise declared by the Contracting State, Article 13 of the Convention and Article X of the Protocol provide for what is called “speedy relief,” under which the creditor has the right to obtain certain court orders prior to judgment “to the extent that the debtor has at any

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diminution in value) of the rights of other parties possessing security or other interests in and/or claims against either the aircraft or the mortgagor.

<sup>271</sup> In Kenya for instance, where an aircraft purchaser becomes insolvent before full payment of the purchase price has been made, an unpaid seller who is no longer in possession of the aircraft, has the right of stopping the aircraft *in transitu*. That is, it may resume possession of the aircraft so long as the aircraft is in the course of transit and it may retain it until payment of the purchase price has been made. Goods are deemed to be in course of transit from the time when they are delivered to a carrier, or other bailee or custodian, for the purpose of transmission to the buyer until the buyer (or his agent) takes delivery of them. If the buyer (or his agent) obtains delivery of the goods before their arrival at the appointed destination, the transit will be at an end. The unpaid seller may exercise its right of stoppage *in transitu* either by taking actual possession of the goods or by giving notice of its claim to the carrier (or other bailee or custodian) in whose possession the goods are and, on receipt of such notice, the goods must be redelivered to, or in accordance with, the directions of the seller (See section 46 of the Sale of Goods Act (Cap 31, Laws of Kenya).

<sup>272</sup> See our previous comment as regards the supposed disadvantage of having parties to agree.

<sup>273</sup> The Official Commentary by Goode refers to the relief pending final determination as “advance relief” for brevity and says that the words “interim relief” were “intentionally avoided in the heading to Article 13 and in Article 13(1) so as to make clear that the relief is a Convention relief and should not be characterized by reference to concepts of municipal procedural law. The Commentary further points out that Article 13 “*builds on forms of relief pending final determination .... commonly available in national legal systems, but it is to be interpreted in accordance with the Cape Town Convention, not by reference to national law.*”



time so agreed”. This means that the relevant agreement should expressly provide for such remedies as most security agreements, title reservation agreements and leases do. “Speedy” means a court order is to be issued within such number of working days from the date of filing of the application for relief as is specified in a declaration made by the Contracting State in which the application is made. Article 13 (4) of the Convention allows the creditor to utilize other forms of interim relief that are permitted under the law of the applicable forum. Thus, the list of speedy court remedies provided by the Convention and Protocol may not be exhaustive of all of the advance remedies available to the creditor. The speedy relief expressly provided by the Convention and Protocol for agreement by the parties are “in the form of such one or more of the following orders as the creditor requests”. These are, preservation of the object and its value; possession, control or custody of the object; immobilization of the object; lease or, except where covered by the preceding grounds, management of the object and the income therefrom; and sale and application of proceeds therefrom (if opted-in), provided that at any time the debtor and creditor have specifically agreed<sup>274</sup>.

In order to obtain speedy court relief in one of the above forms, the creditor must provide evidence to the court of the debtor’s default. The court has the discretion to require notice of the creditor’s request for relief to be given to the interested persons as defined in Article 1(m) of the Convention.<sup>275</sup> Under Article 13(2) of the Convention, the court may impose terms, such as an undertaking or bond from the creditor, to protect the debtor or the holder of a non-consensual right or interest and to protect other interested persons in the event that the creditor fails to perform an obligation under the Convention concept of “interested persons”.

The application for the Convention created advance court relief and any application for other forms of national interim relief can, depending on any opt-outs, be brought in one of 4 jurisdictions (which may be concurrent and may be the same forum). These 4 jurisdictions are a forum, chosen by the parties, that is the location of the aircraft object (other than for relief in the form of lease or management of the object pursuant to Article 13(1)(d)), that is in the territory of which the debtor is situated if the relief sought is in the form of lease or

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<sup>274</sup> The Official Commentary by Goode notes that it does not need to be in writing.

<sup>275</sup> Under Article 1(m) of the Convention “interested persons” means:

(i) the debtor;

(ii) any person who, for the purpose of assuring performance of any of the obligations in favour of the creditor, gives or issues a surety ship or demand guarantee or a standby letter of credit or any other form of credit insurance;

(iii) any other person having rights in or over the object;

management of the object pursuant to Article 13(1) (d) or is a form of national interim relief that shares the *in personam* nature of the Article 13(1)(d) relief or is other relief “not in respect of the object, as for example, a claim for an interim payment by the debtor towards alleged arrears” and that is the jurisdiction of the applicable aircraft *or helicopter* registry.

#### 5.2.4 Remedies on Insolvency – Alternatives A and B

The Convention currently has a 2 tier system of enforcement to deal with insolvency.<sup>276</sup> The general rule under the Convention is that in the event of insolvency proceedings<sup>277</sup> against a debtor, an international interest is effective if it was registered against the debtor prior to the commencement of the proceedings. This principle extends to the effectiveness against an assignor of an international interest if the assignor is subject to insolvency proceedings but the assignment to an assignee was registered prior to the commencement of the proceedings and the effectiveness, against a debtor subject to insolvency proceedings, of a registered non-consensual right or interest. An unregistered international interest may nevertheless be effective under applicable non-Convention law.

The terms “insolvency proceedings” and “insolvency administrator” are defined in the Convention along familiar lines to be used for purposes of reorganization or liquidation. Therefore, as used in the Convention and the Protocol, these terms are not limited to a reorganization. The term “insolvency administrator” includes a debtor in possession if permitted under applicable law.<sup>278</sup> The general rule under the Convention outlined above does not override applicable rules of law relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors, or rules of procedure relating to the enforcement of rights to property under the control or supervision of the insolvency administrator.<sup>279</sup> However, the

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<sup>276</sup> Article 30 of the Convention states that insolvency proceedings against the debtor an international interest is effective if prior to the commencement of the insolvency proceedings that interest was registered in conformity with the Convention. In addition, Article 30 does not impair the effectiveness of an international interest in the insolvency proceedings where that interest is effective under the applicable law and nothing in the Article affects any rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors or any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator. In terms of the convention the “applicable law” is either the domestic law where the item in dispute is situated, or the law that was agreed to in a choice of law contract provision.

<sup>277</sup> According to Article 1(l) of the Convention, “insolvency proceedings” means bankruptcy, liquidation or other collective judicial or administrative proceedings, including interim proceedings, in which the assets and affairs of the debtor are subject to control or supervision by a court for the purposes of re-organisation or liquidation.

<sup>278</sup> See Article 1(k) of the Convention.

<sup>279</sup> See Article 30(3) of the Convention.

rights under Article XI of the Protocol (if applicable) override rights of an insolvency administrator to the extent provided.

The Protocol provides in Articles XI and XXX an opportunity for Contracting States to establish a special insolvency regime to govern creditors' rights in relation to aircraft objects, with the effect that, within a specified and binding time limit the creditor either secures recovery of the aircraft object (Alternative A) or has the opportunity to request the debtor, and if the debtor does not act, the court in its discretion, for the right to take possession of the aircraft under applicable law (Alternative B) or obtains from the debtor or the insolvency administrator the curing of all past defaults and a commitment to perform the debtor's future obligations.

The details of these rules vary depending on whether a Contracting State declares pursuant to Article XXX(3) of the Protocol that it will apply Alternative A or Alternative B of Article XI of the Protocol (which will then apply to the types of insolvency proceedings specified by the Contracting State in its declaration). A Contracting State may decide to make no such declaration, in which case neither Alternative will be applicable. Article XI applies only where a Contracting State that is the "primary insolvency jurisdiction" of a debtor has made the applicable declaration and there has been an insolvency related event.<sup>280</sup> The primary insolvency jurisdiction of a person is where the centre of its main interests is situated, with a rebuttable presumption that it is the place of the statutory seat or, if none, the place of incorporation or formation.

Alternative A is the preferred declaration because it requires the debtor, no later than the earlier of the end of the waiting period specified by the Contracting State that is the primary insolvency jurisdiction and that has adopted Alternative A or the date on which the creditor would be entitled to possession if the Convention and Protocol did not apply, to either give possession of the aircraft object to the creditor<sup>281</sup> under the security agreement, title reservation agreement or lease or cure all defaults other than a default constituted by the

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<sup>280</sup> See Article XI(1) of the Protocol.

<sup>281</sup> This is a direct obligation to give possession, not only a right of the creditor to exercise such remedies as may exist under applicable law. In addition, the remedy requiring the insolvency administrator or debtor to give possession of the aircraft object to the creditor under Alternative A by a certain date specified in paragraph 2 of Article XI cannot be delayed by "any order or action which prevents or delays the exercise of remedies after expiry of the waiting period". As a result, local law procedures required pursuant to Article 14 of the Convention cannot be used to delay the remedy of recovery of the aircraft object and records because the Protocol provision here overrides Article 14.

opening of insolvency proceedings and agree to perform all future obligations under the agreement.

It should be noted that a second waiting period does not apply in respect of a default in the performance of such future obligations. Furthermore, unless and until the creditor is given the opportunity to take possession of the aircraft object, the insolvency administrator or debtor must preserve the aircraft object and maintain it and its value in accordance with the agreement and the creditor shall be entitled to apply for any other forms of interim relief available under applicable law. In addition, the remedies of de-registration and export of the aircraft are required to be made available on an expedited basis by the aircraft registry authority and administrative authorities of a Contracting State which opts into Alternative A. Alternative A adds a special provision that only those non-consensual rights or interests covered by a declaration under Article 39(1) of the Convention<sup>282</sup> have priority over registered interests in insolvency proceedings. To date, most Contracting States have declared Alternative A.<sup>283</sup>

Alternative B is considered much less useful to creditors than Alternative A. Alternative B provides that there shall be a time specified in the declaration after which the insolvent debtor, upon request of the creditor, must give notice that it will either cure all defaults other than a default constituted by the opening of insolvency proceedings and agree to perform all future obligations under the agreement or give the creditor the opportunity to take possession of the aircraft object in accordance with applicable law.

If the insolvent debtor does not give such notice or if the debtor notifies the creditor that it will give the creditor the opportunity to take possession of the aircraft but fails to do so, it is then within the discretion of the court in the relevant insolvency jurisdiction to decide whether or not to permit the creditor to take possession of the aircraft object and, if so, to decide upon the terms and conditions to be applicable to such taking of possession. To date, Mexico is the only

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<sup>282</sup> Kenya has made an opt in declaration. The Government of the Republic of Kenya has made the following declaration pursuant to Article .39(1)(a) of the Convention which relates to priority of a non-consensual right or interest: “Kenya declares that the following categories of non-consensual right or interest:

- (a) Liens of workers for payments due arising out of employment relations;
  - (b) Liens created by repairmen on goods in their possession;
  - (c) Liens created by bailees on goods in their possession; and
  - (d) Taxes, duties and or levies due to the Government,
- have priority under its law over an interest in an object equivalent to that of the holder of a registered international interest and shall have priority over a registered international interest, whether in or outside insolvency proceedings”.

<sup>283</sup> Kenya has made declarations opting for Alternative A.

Contracting State to declare Alternative B. The Mexico declaration stated that the waiting period is the period agreed by the parties in the agreement creating the international interest. Therefore, the remedies clause or other agreement clause between the parties must provide guidance as to the waiting period.

Article XII of the Protocol provides that the courts of the Contracting State where an aircraft object is located will cooperate to the maximum extent possible with foreign courts and insolvency administrators in carrying out the provisions of Article XI Alternatives A or B. This insolvency cooperation clause is only applicable if declared by a Contracting State pursuant to Article XXX(1) of the Protocol.<sup>284</sup> This is a separate declaration from a declaration as to Article XI Alternatives A or B so that, for example, a Contracting State may elect Alternative A or B but not elect to commit to cooperation with foreign proceedings implementing Alternative A or B.

### **5.2.5 Significance of key declarations made by Contracting States**

At the time of ratification, acceptance, approval of, or accession to the Convention, States have the power to make declarations as provided for in the Convention. These include whether or not the non-consensual rights/interests<sup>285</sup> which under the particular State's law have priority over an interest equivalent to that of a registered international interest shall have priority over the registered international interest<sup>286</sup>, that nothing in the Convention shall affect the right of a State entity, intergovernmental organization or other private provider of public services to arrest or detain an object under the laws of that State for payment of amounts owed to such entity, organization or provider directly relating to those services in respect of that object or another object<sup>287</sup>, a list of non-consensual rights or interests which shall be registrable under the Convention as international interests<sup>288</sup>, whether or not the Convention will apply to internal transactions where the center of the main interests of all parties is situated and the object is located in the same Contracting State<sup>289</sup>, if a Contracting State has territorial units in which different system of law are applicable in relation to matters dealt with

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<sup>284</sup> Kenya has opted in regarding this provision.

<sup>285</sup> Article 1 (s) of the Convention defines a non-consensual right/interest to mean a right or interest conferred under the law of a Contracting State to secure the performance of an obligation, including an obligation to a State, State entity or an intergovernmental or private organisation.

<sup>286</sup> Article 39 (1) (a) of the Convention.

<sup>287</sup> Article 39 (1) (b) of the Convention.

<sup>288</sup> Article 40 of the Convention.

<sup>289</sup> Article 50 of the Convention.

in the Convention, whether or not the Convention will extend to all territorial units or to one or more of them<sup>290</sup>; the applicable court(s) for purposes of the Convention and of any claim brought under the Convention<sup>291</sup>; that while the charged object is situated within, or controlled from its territory, the charge shall not grant a lease of the object in that territory<sup>292</sup>; whether or not any remedy available to the creditor under the provisions of the Convention which is not there expressed to require application to the court may be exercised only with leave of court<sup>293</sup>; that a Contracting State will neither apply wholly nor in part the provisions<sup>294</sup> relating to interim relief pending final determination of a claim by the creditor following a default by the debtor<sup>295</sup>; and whether or not the Convention will apply to pre-existing rights/interests enjoyed under the applicable domestic law before the effective date of the Convention.<sup>296</sup>

It is important to note that the Convention and Protocol declarations by different Contracting States change and expand the availability of the creditor's remedies. Key declarations (as illustrated above) including those relating to remedies without leave of court (extra judicial remedies and self-help), the terms of speedy advance court relief, irrevocable deregistration and export request authorizations, contractual choice of law and, most importantly, the insolvency provisions allow return of aircraft objects where defaults are not mitigated.

### **5.2.5.1 Key declarations made by Kenya**

Kenya has made various declarations<sup>297</sup> under the Convention which serve to strengthen the rights of creditors under charges, leases and title reservation agreements in respect of aircraft. This includes the right to exercise remedies that the Convention confers on creditors without

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<sup>290</sup> Article 52 of the Convention.

<sup>291</sup> Article 53 of the Convention.

<sup>292</sup> Article 54 (1) of the Convention.

<sup>293</sup> Article 54 (2) of the Convention.

<sup>294</sup> The provision relating to interim reliefs requires a Contracting State to ensure that a creditor who adduces evidence of default by the debtor may, pending final determination of its claim and to the extent that the debtor has at any time so agreed, obtain from a court speedy relief in the form of such one or more of the following orders as the creditor requests:

- a) preservation of the object and its value;
- b) possession, control or custody of the object;
- c) immobilization of the object; and
- d) lease or (if not covered by (a) to (c)) above, management of the object and income therefrom.

<sup>295</sup> Article 55 of the Convention.

<sup>296</sup> Article 60 of the Convention.

<sup>297</sup> The Convention is not a treaty that a country simply decides to ratify or not. Rather, a number of choices need to be made at the time of ratification. These choices, commonly referred to as declarations, are an integral part of the treaty system. Most importantly, certain declarations are specifically designed to reduce transaction risk, and, thus, produce economic benefits. These declarations have been identified in the OECD Aircraft Sector Understanding as qualifying declarations.

first seeking leave of the court by reason of Kenya's declaration under Article 54 of the Convention and the insolvency provisions of the Convention. With effective domestication, the Convention and its remedies will in our view be in full force and effect in Kenya. The designated courts in Kenya having jurisdiction in respect of claims under the Convention are the High Court and the Court of Appeal. We do not see a claim for a personal remedy by a lessee against the lessor resulting in a barring of the Convention remedies, including repossession of the aircraft, particularly in view of the declarations made by Kenya under Articles 39(1)(b)<sup>298</sup>, 40, 53 and 54(2) of the Convention. However, the enforcement of the Convention and its remedies has not to our knowledge been considered by the courts of Kenya to date. The Kenyan courts are, in some cases, unpredictable and there is nothing to prevent a court from acknowledging the Convention remedies and yet thwarting the remedies by issuing orders for attachment before judgment on the grounds that the lessor is an offshore party and has no assets within the jurisdiction with which to satisfy a judgment on the personal claim. We also note that the Convention does not effectively address issues such as securing the safe release of an aircraft in a forced capture or confiscation by an enemy in political crisis. In light of the foregoing, our study has demonstrated that domestication of the Convention alone is not enough and political diplomacy and goodwill together with administrative assistance are also key particularly in de-registration and export of an aircraft under hostile circumstances or defaulting parties.

In addition, the Protocol provides that, so long as the relevant Contracting State has made the declarations under Article XXX (1) (as described above), the parties to the transaction are free to choose the governing law of their agreements.<sup>299</sup> In this case, if the parties choose for example Kenyan law, they would be afforded protection by both the Convention and the Kenyan law.

The failure of a Contracting State to make such a declaration does not mean that de-registration and export remedies are unavailable to creditors, but rather that the process for exercising such remedies will be determined by the procedural law of the state of registry rather than the Convention.

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<sup>298</sup> See footnote above on declarations made by Kenya.

<sup>299</sup> See Article VIII of the Protocol.

### 5.3 Critic of CAA and enforcement under an aircraft mortgage

The CAA does not prescribe what remedies a mortgagee may exercise in the event the mortgagor defaults. In this case, the circumstances in which the mortgagee may secure possession of the aircraft and sell<sup>300</sup> it to recover its debt are included in the mortgage, the finance agreement or the finance lease. It is invariably provided that the mortgagee, on default, may enter into possession of, and sell, the aircraft - though there will often be a requirement for prior notice.<sup>301</sup> Provision may also be made for a receiver to be appointed, as well as for the appointment of the mortgagee as the agent and attorney of the mortgagor in respect of the taking of possession of the aircraft and its subsequent sale. The mortgagor is usually required to provide an indemnity in respect of any liability incurred by the mortgagee in securing possession of the aircraft -such as by entering private property in order to take possession of the aircraft.

On an event of default the mortgagee may peacefully take possession of the aircraft and subsequently sell it provided that this is a stipulated term of the mortgage or the mortgagor has otherwise agreed. Often, however, there are good practical reasons for the mortgagee to proceed by way of court order in the case where the mortgagee resists re-possession. For example, In the event of the wrongful taking of possession by the mortgagee, damages may be very high, especially those in relation to third parties such as lessees who incur loss as a result of such seizure, the taking of possession may involve the mortgagee in the civil offence of trespass, the KCAA may refuse to grant to the mortgagee the requisite operating licences, airworthiness certificates and other permissions necessary for the continued operation of the aircraft, a mortgagee in possession would be required to maintain the aircraft in necessary repair and be diligent in collecting revenues. It would be liable for sums lost through its own negligence and default. It would also be required to pay outgoings before applying the profits earned by the aircraft to discharge the debt owed to it by the mortgagor or a private sale by the mortgagee of the aircraft may be challenged on grounds such as the authority of the mortgagee to pass good title, the right to sell, the lack of a sale at the best price and the infringement (or

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<sup>300</sup> An important incident of a mortgage is the power to sell the property on default of payment by the mortgagor. This may be an express power or an implied power arising as a legal incident of the mortgage. A first mortgagee does not require the consent of subsequent mortgagees to sell the property (though it is often a term of an aircraft mortgage that the express consent of the first mortgagee shall be obtained before subsequent mortgages or other encumbrances are created). A second, or subsequent, mortgagee can only sell subject to the consent of a prior mortgagee unless it arranges for them to be paid from the proceeds of sale.

<sup>301</sup> Ordinarily, the mortgagee may exercise its power of sale on the non-payment of the debt on the due date without prior notice to the mortgagor. However, there is judicial dictum to the effect that such conduct may be oppressive (*Miller v Cook* 1870 L.R. 10 Eq 641, 647).



diminution in value) of the rights of other parties possessing security or other interests in and/or claims against either the aircraft or the mortgagor.

It should be noted that an injunction to prevent the removal of an aircraft that is the subject of a mortgage within the Kenyan jurisdiction may be granted at the discretion of the court. The court has to be satisfied that it is just and convenient to grant the injunction having regard to the circumstances of the case before it.<sup>302</sup> Therefore, the court will determine whether the mortgagee has shown a prima facie case with a probability of success, whether the mortgagee will suffer irreparable injury that cannot adequately be compensated by an award of damages and whether the balance of convenience demands that it grants the injunction.<sup>303</sup> In this connection, the court should be satisfied that, among other things, the mortgagee has made a full and frank disclosure of all the matters in his knowledge which are material for the court to know, given some grounds for believing that there is a risk of the aircraft being removed before the judgment is satisfied and has given the usual undertaking in damages, which, in appropriate cases, may have to be supported with a bond or security.<sup>304</sup>

The Air Navigation Regulations which were promulgated under the repealed CAA empowered the Director-General to refuse to permit the de-registration of the aircraft if, in his opinion, it would be “inexpedient in the public interest to do so”. We are not aware of any circumstances in which the Director-General has exercised his right to refuse permit de-registration from Kenya on this ground.

#### **5.4 Challenges in enforcing the remedies and outstanding issues**

As discussed above, the availability of key remedies under the Convention is not automatic or guaranteed. Basic remedies must be agreed by the debtor in order to be effective. For instance, the speedy relief available under Article 13 of the Convention and Article X of the Protocol is only available if the debtor had agreed to the same beforehand. Accordingly, if the debtor had not agreed to such a relief, it will not be available. In addition, the availability of the remedies of de-registration, repossession and export of the aircraft may be hampered where the debtor chooses to challenge those remedies in court. If the local law would permit the use of self-help in seizing an aircraft, and the Contracting State did not change that law in its declarations

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<sup>302</sup> See Richard Kuloba, *Principles of Injunctions*, 1987 Edn, page 155.

<sup>303</sup> See *Giella v Cassman Brown* [1973] E.A.359 at 360.

<sup>304</sup> See Richard Kuloba, *Principles of Injunctions*, 1987 Edn, page 156.

when adopting the Convention, the Convention would permit the repossession and sale of an aircraft object without going to court for assistance. However, an aggrieved or interested party may seek court intervention and block the exercise of the remedies. We have also seen in this Chapter that seizing a commercial aircraft in most airports around the world without a court order would be quite challenging, and local administrative regulations must still be observed.

The relationship between political stability and the confidence in lending and extending financing is critical. The key political risk in aircraft financing is the refusal to grant de-registration and export of an aircraft. As we have seen in this Chapter, the Convention has addressed this issue. Article IX (1) of the Protocol states that in addition to the remedies specified in the Convention, the creditor may, to the extent that the debtor has at any time so agreed and in the circumstances specified in the Convention procure the deregistration of the aircraft and procure the export and physical transfer of the aircraft from the territory in which it is situated. In fact, the registry authority in a Contracting State is required to honour the request for de-registration and export where it is satisfied that the request is properly submitted by the authorized party under a recorded irrevocable de-registration and export authorization and the authorized party has certified that all registered interests ranking in priority to that of the creditor in whose favour the authorization has been issued have been discharged or the holders of the interests have consented to the de-registration and export.<sup>305</sup>

Similarly, Article 8 (1) of the Convention provides that with or without leave of court as may particularly be declared by the Contracting State, the chargee may, to the extent that the chargor has at the time so agreed will upon the occurrence of any event of default exercise remedies of taking possession or control of any object charged to it, selling or granting a lease of any such object or collecting or receive any income or profits arising from the management or use of any such object. Moreover, Article 13 of the Convention requires a Contracting State to ensure that a creditor who adduces evidence of default by the debtor is able to obtain speedy reliefs from local courts pending final determination of its claim. These reliefs include but not limited to preservation of the object and its value, possession, control or custody of the object, immobilization of the object and lease or management of the object and income therefrom. These reliefs also require to have been agreed by the debtor beforehand. However, the emerging challenge is in cases where the debtor has not agreed or has disputed the grounds

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<sup>305</sup> Article IX (5) of the Protocol.

being advanced to obtain relief. In such cases then, the remedies specified in the Convention may not be readily available.

Where a chargee is seeking to procure the de-registration and export of an aircraft otherwise than pursuant to a court order, he/she shall give reasonable prior notice in writing of the proposed de-registration and export to the debtor, any surety or guarantor of the debtor or any other persons having rights in or over the object who have given notice of their rights to the chargee within a reasonable time prior to the de-registration and export.<sup>306</sup> Another problem is the imminent legal claim and challenge by interested parties blocking the de-registration and export of the aircraft. From the foregoing paragraph, we are of the view that the remedies and protections available under the Convention and the Protocol do not guarantee automatic repossession and de-registration of an aircraft particularly where the interest parties challenge the repossession and de-registration. The study shall propose amendments to the Convention and the Protocol.

Moreover, Article X (6) of the Aircraft Protocol specifies that the remedies of de-registration and export shall be made available by the registry authority and other administrative authorities, as applicable, in a Contracting State not later than five (5) working days after the creditor notifies such authorities that the relief has been granted. Where the relief of de-registration or export has been granted by a foreign court, the court in a Contracting State is required to recognize the remedy and the creditor is entitled to procure those remedies in accordance with the Convention.<sup>307</sup> The applicable authorities are also required to expeditiously cooperate and assist the creditor in the exercise of such remedies (de-registration and export) in conformity with the applicable aviation safety laws and regulations.<sup>308</sup> However, we note that the Convention does not expressly address the issues of securing the safe release of an aircraft in a forced capture or confiscation by an insurgent, militia or an enemy in political crisis. In light of the foregoing it would appear that ICAO may utilize its powers in moving the United Nations to assist in the release of an aircraft. In addition, political diplomacy and goodwill together with administrative assistance will be key in obtaining de-registration and export of an aircraft particularly under hostile circumstances or defaulting parties. We feel that there is need to amend the Protocol to provide for the powers

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<sup>306</sup> Article IX (6) of the Protocol.

<sup>307</sup> Article X (6) (a) of the Protocol.

<sup>308</sup> Article X (6) (b) of the Protocol.

of ICAO in obtaining release and possession of an aircraft in hostile circumstances including requesting bodies such as the United Nations to intervene.

## CHAPTER 6

### 6.0 CONCLUDING CHAPTER

#### 6.1 Summary of the study and conclusions

##### 6.1.1 Introduction

The study has appraised and exposed in detail, the emerging legal challenges and limitations in modern aircraft financing in Kenya. In summary therefore, we have shown that the existing Kenyan laws lack sufficient provisions which would provide acceptable protections to lenders. The study also notes that the remedies under the Convention and the Protocol are not automatic or readily available but are subject to the limitations which we have exposed.

We set out below the key conclusions reached in the study.

##### 6.1.2 Kenyan laws

###### 6.1.2.1 CAA

CAA does not contain express and specific provisions on aircraft financing and creation of aircraft mortgages although one of its core mandates is to register rights in aircraft.<sup>309</sup> Kenya is also yet to have a register of mortgages or rights over aircraft or a law that specifically governs the same. We understand that KCAA intends to establish a register of mortgages. It is, however, not clear when such an initiative will be implemented. Moreover, CAA and KCAA do not have a mechanism for recordation of irrevocable de-registration and export authorization (popularly known in aviation industry as IDERA).

As discussed in Chapter 3, the CAA does not provide for effective documents of title in relation to an aircraft. The Certificate of Registration in respect of an aircraft which document is issued by the Director-General of the KCAA is stated not to be evidence of ownership. There are also no legal provisions for facilitating the stamping and registration of a bill of sale

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<sup>309</sup> We have discussed in the study that KCAA notes a mortgagee's interest in an aircraft if the original Certificate of Registration is lodged with KCAA together with a written request that the mortgagee's interest be noted on the Certificate of Registration. KCAA will issue the mortgagor with a new Certificate of Registration with the mortgagee's interest noted thereon.

as a valid transfer of title in an aircraft the same way a transfer of immovable property is stamped and registered under the land laws. Although logbooks form part of the title documents in respect of an aircraft (or its engines and propellers), the CAA does not expressly recognise them as documents of ownership of title. It would therefore appear that a lender in an aircraft finance transaction would not, under the CAA regime, hold any document of title pertaining to an aircraft. The CAA requires that the original Certificate of Registration and the logbooks should be carried aboard the aircraft. This means that these documents are incapable of being deposited with a lender as part of the lender's security documentation.

The study has proved the hypotheses that the CAA and the regulations promulgated under it do not adequately provide for an appropriate legal and regulatory framework to facilitate effective aircraft financing in Kenya. The study has also fulfilled its objectives particularly regarding the insufficient role of CAA in aircraft financing in Kenya.

#### **6.1.2.2            *Companies Act***

The study discussed in Chapter 1 and 2 that a mortgage over an aircraft created by a company incorporated or registered in Kenya is registrable at the Companies Registry pursuant to section 96 of the Companies Act. However, an aircraft mortgage over an aircraft created by a company that is not incorporated or registered in Kenya is not registrable at the Companies Registry by virtue of the law. The study has recommend that a temporary register popularly known in the United Kingdom as '*Slavenburg*' register is established by the Registrar of Companies as is the practice in jurisdictions like the United Kingdom. As indicated in the study, the United Kingdom's Companies Office accepts charges created by companies not registered in the United Kingdom and notes them a temporary register<sup>310</sup>. The relevance of a '*Slavenburg*' register is that a person who conducts a search at the United Kingdom's Companies Office would be in a position to know of the existence of that charge.

#### **6.1.3                *The Convention and the Protocol***

The Convention enables creditors and financiers to register international security interests and provides standard remedies in the event of default by the debtor. The Protocol supplements and modifies the Convention by offering creditors additional remedies, including the ability to

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<sup>310</sup> The '*Slavenburg*'s register' as a result of the English case of *Slavenburg's Bank NV v International Natural Resources Limited* [1980] All ER 955; [1980] 1 WLR 1076).

require removal of an aircraft from the national civil aircraft register and export it. The study has exposed the importance of registration of an interest at the International Registry. An interest which has been registered under the International Registry is searchable and the registered security interest is protected internationally and under the Convention. By creating a central registration body for aviation equipment, the Convention has made the task of determining the international interest in an aircraft simpler. There is a single database that can be searched from any computer terminal in the world that has internet access. The Protocol is a major step forward in creating a financial regulatory environment that helps to promote certainty and transparency in the aviation capital financing and acquisition market. However, Chapter 5 of the study has revealed that the remedies provided under the Convention and the Protocol regimes are not automatic.

The process of repossession encompasses many complex decisions, several of which can have far-reaching legal and economic consequences, and some of which can expose the lessor or financier to practical difficulties or even legal liability if not properly handled. The study has discussed that the Convention and Protocol do not replace applicable domestic law such as that relating to debtor property rights and obligations or liability in tort. It also does not override governmental regulations such as those relating to safety. In this regard, repossession and export of an aircraft is a matter of local laws and ensure compliance so as to avoid legal liability or conflict with local governmental authorities. A financier should thus be properly aware of the existing challenges under the domestic laws of that country. As discussed in Chapter 2, repossession and export of an aircraft is coupled with costs and expenses which the financier may have to bear.

As discussed in Chapter 4, aircraft are objects which move frequently and fast and this makes their collection in the case of default a significant problem particularly in relation to a financier. The aircraft may also be moved or removed by a debtor in an attempt to evade collection or repossession in case of a default. Accordingly, any lender would be concerned about repossession and export of an aircraft in the event there is a default by the debtor and would be looking for adequate financial security. To obtain protection under the Convention and the Protocol and benefit from the remedies, the international interest must fulfil the connecting factors discussed in Chapter 4. The Convention specifies that it shall apply if at the time of the conclusion of an agreement creating or providing for an international interest in an aircraft object including an interest arising out of a security agreement, the debtor is situated being the Contracting State. The matter of the nationality of registration of an aircraft is also a

considered connecting factor. If the connecting factors and characterization discussed in this study are fulfilled, the Convention and the Protocol provides remedies and protections will be available to the financier. The fact that a creditor is situated in a non-Contracting State does not, as a matter of fact, affect the applicability of the Convention.

The study has examined how the Convention may assist in mitigating political risks by providing for deregistration and export of an aircraft. It should be noted that the registry authority in a Contracting State is required to honour the request for de-registration and export. This is where the registry authority is satisfied that the request is properly submitted by the authorized party under a recorded irrevocable de-registration and export authorization and the authorized party has certified that all registered interests ranking in priority to that of the creditor in whose favour the authorization has been issued have been discharged or the holders of the interests have consented to the de-registration and export. Where a chargee is seeking to procure the de-registration and export of an aircraft otherwise than pursuant to a court order, he/she shall give reasonable prior notice in writing of the proposed de-registration and export to the debtor, any surety or guarantor of the debtor or any other persons having rights in or over the object who have given notice of their rights to the chargee within a reasonable time prior to the de-registration and export. However, the emerging challenge is where the debtor has disputed or questioned the exercise of those remedies. In such cases then, the remedies specified in the Convention may not be obtainable. Another challenge is a legal claim and challenge by interested parties who may block de-registration and export of the aircraft. From the foregoing, the study has concluded that the remedies and protections available under the Convention and the Protocol do not guarantee automatic repossession and de-registration of an aircraft. This study has proposed amendments to the Convention and the Protocol.

Moreover, Article X (6) of the Aircraft Protocol specifies that the remedies of de-registration and export shall be made available by the registry authority and other administrative authorities, as applicable, in a Contracting State not later than five (5) working days after the creditor notifies such authorities that the relief has been granted. Where the relief of de-registration or export has been granted by a foreign court, the court in a Contracting State is required to recognize the remedy and the creditor is entitled to procure those remedies in accordance with the Convention. The applicable authorities are also required to expeditiously cooperate and assist the creditor in the exercise of such remedies (de-registration and export) in conformity with the applicable aviation safety laws and regulations.



The other issue which the study has examined and considered is that domestication of the provisions of the Convention alone in Kenya is not sufficient in affording absolute protection to lenders besides safeguarding their security interests. Although the study advocates for the domestication of the Convention and the Protocol in Kenya, we note that domestication alone is not sufficient. Although domestication allows for the protections and remedies available under the Convention and the Protocol to be recognized locally, this in itself alone is not sufficient. For example the courts in Kenya would be required to recognize and effectively administer the domesticated provisions. Other administrative agencies such as KCAA and Customs Office would be required to cooperate with aircraft owners/operators in procuring de-registration and export of an aircraft from Kenya. In addition, as discussed in the study, the remedies and protection under the Convention and the Protocol are clothed with certain challenges.

In conclusion, against the gaps and deficiencies discussed above, it is still considered that if an aircraft and a debtor are located in a country that has ratified, and importantly, domesticated the Convention, the enforcement rights of creditors and debtors in such country will be greatly enhanced and they may, in the event of default, and if the applicable agreements and applicable domestic law provide, obtain de-registration of aircraft, take possession or control of aircraft, sell or grant a lease of aircraft, collect or receive any income or profits arising from aircraft, terminate applicable agreements or apply for court orders to enforce applicable agreements.

## **6.2 Suggestions and recommendations for policy and legislative reforms**

Having come to the above conclusions, this study proposes a number of practical measures as a way of institutional and other reforms.

### **6.2.1 Recommendation for amendment of the CAA**

This study recommends that CAA should be amended to provide for express and specific provisions on aircraft financing particularly regarding the creation and registration of security interests. To this end, KCAA should introduce legislation in relation to the registration of mortgages and to establish a register of mortgages, to establish a legal mechanism for acknowledgement and recordation of IDERA in order to standardize and ease deregistration and export of aircraft from Kenya, to provide for a valid title to an aircraft

capable of forming valid security. The Certificate of Registration in respect of an aircraft which document is issued by the Director-General of the KCAA is stated not to be evidence of ownership but CAA does not provide what document evidences ownership of an aircraft and to set up an effective system where a certified copy of the document of title may be issued by KCAA and carried on board an aircraft with a note that the original is held by a particular lender. This will boost confidence to a lender in an aircraft finance transaction and effectuate the creation of equitable mortgages by deposit of title.

Kenya should consider designating KCAA as an entry point through which the information required for registration of an international interest may be transmitted to the International Registry. If KCAA is designated as an authorizing entry point, a party seeking registration of an interest will readily obtain the requisite authorization in order to properly effect a registration. This process will ease the procedures for parties in Kenya and encourage registration at the International Register.

Kenya may also consider the adoption of provisions similar to section 1110 of the US Bankruptcy Code. As discussed in this study, section 1110 of the US Bankruptcy Code is unique among national insolvency laws around the world in giving secured creditors with interests in the aircraft the automatic ability to repossess the aircraft after a fixed 60 day period thus removing any potential uncertainty in the handling of the creditor's rights by the courts.

### **6.2.2 Recommendation for reforms at the Companies Registry**

The study recommends that a temporary register popularly known in the United Kingdom as ‘*Slavenburg*’ register is established by the Registrar of Companies. Under this system, the Companies Registry, Nairobi will be accepting aircraft mortgages created by companies not registered in Kenya and notes them in a temporary register. Currently, this is not possible and the Companies Registry returns such charges and confirms that since the mortgagor is not a company for purposes of the Kenyan Companies Act, the Companies Registry is unable to register that security.<sup>311</sup> As stated above, a notation on the ‘*Slavenburg*’ register serves as notice to third parties on existence of a security and enables an interested person to conduct a

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<sup>311</sup> This is evident in Kenya where a foreign company leases an aircraft to a Kenyan company. The aircraft may have been mortgaged by the foreign company to a foreign lender. The Registrar of Companies cannot note the security interest in respect of the aircraft against the Kenyan lessee as additional protection to the foreign lender.

search and establish the existence of the charge. In the absence of such a register, a prospective lender is unable to establish the fact that an aircraft mortgage exists.

### **6.2.3 Recommendation for reforms under the Stamp Duty Act**

The Stamp Duty Act does not provide with certainty the stamp duty chargeable on an aircraft lease agreement. In this case, lessors and lenders are unable to confirm with certainty what duty will be chargeable and can only confirm after we have presented the lease agreement to the Collector of Stamp Duties for assessment. It is feared that without a legal provision governing the stamp duty payable, there may be inconsistencies with the assessments provided.

### **6.2.4 Recommendation for amendments to the Interests Act**

We have discussed in Chapter 1 that the Interests Act exempts charges over aircraft objects from the provision of section 96(2) of the Companies Act and the provisions of the Chattels Transfer Act and for this reason, a charge over an aircraft object does not require to be registered as required by both Statutes for the same to be valid against a liquidator or creditor. We have submitted that this arrangement could mean that the Registrar of Companies and the Registrar-General would be unable to confirm, by way of a search, that an encumbrance has been registered. Our study recommends that the Interests Act is amended to provide that whenever a charge over an aircraft object is created, the parties in that transaction will notify the Registrar of Companies and the Registrar-General and the Registrar of Companies and the Registrar-General shall maintain a register where such notification will be recorded and searchable.

Our study asserts that the Interests Act does not fully strengthen and support aircraft financing in Kenya compared to similar statutes in other jurisdictions. This is principally because the Interests Act lacks broader and extended provisions which strengthen aircraft financing. Some of the amendments we suggest include ensuring that the Convention and the Protocol prevail over any inconsistent domestic law and requiring the Director General of the KCAA to de-register an aircraft when requested to do so by a creditor in accordance with the processes set out in the Protocol. The requirement on de-registration is a huge step towards bolstering aircraft finance. The Interests Act could also provide for amendment to several other Kenyan

statutes such as the Companies Act and the Bankruptcy Act to ensure that the special insolvency regime provided for in the Protocol prevails over any inconsistent domestic processes. Another amendment that could be made to the Interests Act is to give secured creditors with interests in the aircraft the automatic ability to repossess the aircraft after a fixed 60 day delay, thus removing any potential uncertainty in the handling of the creditor's rights by the courts. In addition, the Interest Act could introduce amendments to the CAA to provide for direct registrations to the International Registry with or without the help of KCAA.

### **6.2.5 Recommendation for the amendment of Convention and the Protocol**

While the Convention has gone a long way to harmonizing and clarifying the rules regarding international interests in aircraft finance, this study postulates that there are always options to improve it and the Protocol. One option that would strengthen the Protocol, but may also make it less attractive for signatory states, would be to make it mandatory for states to offer or make available a given remedy such as the sale of the disputed capital, either by the state, or in a privately run auction. There may also be other creative ways to use the creation of a temporary non-consensual state interest in the object to remove the object from a defaulting, or insolvent party.

The Convention could also go further to ensure that the rights of use of an object are not prejudiced by the transfer of international interest without the consent of the debtor.

This study has shown that some basic remedies are not available unless a debtor agrees to them. Whilst this study appreciates the rationale of that requirement and the need to protect debtors, we strongly feel that debtors could use this avenue to unfairly deprive the creditors certain remedies. In this regard, the study suggests that the Convention and the Protocol are amended to provide that if it is established through a fair and credible system that the debtor unreasonably disagrees or the basis of disagreement is to unfairly deny the remedies to the creditor, the creditor should be allowed to carry on with the remedy.

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## APPENDIX I

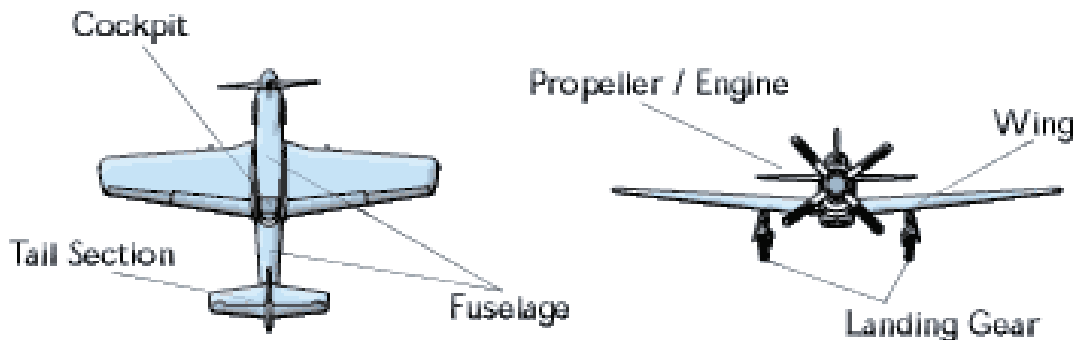
### GENERAL INFORMATION ABOUT AIRCRAFT, ITS PARTS, KEY MANUFACTURERS AND KEY LENDERS

#### The aircraft, its structure and key components

As we interrogate the issue of aircraft financing and the law of financing, it is important to understand the structure of an aircraft, its key components and leading aircraft manufacturers.

#### The key parts of an airplane and their functions

A modern aircraft has five basic structural components: fuselage, wings, tail structures, power plant (propulsion system) and the undercarriage<sup>312</sup> as shown in the diagram below.<sup>313</sup>



The fuselage is the main body structure to which all other components are attached. The fuselage contains the cockpit or flight deck, passenger compartment and cargo compartment. While wings produce most of the lift, the fuselage also produces a little lift. A bulky fuselage can also produce a lot of drag. For this reason, a fuselage is streamlined to decrease the drag. We usually think of a streamlined sports car as being sleek and compact - it does not present a bulky obstacle to the oncoming wind. A streamlined fuselage has the same attributes. It has a sharp or rounded nose with sleek, tapered body so that the air can flow smoothly around it.<sup>314</sup>

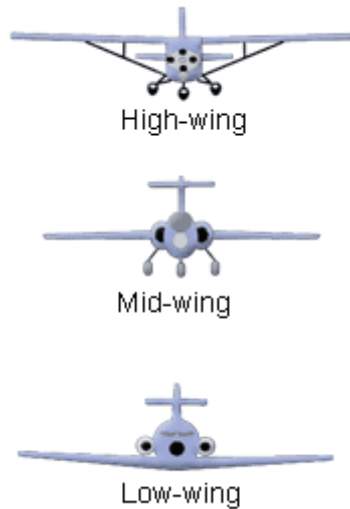
The wings are the most important lift-producing part of the aircraft. Wings vary in design depending upon the aircraft type and its purpose (see diagram below). Most airplanes are designed so that the outer tips of the wings are higher than where the wings are attached to the

<sup>312</sup> See <http://virtualskies.arc.nasa.gov/aeronautics/4.html>

<sup>313</sup> *Ibid*, courtesy of NASA.

<sup>314</sup> *Ibid*.

fuselage. This upward angle is called the dihedral and helps keep the airplane from rolling unexpectedly during flight. Wings also carry the fuel for the airplane.



### **Tail Section Types**

The empennage or tail assembly provides stability and control for the aircraft. The empennage is composed of two main parts: the vertical stabilizer (fin) to which the rudder is attached; and the horizontal stabilizer to which the elevators are attached. These stabilizers of the airplane help to keep the airplane pointed into the wind. When the tail end of the airplane tries to swing to either side, the wind pushes against the tail surfaces, returning it to its proper place. The rudder and elevators allow the pilot to control the yaw and pitch motion of the airplane, respectively.

### **Various Propeller Configurations**

Within a piston engine, the pistons can be arranged in four ways: radial, in-line, oppositional and "V." The radial engine has pistons arranged in a circle with the spinning shaft in the middle. These engines were once the most widely used aircraft engine. They never found much favour outside of aviation and are not used in modern aviation.

The pistons on an in-line engine are lined up one behind the other along the length of the shaft that turns the propeller. These have been used in many applications including cars. They are

not used a great deal in aircraft, as they tend to be long and heavy. Aircraft engines must be as lightweight and compact as possible.

The oppositional piston engine is much like the in-line, except that the pistons are mounted in pairs on opposite sides of the shaft. This makes for a much shorter and lighter engine. In-line engines have become very popular in the small airplane market.

The "V" engine is much like the oppositional engine, except that the pistons are not parallel to each other. Instead they are slanted in a "V" arrangement. The V8 engine is perhaps the most well-known engine as it has been used to power millions of automobiles. The V8 is rarely used in airplanes as they tend to be heavier than the oppositional engines.

Piston engines drive a spinning shaft. The propeller is attached to that shaft. At least two (but usually three or four) blades make up the propeller. The more blades, the more air that can be moved by the propeller. A blade has an airfoil shape which generates lift as the blade slices through the air. Because the propeller is pointed forward the force generated is in a forward direction - that is, it thrusts the airplane forward.

The undercarriage or landing gear consists of struts, wheels and brakes. The landing gear can be fixed in place or retractable. Many small airplanes have fixed landing gear which increases drag, but keeps the airplane lightweight. Larger, faster and more complex aircraft have retractable landing gear that can accommodate the increased weight. The advantage to retractable landing gear is that the drag is greatly reduced when the gear is retracted. When flying on a commercial airliner you will notice that the pilot retracts the landing gear very soon after the airplane leaves the ground. This helps to decrease drag as the airplane ascends.<sup>315</sup>

The power plant is simply the propulsion system and consists of the engines. The sole purpose of the engines is to provide thrust for the airplane. There are many different types of aircraft

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<sup>315</sup> The landing gear is made up of the wheels and the supporting framework that the airplane usually lands on. Landing gear is often omitted on some of the smaller electric airplanes when flying over grass, because the wheels catch on grass when taking off or landing. This could result in damage to the airplane when it flips over or if the landing gear is ripped from the airplane. In cases where the landing gear is removed the airplane is landed on its belly. One also finds retractable landing gear which allows for the landing gear to be retracted in to the airplane during flight so as to reduce drag and allow the airplane to fly faster and more efficiently. Steerable landing gear refers to landing gear that one can control using the transmitter so as to steer the airplane while it is still on the ground to improve the airplane's ground handling.

engines including: piston, turboprop, turbojet and turbofan. Turbojet and turbofan are jet engines. Some aircraft, notably gliders, do not have an engine. To take off they must have another source of thrust - that is, the tow-plane which pulls them into the air.

### **Jet Propulsion and Jet Engines**

Jet propulsion is similar to the release of an inflated balloon. The pressure inside the balloon is pushing in all directions. It is also "jetting" out from the mouth of the balloon. The end of the balloon opposite to the mouth is not open. This creates an imbalance and causes the balloon to move in the direction away from the open mouth. Jet engines work in a similar fashion.<sup>316</sup>

There are several types of jet engine: ramjet, pulsejet, turbojet, turbofan. The last two are the most widely used.

### **Aircraft logbooks**

Each aircraft has a unique set of logbooks that document historical data dating back to the manufacturing date of the aircraft. As an aircraft owner, one has a regulatory obligation to ensure that the logbooks are complete and kept up to date. Aircraft logbooks enable the aircraft owner to keep records of the entire aircraft in chronological order including: inspections, tests, repairs, alterations, Airworthiness Directive (AD) compliance, service bulletins, and equipment additions, removals, or exchanges. Most logbooks also include sections for major alterations and altimeter/static system checks. Anyone performing maintenance on an aircraft will require complete aircraft logbooks to review the aircraft's compliance history before performing maintenance on the aircraft.

### **Leading aircraft, engine manufacturers and leading aviation finance providers**

#### **Selected aircraft manufacturers**

Boeing Commercial Airplanes is the only US. manufacturer of large civil aircraft. Civil aircraft engines are manufactured by General Electric (GE), in partnership with Safran (of France), and by Pratt & Whitney. Numerous firms manufacture sections and parts of the

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<sup>316</sup> *Ibid*

airframe, as well as original equipment for both domestic and foreign airframe manufacturers. The civil and military aerospace sectors are complementary in that many firms manufacture products for both.<sup>317</sup>

If the small commercial jet segment is about to enter a new competitive phase, there is no evidence that the dominance of Airbus and Boeing over large (or wide-body) aircraft or very large (or super-jumbo) aircraft will face a similar challenge anytime soon. The small commercial jet segment represents a significant share of U.S. aerospace manufacturing sector output (see text box above for a discussion of aircraft types). In 2010, Boeing delivered 462 aircraft, of which 376 (81%) were Boeing 737s. Boeing also reported that it booked 486 net 737 orders in 2010, and had a firm order book of 2,186 737s as of December 31, 2010.<sup>318</sup> Boeing's rival, Airbus, delivered 510 aircraft, of which 401 (79%) were A320s.<sup>319</sup> Airbus booked 416 net orders for the A320 Family and had an order backlog of 2,418 A320 airplanes.<sup>320</sup>

Boeing and Airbus will likely face intense and determined competitors that see an opportunity to manufacture large civil aircraft in the 90–220 seat range. However, with the exception of Embraer's 190 and 195 E-Jets, none of the new competitors have yet to build any of the planes that they claim will be superior to Boeing and Airbus products.<sup>321</sup>

Both Boeing and Airbus recognize the possibility that one or more aircraft manufacturers may succeed in building planes that will compete with the Boeing 737 and the Airbus A320 families. Boeing's Jim McNerny has to do little more than look at Airbus to recognize that additional competitors have the potential to fundamentally change the global aircraft manufacturing industry. But history has not been kind to a market crowded with suppliers of commercial jet aircraft.

Boeing and Airbus are the dominant producers of narrow-body commercial transport aircraft (90-220 seats). Two other aircraft manufacturers, Bombardier and Embraer, are the dominant

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<sup>317</sup> See article titled: *Challenge to the Boeing-Airbus Duopoly in Civil Aircraft: Issues for Competitiveness*: <http://www.fas.org/sgp/crs/misc/R41925.pdf>

<sup>318</sup> *Ibid*

<sup>319</sup> Net orders include total orders minus cancellations.

<sup>320</sup> Boeing, Annual Report 2010; Airbus, 2010 Commercial Review.

<sup>321</sup> Embraer, which delivered 58 E-190s and 17 E-195s in 2010, is competing against Airbus' smallest jet, the A318, which has not experienced strong sales.

producers of regional jets (RJs, which are defined as having fewer than 90 seats) and also manufacture narrow-body aircraft.<sup>322</sup>

The entry of new competitors into both the RJ and narrow body markets could result in a much higher level of competition for both the dominant RJ manufacturers (Bombardier and Embraer) and the dominant narrow-body manufacturers (Airbus and Boeing).

Chinese, Russian, and Japanese manufacturers have not previously built commercially competitive large civil aircraft, and Canada's Bombardier and Brazil's Embraer have primarily manufactured regional jets, albeit with considerable success. The complexities that aircraft integrators, such as Boeing and Airbus, have faced with various aircraft development programs (including recent programs such as the Airbus A380 and A350 and the Boeing 787) would be sufficient to sink all but the strongest aerospace companies. However, because some of the new entrants into the large civil aircraft sector are state-owned and -controlled companies (i.e. Russia's United Aircraft Corporation and China's Commercial Aircraft Corporation of China) that are funded by the government, commercial considerations may be less important during the development phase of the Russian and Chinese commercial aerospace projects.

## **Manufacturers**

Airbus Industries' aircraft manufacturing partners brought European competition to the forefront of the world market. The consortium's first airliner combined more passenger comfort with greater airline profitability and, by 1999, when its turnover reached 16.7 billion United States dollars, Airbus had received 3600 orders in total and had 2200 aircraft in service with 176 operators.

The Boeing Company<sup>323</sup> is the world's largest manufacturer of commercial jetliners, military aircraft and the nation's largest NASA<sup>324</sup> contractor. Boeing is among the largest global

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<sup>322</sup> With some "regional jets" seating more than 120 passengers, the term "regional jet" has becoming increasingly meaningless. Larger Bombardier and Embraer RJs are classified by Boeing in the same single-aisle category as the Boeing 737 and the Airbus A320 (90 – 175 seats). Thus Boeing definition of RJs accounts for jet airplanes that carry fewer than 90 passengers. According to a 2001 study by the U.S. General Accounting Office (GAO) (since renamed the U.S. Government Accountability Office): "There is no uniformly accepted definition of a regional jet either in the industry or in federal laws and regulations". For example, the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century, P.L. 106-181, variously defines a regional jet as having a maximum seating capacity of "not less than 30 nor more than 75" (sec. 210) or "less than 71" (sec. 231).

aircraft manufacturers by revenue, orders and deliveries, and the third largest aerospace and defense contractor in the world based on defense-related revenue. Boeing is the largest exporter by value in the United States. Boeing products include commercial and military aircrafts, satellites, weapons, electronic and defense systems and advanced information and communications systems.

Bombardier Aerospace, is one of the world's largest civil airframe manufacturer and a leader in the manufacture of regional airliners, business jets and amphibious aircraft.

The Cessna Aircraft Company is an American general aviation aircraft manufacturing corporation headquartered in Wichita, Kansas. Best known for small, piston-powered aircraft, Cessna also produces business jets.<sup>325</sup>

Embraer is a Brazilian company. It is now among the world's largest aircraft manufacturers and a leading force in aerospace technology and innovation. Embraer has delivered more than 5,000 executive, commercial and defense aircraft in its more than 40 years and these aircraft are now operating in over 90 countries.<sup>326</sup>

Hawker Beechcraft Corporation (formerly Raytheon Aircraft Company) Beechcraft designs, builds and supports versatile and globally renowned aircraft, including the King Air turboprops, piston-engine Baron and Bonanza, and the T-6 trainer and AT-6 light attack military aircraft. Its 5,400 highly skilled employees are focused on continuously improving the company's products and services which are sold to individuals, businesses and governments worldwide. In business since 1932, Beechcraft has built more than 54,000 aircraft and more than 36,000 continue flying today. It leads the industry with a global network of more than 90 factory-owned and authorized service centers. The company's headquarters and major manufacturing facilities are located in Wichita, Kan.

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<sup>323</sup> The Boeing Company is an American multinational aerospace and defense corporation, founded in 1916 by William E. Boeing in Seattle, Washington. Boeing has expanded over the years, merging with McDonnell Douglas in 1997. Boeing Corporate headquarters has been in Chicago, Illinois since 2001. Boeing is made up of multiple business units, which are Boeing Commercial Airplanes; Boeing Defense, Space & Security; Engineering, Operations & Technology; Boeing Capital; and Boeing Shared Services Group.

<sup>324</sup> Acronym for National Aeronautics and Space Administrator.

<sup>325</sup> See Cessna.com

<sup>326</sup> See <http://www.embraerexecutivejets.com/en-US/about-embraer/Pages/History.aspx>

Hawker Beechcraft delivered 204 business, military and general aviation aircraft in 2012<sup>327</sup> and over 54,000 aircraft built since 1932 with more than 36,000 flying today.

Other aircraft manufacturers include AASI Aircraft, Inc., The Aerospatiale Matra group, Derringer Aircraft Company LLC, Diamond Aircraft Industries Inc., European Aeronautic Defence and Space Company, Fairchild Aerospace Corporation, Gulfstream, JetProp DLX, Kolb Aircraft Company, Lockheed Martin, Mooney Aircraft Corporation, Pilatus Business Aircraft, Piper Aircraft, Inc. and Zenith Aircraft Company.

### **Selected engine manufacturers**

Some of the world's manufacturers of aircraft engines are BMW Rolls Royce, Garrett Aviation, GE Aircraft Engines, Pratt & Whitney Canada and Lycoming.

### **Selected aviation lenders**

GE Capital Aviation Services (GECAS)<sup>328</sup> is a leading global player in commercial aircraft leasing and financing, with over 1,680 owned and managed aircraft currently and over 230 customers in over 75 countries. We have local presence in all corners of the world with teams of financial and aviation industry professionals on call to serve you. They also provide leasing and financing options for commercial operators, engines and parts.<sup>329</sup> GECAS has one of the world's largest fleets of commercial aircraft including wide and narrow body commercial jets from Boeing and Airbus and 50, 70 and 90-seat model regional aircraft from Bombardier and Embraer. GECAS services commercial operators around the world with passenger fleet solutions, cargo and specialty aircraft for government/VIP use. With over 30 years' experience, GECAS offers a full range of the leasing and financing products including purchase/leasebacks, operating leases and finance leases. GECAS is also a leading provider of loan financing primarily senior secured loans. GECAS is also active in the buying and selling

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<sup>327</sup> See website, [www.hawkerbeechcraft.com](http://www.hawkerbeechcraft.com).

<sup>328</sup> GECAS, a division of GE Capital, has offices in 24 cities around the world. With over 25 years of experience and more than 2,000 aircraft financed across the world, GE Capital is a leading financing provider in the corporate aviation market.

<sup>329</sup> With more than 100,000 certified aviation parts in inventory, GECAS' parts trading operation is a global player with comprehensive services to help airlines finance and manage their rotatable and repairable aviation components. GECAS also offers a range of leasing and rental spare engine solutions for GE, CFMI, Rolls-Royce, Pratt & Whitney and IAE engines.



of commercial aircraft - both in partnership with airline customers and to manage its own portfolio.

BNP Paribas is one of the leading aviation finance banks. BNP Paribas has arranged a vast number of aircraft financing transactions for cargo and passenger airlines, operating lessors (aircraft/engines, new or used) as well as business jets owners. Credit Suisse is a recognized professional service provider in the high-end aircraft finance market. They offer financing for new or used, medium-sized or large business or private jets from leading manufacturers. The minimum amount for financing is 10 million United States dollars and their financing products include leasing finance, airplane mortgages, financing prior to delivery, and Islamic finance.

DVB Bank, Germany is the world's largest aircraft financier. It is one of the largest providers of recourse and limited-recourse debt (senior and junior) to passenger/cargo airlines and aircraft operating lessors worldwide. It has funded 900 aircraft all over the world, and in India, the bank has, in the past, done "significant financing" for Jet Airways, Indi-Go, Air India and SpiceJet in addition to Kingfisher aircraft. In some cases, DVB has done indirect financing for Indian airline companies.<sup>330</sup>

First Priority Bank (US) offers aircraft financing and is experienced and knowledgeable in aircraft financing.

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<sup>330</sup> [http://articles.economicstimes.indiatimes.com/2012-12-20/news/35933822\\_1\\_dvb-bank-aircraft-kingfisher-airlines](http://articles.economicstimes.indiatimes.com/2012-12-20/news/35933822_1_dvb-bank-aircraft-kingfisher-airlines).

## APPENDIX II

### REGISTRATION OF INTEREST IN THE INTERNATIONAL REGISTRY AND HOW TO CONDUCT SEARCHES

#### Registration of international security interests

##### *International interest*

Central to the purpose of the Convention is the creation of the International Registry for aircraft objects. All security-type interests created by or subject to security agreements, lease agreements and title reservation agreements relating to aircraft objects (known as “international interests”), both current and prospective, may be recorded on the International Registry<sup>331</sup> by reference to the manufacturer’s name, the manufacturer’s generic model and the manufacturer’s serial number with respect to such aircraft object and, subject to certain declared local priorities arising by law (not contract), such interests are accorded priority based upon the order of registration.<sup>332</sup> The Protocol extends certain provisions of the Convention to outright sales, enabling buyers to avail themselves of the registration facilities and priority provisions.<sup>333</sup>

An international interest (security agreement, leasing agreement or title reservation agreement) or contract of sale must meet certain formalities in order to be validly constituted for purposes of the Convention, namely, it must be in writing, it must relate to an aircraft object of which the chargor, conditional seller, lessor or seller, as applicable, has power to dispose, it must describe the applicable aircraft object by manufacturer’s serial number, name of manufacturer and generic model designation and, in the case of a security agreement, it must enable the secured obligations to be determined (although the agreement need not state a sum or maximum sum secured).

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<sup>331</sup> Modalities of registering an international interest in the International Registry will be discussed in this Chapter.

<sup>332</sup> Registration with the International Registry has no effect on the registration of aircraft for nationality purposes under the Chicago Convention, which would continue to apply.

<sup>333</sup> Article III of the Protocol. While outright sales are not themselves international interests, their inclusion allows parties to take advantage of the registration system to facilitate the protection and priority of outright buyers. See also Article 29(3) of the Convention and Article XIV(2) of the Protocol.

The creation of the international interest (including, for this purpose, a contract of sale) is determined by the Convention, and not by local law. Thus, an international interest comes into existence when the above conditions are met, even if these conditions would not be sufficient to create a lease, security interest, conditional sale or sale under otherwise applicable law and even if the international interest is of a kind not known under local law. No other condition (for example, as to the effectiveness of security under the *lex situs*, the payment of any documentary or registration tax or duty or the identity or nationality of the creditor) needs to be satisfied.<sup>334</sup>

Under the Convention, a registered interest has priority over any other subsequently registered interests and over unregistered interests. This priority rule applies even if the registered interest was acquired or registered with actual knowledge of the existence of an unregistered interest. The foregoing rule is intended to avoid factual disputes as to whether a second creditor did or did not know of an earlier interest. Because the registration provisions of the Convention also cover outright sales of aircraft objects, only a buyer of an aircraft object who has registered the sale in accordance with the Protocol takes free from a subsequently registered interest.

A Contracting State<sup>335</sup>, however, may declare that certain categories of non-consensual rights or interests (excluding those that are specifically registrable in accordance with the terms of the Convention) may be entitled to priority without registration over a registered international interest, provided such declaration does not purport to expand rights beyond those afforded under national law.<sup>336</sup>

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<sup>334</sup> See *Practitioner's Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 14.

<sup>335</sup> A Contracting State is a state that has ratified the Convention and the Protocol.

<sup>336</sup> The Government of the Republic of Kenya has made the following declaration pursuant to Article 39(1)(a) of the Convention which relates to priority of a non-consensual right or interest:

“Kenya declares that the following categories of non-consensual right or interest:

- (a) Liens of workers for payments due arising out of employment relations;
- (b) Liens created by repairmen on goods in their possession;
- (c) Liens created by bailees on goods in their possession; and
- (d) Taxes, duties and or levies due to the Government,

have priority under its law over an interest in an object equivalent to that of the holder of a registered international interest and shall have priority over a registered international interest, whether in or outside insolvency proceedings”.

## Benefits of registering international interests

As stated in Chapters 1 and 2, the Convention and the Protocol were intended to significantly improve financial security for investors in cross-border transactions relating to high-value mobile equipment, such as an aircraft. As we shall expose in this study, the Convention enables creditors and financiers to register international security interests<sup>337</sup> and provides standard remedies in the event of default by the debtor.

There were serious issues in relation to credit availability and protection of creditors in the period prior to the Convention. During that period, the sale and financing of any aircraft, aircraft parts, and other mobile capital was principally governed by the laws of each party's home country. This created uncertainty as each country had substantially different laws and regarding the registration and recognition of international financial interests in aircraft.<sup>338</sup>

With no international standard to govern the rights of the creditor and debtor, it was difficult to appreciate and determine the extent of the risk associated with a particular transaction. Usually, financial institutions determine the cost of borrowing by pricing the risk of a transaction. In an environment where the risk is unknown, and subject to rapid change, the cost of doing business is potentially high. When it is more expensive to borrow, effectively the growth of an industry is restricted and hampered. Prior to the Convention, it was not only more difficult to acquire affordable financing, but it was also difficult for lenders to be sure that their interests were protected throughout the life of their investment.<sup>339</sup> There was also difficulty in determining and sufficiently recognizing ownership of an aircraft at the international level. This is because there was no international registry for interests in aircraft and aircraft parts. Each country had its own aircraft registry, and its own different structure for registering an aircraft and international interests over that aircraft.<sup>340</sup> As stated earlier in this study, the Convention on International Civil Aviation also known as the Chicago Convention<sup>341</sup> was the only international source of regulation regarding aircraft prior to the

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<sup>337</sup> Please refer to the definition of an international interest and prospective international interest in Chapter 1.

<sup>338</sup> See article by Serap Zuvin Law Offices, Istanbul on "*Convention*" September 20, 2010 published on <http://www.hg.org/article.asp?id=19883> <accessed on 19<sup>th</sup> June, 2012>.

<sup>339</sup> *Ibid.*

<sup>340</sup> *Ibid.*

<sup>341</sup> In an article published in the website specified below, it has been argued that the tremendous development of aviation during World War II demonstrated the need for an international organization to assist and regulate international flight for peaceful purposes, covering all aspects of flying, including technical, economic, and legal problems. For these reasons, in early 1944, the United States conducted exploratory discussions with its World War II allies, on the basis of which invitations were sent to 55 allied and neutral states to meet in Chicago, United States in November 1944. In November and December 1944, delegates of 52 nations met at the International

entry into force of the Convention. Chapter III of the Chicago Convention governs registration and nationality of aircraft. Under the Chicago Convention regime, aircraft are not allowed to be registered in more than 1 state and registration is governed by the laws of the registering state. The registering state is required to provide a list of registered aircraft to the International Civil Aviation Council.<sup>342</sup>

Prior to the Convention, in the event an issue arose regarding the repayment of debt on an aircraft, there were no consistent set of remedies that could be sought by the creditor.<sup>343</sup> The regulations that would govern the default changed significantly from state to state. Many states had laws which allowed repossession of a good which had not been paid for. Others did not. In some countries bankruptcy acted as a shelter that would protect the aircraft from repossession. Without an internationally recognized set of available remedies in the case of a default, it was increasingly harder for borrowers to secure financing<sup>344</sup> and the financiers to provide the much needed and after sought financing.

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Civil Aviation Conference in Chicago to plan for international cooperation in the field of air navigation in the postwar era. It was this conference that framed the constitution of the International Civil Aviation Organization - the Convention on International Civil Aviation, also called the Chicago Convention. This Convention stipulated that ICAO would come into being after the convention was ratified by 26 nations. Pending ratification of the Convention on International Civil Aviation (also known as Chicago Convention) by 26 States, the Provisional International Civil Aviation Organization (PICAO) was established. It functioned from 6<sup>th</sup> June 1945 until 4<sup>th</sup> April 1947. By 5<sup>th</sup> March 1947 the 26<sup>th</sup> ratification was received. ICAO came into being on 4<sup>th</sup> April 1947. In October of the same year, ICAO became a specialized agency of the United Nations (linked to the Economic and Social Council (ECOSOC)) and charged the responsibility of coordinating and regulating international air travel. The Chicago Convention establishes rules of airspace, aircraft registration and safety, and details the rights of the signatories in relation to air travel and also exempts air fuels from tax. For more details see an article entitled *Creation - The International Civil Aviation Organization (ICAO) - problem, policy, The Chicago Conference of 1944* at <http://www.nationsencyclopedia.com/United-Nations-Related-Agencies/The-International-Civil-Aviation-Organization-ICAO-CREATION.html#ixzz1y4DIZilo>.

<sup>342</sup> According to the ICAO website ([www.icao.int](http://www.icao.int) <accessed on 25<sup>th</sup> July, 2012>), the Council, a governing body of ICAO, is a permanent body of ICAO responsible to the Assembly. It is composed of 36 Member States elected by the Assembly for a 3 year term. The Council has numerous functions, notable among which are to submit annual reports to the Assembly; carry out the directions of the Assembly; and discharge the duties and obligations which are laid on it by the *Convention on International Civil Aviation* (Chicago, 1944). It also administers the finances of ICAO; appoints and defines the duties of the Air Transport Committee, as well as the Committee on Joint Support of Air Navigation Services, the Finance Committee, the Committee on Unlawful Interference, the Technical Co-operation Committee and the Human Resources Committee. It appoints the Members of the Air Navigation Commission and it elects the members of the Edward Warner Award Committee and appoints the Secretary General. The Council elects its President for a term of three years, and he may be re-elected. The Council of ICAO elected Roberto Kobeh González (Mexico) as its President, effective 1<sup>st</sup> August 2006. He was re-elected on 19<sup>th</sup> November 2007 and again on 15<sup>th</sup> November 2010 for a second three-year term. Mr. Kobeh served 8 years as the Representative of Mexico on the Council, from 1998 until his election as Council President.

<sup>343</sup> See article by Serap Zuvin Law Offices, Istanbul on “*Convention*” September 20, 2010 published on <http://www.hg.org/article.asp?id=19883> <accessed on 27<sup>th</sup> July, 2012>.

<sup>344</sup> *Ibid.*

The Convention created an International Registry<sup>345</sup> which allows security and other interests relating to an aircraft which is subject to the Convention to be registered in a central place. The International Registry is searchable in real time, and allows parties to track their interest in an object, as well as search whether other parties have claim on that object. As discussed below, in order for the Convention to apply, the debtor should be located in a signatory state. As discussed in Chapter 2, to be eligible for registration at the International Registry, an interest must be memorialized in writing and should relate to a specific and identifiable aircraft or object to which the seller has the right to dispose.<sup>346</sup>

In addition to setting up an International Registry for international interests in capital, the Convention creates a unified set of procedures in the event of a default on the part of the debtor.<sup>347</sup> Prior to the convention there was little certainty on the part of the rights of a financier in relation to the object in question. Under the Convention regime, there is a consistent set of guidelines for resolving financial claims regarding international interests. The accompanying Protocol not only sets out the potential remedies that are available to the creditor,<sup>348</sup> but also allows for the interests to be satisfied in the proper order.<sup>349</sup>

The Convention protects claim relating to registered interests only. Under the Protocol, unregistered interests are not recognized and/or protected. Article 29 (1) of the Convention, states that a registered interest in an object has priority over an unregistered interest, which predates it, even if the registered party is aware of the unregistered interest. This is an important feature of the Convention as a means of maintaining transparency.<sup>350</sup>

As discussed in Chapter 4, aircraft are objects which move frequently and fast and this makes their collection in the case of default a significant problem particularly in relation to a financier. The aircraft may also be moved or removed by a debtor in an attempt to evade collection or repossession in case of a default. Accordingly, any lender would be concerned

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<sup>345</sup> Article 1(p) of the Convention defines “International Registry” to mean the international registration facilities established for the purposes of the Convention or the Protocol.

<sup>346</sup> See article by Serap Zuvin Law Offices, Istanbul on “*Convention*” September 20, 2010 published on <http://www.hg.org/article.asp?id=19883> <accessed on 19<sup>th</sup> June, 2012>.

<sup>347</sup> Article 1 (j) of the Convention defines a “debtor” to mean a chargor under a security agreement, a conditional buyer under a title reservation agreement, a lessee under a leasing agreement or a person whose interest in an object is burdened by a registrable non-consensual right or interest.

<sup>348</sup> Article 1 (i) of the Convention defines a “creditor” to mean a chargee under a security agreement, a conditional seller under a title reservation agreement or a lessor under a leasing agreement.

<sup>349</sup> *Ibid*

<sup>350</sup> See article by Serap Zuvin Law Offices, Istanbul on “*Cape Town Convention*” September 20, 2010 published on <http://www.hg.org/article.asp?id=19883> <accessed on 19<sup>th</sup> June, 2012>.

about repossession and export of an aircraft in the event there is a default by the debtor and would be looking for adequate financial security. To this end, if the interest over the aircraft is registered in line with the Convention and the Protocol, the remedies and protections are available to financiers.

## **International Registry**

### **Why do we need the International Registry?**

It has been argued that the rationale behind the International Registry is reduction of risks associated with financing aircraft, allowing greater certainty to creditors and aircraft manufacturers and resulting in larger amounts of credit being made available to airlines and aircraft owners at lower costs, which in turn generates increased airline profits and spin-offs to the broader economy. Specifically, the International Registry reduces the risks of purchasing and financing aircraft by allowing individuals and organizations to electronically register interests in aircraft on a “first-to-file” priority basis, allowing individuals and organizations to search the registry to ensure the priority of their interests and allowing for various remedies for individuals and organizations in the case of default of registered interests, including de-registration, re-possession, sale, lease and export of aircraft.<sup>351</sup>

The International Registry<sup>352</sup> in respect of “aircraft objects” is an electronic web-based system that is located in Dublin, Ireland. It is operated by the Registrar, Aviareto Limited.<sup>353</sup> The International Registry, established by the Supervisory Authority<sup>354</sup> under the Convention, is the facility for effecting and searching registrations created pursuant to the Convention.<sup>355</sup> It provides a mechanism to determine the priority of registrations made against a specific aircraft object. The Protocol requires the centralized functions of the International Registry to be

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<sup>351</sup> See article by Parlee McLaw LLP, Canada in April 2006 and posted on [www.parlee.com/e\\_upload/files/PM\\_Aviation\\_LA\\_2006\\_04.pdf](http://www.parlee.com/e_upload/files/PM_Aviation_LA_2006_04.pdf) <accessed on 19<sup>th</sup> June, 2012>.

<sup>352</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group on page 49 at footnote 123 which indicate that the Registrar is developing materially enhanced registry functions, mainly designed to align registration and transaction closing processes. The Guide states that these enhancements, loosely referred to as “Generation 2”, are planned for development and implementation in phases over the next few years, subject to the approval of the Supervisory Authority. In addition, according to the *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 49 at footnote 123, the enhancements will require certain changes to be made to the Regulations and Procedures for the International Registry.

<sup>353</sup> *Ibid* where it is stated that in October 2009, the Council of ICAO opted to reappoint Aviareto Limited to operate the International Registry for a second 5 year term from 2011 to 2016.

<sup>354</sup> The Supervisory Authority is the ICAO.

<sup>355</sup> See Section 3.1 of the Regulations under the Regulations and Procedures for the International Registry.

operated and administered 7 days a week on a 24 hour basis.<sup>356</sup> The International Registry system is “object specific”, that is asset-based, meaning registrations are performed against an “aircraft object.”<sup>357</sup>

### **Interests in objects**

In an asset-based registry such as the International Registry, the most critical task is to properly identify the aircraft object in question. “Interests” in aircraft objects are registered electronically on the International Registry with the consent of the appropriate parties. No documents are deposited with the International Registry and therefore, the International Registry system is intended to be a “notice”<sup>358</sup> system in that users, by obtaining a priority search certificate against a specific aircraft object, are given notice of an asserted specific interest in an aircraft object and the identity of the parties to that registered interest. This is a significant distinction from a document-based registry or filing system which allows parties to obtain and examine documents which have formed the basis of a transaction. Instead, under the system established by the Convention, interested parties must examine the priority search certificate issued by the International Registry to determine what interests are claimed in an aircraft object and who has made the claim. The interested party must then conduct whatever diligence it deems necessary to confirm or otherwise deal with such interests. This keeps administrative costs of the International Registry to a minimum, and protects the confidentiality of the terms of each transaction. For reason that the International Registry is an electronic database searchable over the worldwide web,<sup>359</sup> a user must have an internet connected computer and the necessary software to access the International Registry (primarily a browser and Java). While the search function of the International Registry is fully open to the public, understandably, there are several restrictions established by the Cape Town

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<sup>356</sup> See Article XX (4) of the Aircraft Protocol. The exceptions being such time as the International Registry may not be available due to maintenance or other unforeseen circumstances.

<sup>357</sup> As discussed later in this Chapter, searches are made against “aircraft objects” and for purposes of determining priority cannot be made against debtors or other parties to a transaction.

<sup>358</sup> Section 5.4(c) of the Regulations and Procedures for the International Registry provides that the International Registry is a notice-based system and registration is made against a uniquely identified aircraft object (and not against the debtor). The information required to effect a proper registration, as it relates to the identification of an aircraft object, is (i) the type of object, (ii) manufacturer’s name, (iii) manufacturer’s generic model designation, and (iv) manufacturer’s serial number assigned to such aircraft object. The International Registry requires the user making a registration to select information pertaining to a specific aircraft object (specifically, the manufacturer, model designation and serial number) from the drop-down list of options provided on the registry.

<sup>359</sup> The web address is <https://www.internationalregistry.aero>.



Regulations for the International Registry to ensure that only authorized users are permitted to make registrations.<sup>360</sup>

The International Registry allows for direct registration of international interests and notices of national interests held by a chargor under a security agreement, a conditional seller under a title reservation agreement or a lessor under a leasing agreement.<sup>361</sup>

### **Conducting searches at the International Registry**

A search of the International Registry is normally conducted prior to a closing to identify existing registrations against an aircraft object and after a closing to confirm the new registrations are searchable, thus establishing the intended priorities under the Convention.

The Regulations and Procedures for the International Registry<sup>362</sup> provide for the procedures and regulation in relation to the conduct of searches at the International Registry. Any person may, following payment of the required fee<sup>363</sup>, search the International Registry, and that searching person<sup>364</sup> shall<sup>365</sup> follow the relevant process and instructions specified on the website and complete the electronic forms contained on the website, with the relevant information required by Section 7 of the Regulations.

All searches shall be performed by electronic means. Section 7.6 of the Regulations under the Regulations and Procedures for the International Registry requires that each search certificate and listing shall be issued and made available in electronic form and upon request, a printed copy of a priority search certificate or Contracting State search certificate shall be provided by the Registrar.

Section 7.1 of the Regulations<sup>366</sup>, searches of the International Registry may be performed against the following a manufacturer's name, a manufacturer's generic model designation

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<sup>360</sup> See Section 4 of the Regulations under the Regulations and Procedures for the International Registry and section 7 of the Regulations and Procedures for the International Registry under the Cape Town Regulations.

<sup>361</sup> See Article 2 (2) of the Convention.

<sup>362</sup> The 2006 Edition accessed by our study is divided into 2 parts namely the Regulations and the Procedures.

<sup>363</sup> Currently 35 United States Dollars.

<sup>364</sup> Section 4.5 of the Regulations require that no searching person shall have access to the International Registry unless that person is first in compliance with the Regulations and the International Registry Procedures. Accordingly, the searching person must be approved and authorized by the Registrar to use the International Registry.

<sup>365</sup> See Section 13.1 of the Procedures under the Regulations and Procedures for the International Registry (2006 Edition).

<sup>366</sup> See the Regulations and Procedures for the International Registry (2006 Edition).

and a manufacturer's serial number of an aircraft object. In the case of an airframe or helicopter, against, searches may be performed against the State of Registry of the aircraft of which it is part or the nationality or registration mark.<sup>367</sup>

There are various types of searches which may be conducted at the International Registry.

These are informational search, priority search and contracting State search.

### **Informational search**

An informational search<sup>368</sup> may be performed for registration information against the items listed above in relation to section 7.1 of the Regulations. The object of an informational search is to provide the searching person with sufficient information to perform a priority search.<sup>369</sup>

Section 13.3 of the Procedure under the Regulations and Procedures for the International Registry provides that an informational search listing shall be made available in electronic form to the person undertaking the search and for the avoidance of doubt, an informational search will not generate a search certificate. The Registrar shall not be liable in respect of the content of an informational search listing.

The use of the "information search" is an important tool that allows the person conducting a priority search to be confident they have searched in the appropriate manner. An "informational search" was developed by the International Registry at the request of the industry to address the challenges created by the restricted nature of the priority search.<sup>370</sup> It is a preliminary search function which allows the person searching to determine what priority searches should be conducted. The informational search is based primarily on a search of the system on the basis of the object type and all or part of an object's manufacturer's serial number. Unlike the priority search, the informational search will produce a listing of any aircraft object that matches in whole or part the numeric serial number of an aircraft object

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<sup>367</sup> See also Procedure 13.2 of the Procedures under the Regulations and Procedures for the International Registry (2006 Edition).

<sup>368</sup> See Regulation 7.3 of the Regulations under the Regulations and Procedures for the International Registry, where an "informational search" is defined as a search other than a priority search and the results of an informational search, an "informational search listing", shall be a list of all matching aircraft objects, described by the items set out in Section 7.1 (a) to (c) and, if available in the International Registry, the items in Section 7.1 (d) to (e). The facility to perform such an informational search does not make that information "searchable" for the purposes of Articles 19 (2) and (6) of the Convention and Article XX (1) of the Protocol.

<sup>369</sup> See Procedure 13.2 of the Procedures under the Regulations and Procedures for the International Registry (2006 Edition).

<sup>370</sup> See page 71 of the *Practitioner's Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group.

identified in the pre-populated manufacturers' drop-down list as well as any aircraft object that has been the subject of a prior registration (whether such registration was made using the drop-down list or by free-text).<sup>371</sup> An informational search will only reflect results with regard to a maximum of 50 items, and will provide a notice if there are additional aircraft objects. In this instance, the searcher must conduct a second informational search using additional criteria, such as the manufacturer or model designation, to narrow the focus of the search.

It should be emphasized that an informational search alone is not sufficient to properly establish the status of the records of the International Registry with regard to an aircraft object. The informational search should only be used to gather information to allow a party to make the necessary priority searches and obtain the appropriate priority search certificate, which is the official reflection of the records of the International Registry.

### **Priority search**

Section 7.2 of the Regulations<sup>372</sup> defines a “priority search” as a search for registration information using the 3 criteria specified in Article XX (1) of the Protocol, as set out in Section 7.1 (a) to (c) of the Regulations under Regulations and Procedures for the International Registry.<sup>373</sup> Upon conclusion of the search process, the person searching is issued by the International Registry with a priority search certificate which can be downloaded and printed.

The “priority search certificate”<sup>374</sup> provided by the International Registry is a reflection of the official records of the International Registry with regard to an aircraft object. The priority search certificate will provide the information relating to a prior registration or registrations against a particular aircraft object, or it will confirm that no registrations have been made with

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<sup>371</sup> See page 72 of the See *Practitioner's Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group.

<sup>372</sup> See the Regulations and Procedures for the International Registry.

<sup>373</sup> Such information is searchable for purposes of Articles 19 (2) and (6) of the Convention and Article XX (1) of the Protocol.

<sup>374</sup> According to Section 7.4 of the Regulations under the Regulations and Procedures for the International Registry, a “priority search certificate” is a certificate issued in response to a priority search and which shall:

- (a) set out the information required by Article 22 (2) (a) of the Convention, as applicable, and comply with Article 22 (3) of the Convention; and
- (b) in the case where Article 22 (2) (a) of the Convention applies, list the registered information in both:
  - (i) chronological order; and
  - (ii) a manner that indicates the transactional history of each registered interest.

regard to an aircraft object.<sup>375</sup> The information in relation to registrations will be listed in chronological order. It should be noted that a priority search certificate will not state whether an interest was registered as a prospective interest.<sup>376</sup>

### **Contracting State search**

A “Contracting State search”<sup>377</sup> is a search for all declarations and designations, and withdrawals thereof, made under the Convention and the Protocol by the Contracting State specified in the search. A “Contracting State search certificate” is a certificate issued in response to a Contracting State search.<sup>378</sup>

In making a priority search or a Contracting State search, the searching person shall state the name of the person or persons having the benefit of the search.<sup>379</sup> The name of such person or persons shall appear on the priority search certificate or the Contracting State search certificate, as the case may be. Beneficiaries may include parties entering into, planning or forbearing from commercial transactions involving a named party of an aircraft object or parties providing legal or other professional advice to, or insuring, the parties specified above.

Section 13.5 of the Procedures under the Regulations and Procedures for the International Registry provide that priority search certificates and Contracting State search certificates will be digitally signed by the Registrar and must be so signed in order to be valid. They shall be stored electronically by the Registrar. An electronic version thereof shall be issued and made available to the searching person. A printed version of either such certificate shall be made available upon payment of the required fee.

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<sup>375</sup> Article 22(2) of the Convention.

<sup>376</sup> Article 22(3) of the Convention, and Article III of the Protocol.

<sup>377</sup> See section 7.5 of the Regulations under the Regulation and Procedures for the International Registry.

<sup>378</sup> *Ibid.* A Contracting State search certificate shall:

- (a) indicate, in chronological order, all declarations and designations, and withdrawals thereof, by the specified Contracting State;
- (b) list the effective date of ratification, acceptance, approval or accession of the Convention and the Protocol, and of each declaration or designation, and withdrawal thereof, by the specified Contracting State; and
- (c) attach, in the electronic form set out in the International Registry Procedures, a copy of all instruments deposited by the specified Contracting State relating to items within the scope of Section 7.5 (b) of the Regulations.

<sup>379</sup> Section 13.6 of the Procedures under the Regulation and Procedures for the International Registry provides that the fees for Contracting State searches undertaken by government authorities in Contracting States for official purposes shall be waived. The fees for other searches performed by such authorities may be waived pursuant to arrangements made with the Registrar.

## Person authorized to make registration

Prior to “registration” of a notice of an interest with the International Registry, each party to the interest must first establish an account with the International Registry as a transacting user entity (“TUE”). Registrations of interests in aircraft objects are then accomplished electronically.<sup>380</sup> The primary entity which makes registrations on the International Registry is known as a TUE, which is a legal entity, natural person, or more than one of the foregoing acting jointly, intending to be a named party in one or more registrations.<sup>381</sup>

While accounts are established in the name of individuals and entities, the actual process of registrations can be taken only by individuals. There are three classes of individuals who can act for a TUE, an individual “administrator” of the TUE (the establishment of an administrator is discussed below), a transacting user (“TU”) which is an individual employee, member or partner of a TUE or an affiliate of a TUE and a professional user (“PU”), which is an individual employee, member or partner of a professional user entity (discussed below).

The other type of entity which can establish an account on the International Registry is a professional user entity (“PUE”), which is a firm or other grouping of persons providing professional services to TUEs. A PUE is typically a law firm or other company that assists TUEs in making registrations on the International Registry when authorized to do so. Similar to a TUE, the PUE, once established, must act through individuals. There are two classes of individuals who can take action on behalf of a PUE namely an individual “administrator” of the PUE and a PU. A registry user entity (“RUE”) can be either a TUE or a PUE and a registry user (“RU”) can be either a TU or a PU.<sup>382</sup>

As stated above, no party can access the International Registry for purposes of making a registration until it has established an account as either a TUE or a PUE. An account is established by making an application on-line at, and following the instructions on, the International Registry website.<sup>383</sup> Each entity on the system must have an administrator to

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<sup>380</sup> This is done by data entry into the website of the International Registry and consent given by way of digital signatures utilizing Public Key Infrastructure (PKI) technology and Digital Certificates.

<sup>381</sup> See Section 2.1.15 of the Regulations and Procedures for the International Registry. A “transacting user” means an individual employee, member, or partner of a TUE or an affiliate of that entity.

<sup>382</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 53.

<sup>383</sup> *Ibid.*

make registrations on its behalf, to approve other users and to authorize other users to make registrations on behalf of such entity. The person who applies to establish the entity's account must be the proposed administrator (an "administrator"<sup>384</sup>). When applying for an account, the applicant must provide the legal name of the entity and its address. The administrator must also provide his or her own phone number and email address and create a password which is known only to such individual and which is stored locally on the computer to be used to make registrations. The password will be used when digitally signing or making consents on the website.<sup>385</sup> The applicant must pay for the account and provide the International Registry by email or by fax evidence of its existence such as a certificate of formation or good standing and Certificate of Entitlement to Act ("CEA") in a form prescribed by the International Registry, which must be on the letterhead of the applicant and signed by a person who has authority to act for the applicant. The CEA is the official appointment of both the administrator and a "back-up contact"<sup>386</sup> for the entity.

A registry official at the International Registry will verify, according to the standards set forth in the Cape Town Regulations, the following<sup>387</sup> that the entity exists and its contact details are accurate, that the proposed administrator and back-up contact may be contacted at the email addresses and phone numbers provided by the administrator and that the CEA form nominates such individuals to act in these roles on behalf of the entity.

This account vetting is carried out by phone and email and typically takes 1 or 2 business days once all documentation has been received.<sup>388</sup> Once vetting is successfully completed, the registry official approves the account and an email is automatically sent to the administrator containing a link to its digital certificate.<sup>389</sup> The administrator must download this certificate

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<sup>384</sup> Section 2.1.1 of the Regulations and Procedures for the International Registry defines "administrator" as an individual with authority to act on behalf of a RUE on administrative matters dealing with the International Registry.

<sup>385</sup> Currently, the International Registry offers a 1 year license in the amount of 200 United States Dollars (the International Registry previously permitted users to obtain a 5 year license but this option was recently terminated). Payment should be made on-line and by credit card.

<sup>386</sup> Section 5.12 of the Procedures under the Regulations and Procedures for the International Registry requires a registry user to appoint a "back-up contact" in order to assist should a security breach occur which could reasonably be expected to result in unauthorized access to and use of the International Registry.

<sup>387</sup> See *Practitioner's Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 55.

<sup>388</sup> See *Practitioner's Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 55.

<sup>389</sup> *Ibid* at page 55.

into the same key store<sup>390</sup> which stores the password previously created (that is, the certificate must be downloaded onto the computer from which the original application was made and upon which the password was created). The key store also contains the private key for the administrator. The private key and password are never transmitted to the International Registry.<sup>391</sup>

The restrictions placed on the digital certificate requires the administrator (and each related registry user) to carefully consider the specific computer/work station to be used to interact with the International Registry as such interactions can only be made from the specific computer housing the key store. It is possible to transfer the key store to another computer with support from a registry official and it is also possible, indeed recommended, to back-up this critical file.<sup>392</sup> A digital certificate may be transferred from one computer to another only with assistance from the helpdesk at the International Registry. If the computer that holds a digital certificate is damaged or otherwise inoperable, the applicable user will have to contact the International Registry to obtain a new digital certificate which may cost as much as the original digital certificate. The use of a digital certificate in order to effect registrations on the International Registry is also password protected but the International Registry does not have access to the password, so if it is lost, the applicable user must disable and re-establish the account (which may cost as much as the original digital certificate).<sup>393</sup>

### **Modalities for registering the security interest**

In order to effect a registration, a TUE<sup>394</sup> must begin the creation of a new registration by entering the required data in the appropriate electronic form with the International Registry and consenting to it. Once this has been accomplished and the applicable fee has been paid, the other party or parties to such interest will be given notice that a registration has been initiated and will have 36 hours in which to consent. Much of the data for a registration is available through a “drop down” or “look-up” list on the International Registry website, and

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<sup>390</sup> *Ibid.* A “key store” is an encrypted file protected by the password entered by the user upon application, located on the user’s computer which stores the user’s digital certificate and private key.

<sup>391</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 55.

<sup>392</sup> While the establishment and maintenance of an account is relatively easy, many registry users have opted instead to engage law firms or other service companies to assist in establishing the TUE account and to act as an administrator for the TUE.

<sup>393</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 59.

<sup>394</sup> By and through its administrator or a professional user authorized on its behalf.

critically, such “drop down” list must be used where available.<sup>395</sup> This data includes make, generic model designation<sup>396</sup> and serial number of the applicable aircraft objects and the names of the TUEs who are the parties to registrations. Once all parties have consented to the registration<sup>397</sup>, it is complete and the Registrar automatically provides prompt electronic notification of registration to the named parties and the registering person. The registering party should then search its own registration to ensure that all is in order, with the relevant registration being documented in a priority search certificate.<sup>398</sup>

A TUE administrator is authorized to make registrations for the TUE based upon the CEA form submitted at the time of account set-up.<sup>399</sup> The TUE administrator will either make a registration directly or authorize a registry user or professional user to do so.<sup>400</sup> The TUE administrator uses a “manage authorization” function on the website for the purpose of managing other users. All other users (registry users and professional users) are allowed to make registrations if they first request authorization and are subsequently authorized by the TUE administrator. The authorizations apply to a specific aircraft object and must be requested for each aircraft object on which the user intends to make a registration. Therefore, the first step for an International Registry user is to ensure that it has authorization to make the relevant registration. For professional users, there is a “request authorization” function on the website that will enable the professional user to become authorized to make registrations on a particular aircraft object.<sup>401</sup>

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<sup>395</sup> See Section 5.1 of the Regulations under the Regulations and Procedures for the International Registry.

<sup>396</sup> The Convention and the Protocol, together with the regulations related thereto, specifically contemplate the use of “generic model designations” as opposed to the use of a model designation specific to a particular party. For example, instead of “737-322” airframe, the Convention would use the generic form “737-300”. See Article 7(c) of the Convention and Article V(1)(c) of the Protocol. See also Section 5 of the Regulations under the Regulations and Procedures for the International Registry. This is consistent with the Convention’s basic intent of universality and simplicity.

<sup>397</sup> For most registrations the consent of both parties is required, so when the first party completes the entry of the registration data, pays the registration fee and indicates its consent, the registration goes into a pending state and it is not reflected on the International Registry. The registration will “go live” (that is, be searchable) only when consented to by the second party.

<sup>398</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 57.

<sup>399</sup> *Ibid* at page 58.

<sup>400</sup> Section 6.2 of the Regulations under the Regulations and Procedures for the International Registry.

<sup>401</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 58.



In requesting an authorization, the critical elements are selecting the correct aircraft object identifier (make, generic model and manufacturer's serial number) in the correct format and selecting the correct TUE or controlled entity.<sup>402</sup>

In the case of the first element, where the data is supplied by the manufacturer via the “drop down” list, that data should be used and Section 5.1 of the Regulations under the Regulations and Procedures of the International Registry makes such use mandatory where available. Where such data is not available, the user has the option of entering the data directly, which is commonly referred to as a “free text” entry; however, the use of free text entries should only be made when the information is not available through the drop down list and the use of a free text description increases the risk that the registration will not be given proper effect. A registration that is made using an incorrect or incomplete aircraft object identifier may allow a subsequent registration covering the correctly identified aircraft object to take priority over a prior registration covering the incorrectly identified aircraft object. The practitioner must therefore be very careful to identify an aircraft object correctly.<sup>403</sup>

With respect to the selection of the correct entity for a registration, the user must note that many entities have similar names and it may be necessary to perform additional due diligence before selecting a particular entity. The user should note that a name may not be unique and information on where the firm is registered or situated may be necessary to select the correct entity.<sup>404</sup> Moreover, in dealing with a trust or trustee, where names can be both similar and lengthy, and the subject of abbreviation, it is essential to confirm as much information as possible about the trust name and to carefully review all of the information on the website to be certain the correct entity is selected.<sup>405</sup>

When a TUE administrator receives notice of a request for authorization from a professional user or a registry user, the administrator should carefully review the notice to ensure that the requesting party selected the correct aircraft object identifier as this will be the aircraft object upon which the registrations will be made.<sup>406</sup> The TUE administrator should also carefully manage authorizations of PUEs to work on particular aircraft objects. This includes revoking

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<sup>402</sup> *Ibid*

<sup>403</sup> See *Practitioner's Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 59.

<sup>404</sup> *Ibid* at page 59.

<sup>405</sup> *Ibid* at page 58.

<sup>406</sup> *Ibid* at page 58.

authorizations after they are no longer necessary. There is no cost to revoking or approving authorizations, and accordingly there should be no impediment to keeping the authorization list to a minimum.<sup>407</sup>

Once the relevant authorizations are in place, the person initiating the registration must log on to the International Registry website, select the aircraft object, the type of registration to be made, and the parties to the registration and pay the registration fee.<sup>408</sup> When entering the registration data the user will also be required to enter the State of Registry for the airframe, and if applicable, the relevant unique authorization code for states with a direct entry point. Finally, the user must decide whether to specify a lapse date for the relevant registration. In practice, this feature of the registry system is almost never used and the practitioner is advised to use a lapse date only in rare circumstances.<sup>409</sup>

For some registrations only a single consent is required (for instance, a discharge will go live immediately when consented to by the discharging party).<sup>410</sup>

Payment is processed at the time when the registration is initiated. Payment can be made by credit card (Visa, Master Card or Amex) but not by debit card.<sup>411</sup> Payment may also be made from a prepaid credit card which has been loaded on the system.<sup>412</sup> This can be done by making a credit card payment, such funds then being available to all users of that entity through the use of a personal identification number (PIN).<sup>413</sup> Alternatively, for larger amounts, a wire transfer can be arranged with registry officials. For registrations requiring a second consent, the second party will receive an email notifying such party that a registration has been initiated and that it has 36 hours to consent. A registry user can use the “list interest with status/give consent” function on the website to review the registration data and provide its consent. Again, the user should check the data carefully with a particular emphasis on the aircraft object identifier, the type of registration and the parties.<sup>414</sup> Clearly, all data is critical and must be reviewed before a user consents to a registration. Once the second party consents,

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<sup>407</sup> *Ibid* at page 59.

<sup>408</sup> *Ibid* at page 59.

<sup>409</sup> *Ibid*

<sup>410</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 59.

<sup>411</sup> Such as French Carte Bleu.

<sup>412</sup> See *Practitioner’s Guide to the Cape Town Convention and the Aircraft Protocol 2011*, Published by the Legal Advisory Panel of the Aviation Working Group at page 60.

<sup>413</sup> *Ibid*.

<sup>414</sup> *Ibid*.

the registration enters a queue to be processed before the registration is complete and searchable on the International Registry, however, in normal circumstances this process takes only a matter of seconds.<sup>415</sup>

### ***Significance of entry point***

The Convention provides that a Contracting State may designate an entity in its territory as the entry point through which the information required for registration of an international interest may be transmitted to the International Registry (in the place of direct transmittal to the International Registry directly).<sup>416</sup> Although not expressly stated in the Convention, designation of such entry point may only be made if, in relation to an airframe or a helicopter, the declaration is made by the state that is the state of registry of such aircraft object.<sup>417</sup> Depending on the applicable Contracting State, use of the designated entry point<sup>418</sup> may be optional or compulsory (except in the case of aircraft engines).

There is no system of nationality registration in respect of aircraft engines so the use of the designated entry point cannot be made compulsory.<sup>419</sup> No such designation may be made in relation to registrable non-consensual rights or interests arising under the laws of another Contracting State.<sup>420</sup> If a Contracting State designates an entry point, it may specify the requirements, if any, to be satisfied before registration is transmitted to the International Registry.<sup>421</sup> If these conditions are not satisfied, there is a material risk that the resulting registration will be invalid and/or open to challenges.

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<sup>415</sup> *Ibid.*

<sup>416</sup> See Article 18(5) of the Convention.

<sup>417</sup> See Goode at para. 5.87 (Unidroit 2008).

<sup>418</sup> An entry point may be designated either as an “authorizing entry point” or a “direct entry point”. An “authorizing entry point” is one which effectively authorizes transmissions of information required for registration under the Convention to the International Registry. In this scenario, the entity designated as the authorizing entry point provides the party seeking to effect a registration with authorization (in the form of a unique authorization code) which is required to be included with the information submitted to the International Registry in order to properly effect a registration of an interest. The inclusion of the authorization code in such circumstances is mandatory. A “direct entry point” is one through which information is directly transmitted to the International Registry by the designated entity automatically and without any need for authorization. Please see Section 12.4 of the Regulations under the Regulations and Procedures for the International Registry. To date, the only Contracting State which has designated an entity as a direct entry point is the United Arab Emirates.

<sup>419</sup> Article XIX(2) of the Protocol.

<sup>420</sup> See Goode at para. 3.37 (Unidroit 2008).

<sup>421</sup> See Article 18(5) of the Convention.