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## **Aircraft operating leasing: a legal and practical analysis in the context of public and private international air law**

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Aircraft Operating Leasing: A Legal and Practical Analysis  
in the Context of Public and Private International Air Law

**PART 2:**

**OVERVIEW**

## 2 OVERVIEW

### 2.1 *Aircraft operating leasing and other forms of leasing and financing*

In the context of personal property, such as an aircraft, a lease may be defined as:

“a contract by which one owning such property grants to another the right to possess, use and enjoy it for specified period of time in exchange for periodic payment of a stipulated price, referred to as rent.”<sup>61</sup>

However, this definition, although it may work for most purposes, may not be entirely correct or comprehensive.<sup>62</sup>

There seems no good reason why such grant must be in exchange for a periodic payment (rent could be paid in advance in full, for example) of a stipulated price (the rent may be floating by reference to interest rate fluctuations, rather than fixed, or may otherwise be reviewable during the term) or at all (there could be a power by the hour arrangement whereby the airline is only obliged to store, maintain and use the aircraft, but is only obliged to pay rent, howsoever described, based on actual usage, with or without minimum usage requirements).<sup>63</sup>

The Cape Town Convention perhaps comes closer to a comprehensive definition by defining a lease agreement as:

“an agreement by which one person (the lessor) grants a right to possession or control of an object (with or without an option to purchase) to another person (the lessee) in return for a rental or other payment”<sup>64</sup>

The International Civil Aviation Organization (ICAO), the specialized agency of the United Nations dealing with international civil aviation, has, perhaps wisely, declined to define what constitutes a leased aircraft other than as one “used under a contractual leasing arrangement” according to its Manual on the Regulation of International Air Transport.<sup>65</sup> Given the tailor-made nature of leases negotiated for specific situations, its Air Transport Committee has stated that a more precise definition has not proven possible.<sup>66</sup>

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<sup>61</sup> Nolan J R and Nolan-Haley J M, *Black's Law Dictionary*, West Publishing Co., 6<sup>th</sup> edition, 1990 at 889.

<sup>62</sup> For example, the lessor may not be the owner where it itself holds the leased property pursuant to a head lease.

<sup>63</sup> Thus, the various attempts to define a lease in Abeyratne R I R, *Aviation Trends in the New Millenium*, Ashgate, 2001, 14 *et seq.*, while good, fail likewise to be comprehensive.

<sup>64</sup> Article 1(q).

<sup>65</sup> Doc 9626.

<sup>66</sup> *Study on Aircraft Leasing*, Air Transport Committee, 156<sup>th</sup> Session of the Council, ICAO, 1999, at 1.1.

Aircraft leases are classified as being either operating leases on the one hand or finance or capital leases on the other hand. This study will examine the aircraft operating lease.<sup>67</sup>

The International Accounting Standards Board<sup>68</sup> has adopted Standard 17 (IAS 17) which provides that:

“The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

“A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.”

In the United States, the Financial Accounting Standards Board<sup>69</sup> has adopted Statement of Financial Accounting Standards 13 (FAS 13), which is more detailed than IASB 17.

Under paragraph 7 of FASB 13, a capital lease is one in which, *inter alia*:

- (1) the lease transfers ownership of the property to the lessee by the end of the lease term;
- (2) the lease contains a bargain purchase option;
- (3) the lease term is equal to 75 percent or more of the estimated economic life of the leased property, or
- (4) the present value of the lease payments, discounted at an appropriate discount rate, exceeds 90% of the fair market value of the asset.

An operating lease is simply defined as any lease which is not a capital lease.

It is hoped to harmonise IAS 17 and FAS 13 but such harmonization has not been achieved as at the time of writing.<sup>70</sup>

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<sup>67</sup> Specifically, the dry aircraft operating lease. For the distinction between dry and wet leases (which latter are more akin to charters of aircraft in certain respects and in any event beyond the scope of this study), see 3.5.1.4 and 3.5.2.5 *infra*. Also note Hamilton’s statement that the United States Federal Aviation Administration has a basic presumption that, where an aircraft and crew are provided from the same source, the arrangement is a charter and not a lease, with wet leases being closely scrutinized: Hamilton J S, *Practical Aviation Law*, 4<sup>th</sup> edition, Blackwell, 2005, at 218.

<sup>68</sup> <http://www.iasb.org> on 15 April 2011.

<sup>69</sup> <http://www.fasb.org> on 15 April 2011.

<sup>70</sup> <http://www.iasb.org/Current+Projects/IASB+Projects/Leases/Leases.htm> on 15 April 2011.

The Unidroit Convention on International Financial Leasing<sup>71</sup>, which has not been widely adopted,<sup>72</sup> sets out provisions dealing with “financial leasing” which it defines as including, *inter alia*, the characteristic that:

“the rentals payable under the leasing agreement are calculated so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment.”<sup>73</sup>

From a commercial and accounting point of view, the main difference between an operating and a finance lease is that, with the former, the lessor is expecting to receive the aircraft back while it still has a useful economic life and thus will be more concerned as to the physical condition of the aircraft since it must lease it out afterwards to a subsequent lessee. The aircraft remains accounted for as an asset on the books of the lessor, who is entitled to depreciation of the aircraft since the risks and rewards of ownership lie with it. Further, a benefit for the lessee in entering into an operating lease is the corollary that the operating lease does not appear on its books as a liability<sup>74</sup> since, with it:

“...lease structures can be devised to meet accounting objectives of removing liabilities from a balance sheet –thereby, among other things, preserving the lessee’s debt-to-equity ratio.”<sup>75</sup>

With the finance lease, on the other hand, the aircraft is accounted for as an asset on the books of the lessee, with the depreciation rights which that entails, since the risks and rewards of ownership have been assumed by it. Barring a default on the part of the lessee, the lessor does not expect to retake possession of the asset.

In *Lithoprint (Scotland) Ltd. v Summit Leasing Ltd. & Ors.*,<sup>76</sup> a case before Lord Milligan of the Scottish Court of Sessions, the dispute did not concern whether the lease in question was an operating lease or a finance lease. In it, the pursuers<sup>77</sup> asserted, and the defenders<sup>78</sup> did not dispute that, “a finance lease typically transfers many of the risks and rewards of ownership to the lessee in return for payment of a rental, that most finance lessors fix the rental as if the transaction is a loan”<sup>79</sup> and “that the rental is fixed with a view to a full return to the lessor of capital and interest.”

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<sup>71</sup> Signed at Ottawa on 28 May 1988.

<sup>72</sup> It is only in force in 10 states - <http://unidroit.org/english/implement/i-88-1.pdf> on 27 April 2011.

<sup>73</sup> Article 2(c).

<sup>74</sup> This is, of course, only one benefit to the lessee of an operating lease. Even without such accounting treatment, the operating lease would still offer flexibility in terms of a finance lease in terms of committing the airline to an aircraft for only a portion of its economic life.

<sup>75</sup> Bunker D H, *Aircraft Financing in the Future*, Annals of Air and Space Law, Volume XXVII, 2002, 139-160, at 149.

<sup>76</sup> [1998] ScotCS 36 (23 October 1998).

<sup>77</sup> Plaintiffs in Scottish courts.

<sup>78</sup> Defendants in Scottish courts.

<sup>79</sup> At page 2.

To that extent, the finance lessor can be considered as essentially akin to a secured lender, choosing to structure its security by way of ownership where the asset is subject to a finance lease in favour of what is thus essentially akin to a borrower rather than by allowing the borrower legal ownership while taking a mortgage over the aircraft.<sup>80</sup>

This argument was raised before Hamblen J of the English High Court in *Celestial Aviation Trading 71 Limited v Paramount Airways Private Ltd.*<sup>81</sup> In that case, Hamblen J considered *Shiloh Spinners Ltd. v Harding (HL)*,<sup>82</sup> which allowed the court to consider whether the insertion of a right of forfeiture essentially to secure the payment of money was a ground on which relief against forfeiture could be granted. In *Celestial*, Hamblen J held that the lease in question was an operating not a finance lease, that possessory rights for the lease term only were transferred not proprietary rights, and rejected the claimant's argument that relief against such forfeiture should be granted since, *inter alia*, the total of all lease rentals and supplemental reserves (as to which see 3.7 *infra*) to be paid to the defendant would exceed the cost of the aircraft. His reasoning included the fact that this was an operating lease and that, for leases of this type, the rent was set by reference to prevailing demand and supply for aircraft of the same type. He also rejected the claimant's method of calculation (specifically excluding supplemental rent as a fund to be used for major aircraft maintenance).<sup>83</sup>

Both the IASB and FASB are considering abolishing the distinction between operating and finance leases for accounting purposes. According to IASB:

“Classification as an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either International Financial Reporting Standards or US standards.... This results in many investors having to adjust the financial statements....to estimate the effects of lessees' operating leases for the purpose of investment analysis. The proposals would result in a consistent approach to lease accounting for both lessees and lessors—a 'right-of-use' approach. This approach would result in all leases being included in the statement of financial position....”<sup>84</sup>

Even if such convergence should take place for accounting purposes, it is submitted that this would not have any effect on the legal distinction between operating and finance leases, at least under English law. In *Celestial*,<sup>85</sup> Hamblen J referred to the distinction in

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<sup>80</sup> See the discussion “Scope Problem: True Lease or Disguised Security Interest?” in Clark B, *The Law of Secured Transactions under the Uniform Commercial Code*, Volume 1, Thomson Financial, 2000, at 1-45 *et seq.*

<sup>81</sup> [2010] EWHC 185 (Comm.).

<sup>82</sup> [1973] AC 691.

<sup>83</sup> *Id.*, at 47.

<sup>84</sup> <http://www.ifrs.org/Current+Projects/IASB+Projects/Leases/ed10/Ed.htm> on 15 April 2011.

<sup>85</sup> At 55.

accounting treatment<sup>86</sup> between operating leases and finance leases but did not base his judgment on it. He based his judgment on the following:

“In the present case..., Paramount only has a right to possess the Aircraft for a proportion of its economic life. As such Celestial retains a very real interest in the Aircraft themselves, including their proper maintenance, the extent of their use, their condition, and their rental and resale value. Possession of the Aircraft will revert to it at a time when the bulk of their economic life is still to run, and there are detailed terms addressing the return of the Aircraft and their required redelivery condition. Celestial therefore retains many of the risks and rewards of ownership. Moreover, Rent was not calculated on the basis of recouping the cost of the Aircraft together with interest and profit.”<sup>87</sup>

The Cape Town Convention, which will be examined in detail in Part 3 later,<sup>88</sup> particularly in the context of remedies, does not distinguish between operating and finance leases and thus a change in accounting treatment of operating leases would have no effect thereunder. This is not surprising since one of the main purposes of the Cape Town Convention is to establish “clear rules to govern” asset-based financing and leasing alike: Article 1(i) thereof defines a creditor as being variously “a charge under a security assignment, a conditional seller under a title reservation agreement and a lessor under a leasing agreement.”

This lack of distinction between operating and finance leases in the Cape Town Convention makes sense when one considers that it protects both the lessor under a lease (whether operating or finance) and the lender under a secured financing. If the lender chooses to lend under a finance lease, it will be protected as lessor under the Cape Town Convention. If it chooses to lend instead with the security of a mortgage over the aircraft, it will be protected as the holder of a charge thereover.

Further, Article 83 *bis* of the Chicago Convention, also dealt with in detail in Part 3,<sup>89</sup> and dealing with leasing, likewise does not distinguish between operating and finance leases. Therefore, a change in the accounting treatment of operating leases would not have any effect under the Chicago Convention either.

The many other forms of aircraft financing available to an airline are beyond the scope of this study but are discussed in detail in Bunker<sup>90</sup> but there is one thing worth pointing out here – operating leasing, as with finance leasing, secured finance and outright purchase are all tools available to the airline to choose how it wishes to acquire and pay for the aircraft it uses. Although operating leasing may have once been seen as the preserve of carriers with a lower credit quality (who, lacking sufficient financial resources to place their own orders

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<sup>86</sup> Referring there to a Statement of the Institute of Chartered Accountants, SSAP 21.

<sup>87</sup> At 54.

<sup>88</sup> *Vide* 3.15.3 *infra*.

<sup>89</sup> *Vide* 3.15.8 *infra*.

<sup>90</sup> Bunker D H, *International Aircraft Financing*, IATA, 2005.

for new aircraft, were forced to rely on a small number of leasing companies), such has not been the case for at least the past decade.<sup>91</sup>

With the option of operating leasing, airlines can target certain aircraft for ownership as strategic long term assets, but using additional aircraft on operating lease, which they can allow to expire at the end of the lease term or extend, depending on their needs at that time. Further, whereas, upon a strict comparison, operating leasing may appear expensive compared with other sources of finance, this is not necessarily the case, especially when the cost of pricing in the lessor's assumption of the residual value risk is factored in.<sup>92</sup> In all cases other than operating leases, the airline assumes the residual value risk of the aircraft and this assumption should be priced into a comparison when deciding whether to buy or to lease.

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<sup>91</sup> Lobkowitz P & Detrich B, *Operating Leasing: Who wins economically?*, Airfinance Journal: A Guide to Operating Lease, June 1997.

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

## 2.2 Structuring the lease

Having decided to proceed with an aircraft operating lease, the airline must next determine with the lessor how it should best be structured.<sup>93</sup>

In the simplest case, the lessor will own the aircraft and lease it to the lessee. However, many other permutations and combinations are possible and it is desirable for the team putting a lease together to obtain relevant legal advice pursuant to the jurisdictional questionnaire,<sup>94</sup> accounting advice, and technical advice<sup>95</sup> before fixing on the structure, which should be clear before committing to the letter of intent.<sup>96</sup>

For example, the owner and the lessor may not be the same. In such case, typically, the owner will lease the aircraft to the lessor under a head lease and the lessor will then lease the aircraft to the airline under a sub-lease.<sup>97</sup> The reasons for this may vary for reasons discussed below.

The lessor's financier (if it has one) may insist on having ownership of the aircraft placed in a special purpose vehicle (SPV) over which it has a pledge of shares<sup>98</sup> rather than allowing the lessor to retain ownership of the aircraft and accepting a mortgage of the aircraft. Reasons for so doing may be the greater ease of enforcement of a pledge of shares in the jurisdiction of incorporation of the SPV owner as compared with enforcement of a mortgage in the jurisdiction where the aircraft is registered or was located at the time of the creation of the mortgage or is located at the time of enforcement of the mortgage.<sup>99</sup>

Alternatively, there may be a withholding tax which, subject to any relevant tax treaty, the lessee would be obliged to withhold on payments to the owner's jurisdiction under the lease, and in respect of which the owner would oblige the lessee to gross up so as to ensure that, after making the necessary withholding, the lessor receives net the amount specified in the lease.<sup>100</sup> However, such a withholding tax may not apply with respect to another jurisdiction or it may apply at a lower rate. In such event, the owner will set up an SPV in a tax favorable jurisdiction and lease the aircraft to the SPV under a head lease. The SPV will then lease the aircraft to the airline under a sub-lease.

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<sup>93</sup> See Bunker D H, *International Aircraft Financing, Volume 2: Specific Documents*, IATA, 2005, at 46.

<sup>94</sup> *Vide* 2.4 *infra*.

<sup>95</sup> For example as to the desirability of one aircraft nationality register over another.

<sup>96</sup> *Vide* 2.3 *infra*.

<sup>97</sup> *Vide* Annex 1 *infra*.

<sup>98</sup> *Vide* Annex 3 *infra*.

<sup>99</sup> Likewise, stamp duty in certain jurisdictions on mortgagors must be such as to make a mortgage uneconomical to pursue, in which case the lender will likely look to a solution involving its reliance instead on ownership in an SPV. In some cases, a lender will pursue a "belt and braces" approach, wanting both ownership in an SPV over which it has a pledge of shares and also a mortgage by that SPV in its favor securing the amounts due to it.

<sup>100</sup> This is the so called "hell or high water clause" (as in, come hell or high water the lessee must ensure that the lessor receives the full amount of rent referred to in the lease). *Vide* 3.7.1 and 3.8 *infra*.

In the two examples above, the structure is the same (head lease and sub-lease) but the substantial party differs: in the first case it is the lessor (the owner being simply an SPV); in the latter, it is the owner (the lessor being simply an SPV).

Another example of the same structure on paper is a head lease and sub-lease where the airline is owned by a parent company which does not hold an air operator's certificate or air transport license<sup>101</sup> but which, for whatever reason, wants to be the immediate lessee of the aircraft. That parent will then sub-lease to its certificated and licensed airline subsidiary.

A different structure may occur where, for example, the owner wants to use an owner trust. This may be required due to restrictions on registration of aircraft on the nationality register of the airline's jurisdiction. For example, a non-US owner may wish to lease to a US airline with the aircraft being registered in the United States. It may enter into a trust agreement as beneficiary with a US owner trustee which will then lease the aircraft, not in its individual capacity, but solely in such capacity as owner trustee, to the airline.

In this case, and in the first two cases, the airline may well want a guarantee if the lessor is not leasing in its own capacity or is not the party in the transaction structure with substantial assets, and it should seek a letter of quiet enjoyment whereby any owner, head lessor or trust beneficiary undertakes not to interfere with the airline's quiet enjoyment and use of the aircraft so long as it is performing its obligations under the lease.

Indeed, owner trusts as lessor are not restricted to this instance: a non-US airline wishing to have an aircraft registered in the United States may also rely on an owner trust. In May 2010, the United States Federal Aviation Administration (FAA) expressed concern in a Notice of Proposed Rulemaking<sup>102</sup> over the situation where the beneficiary of the owner trust is the same entity as the entity that has operational control over the aircraft<sup>103</sup> - it did not express concern about where the parties are different (such as where the beneficiary of the owner trust is a lessor and the party with operational control of the aircraft is a lessee).

Although this issue remains under review, there has been no change so far in regulations or FAA practice and the issue, in any event, did not concern non-US lessors using owner trusts.<sup>104</sup>

The different possibilities involved due to aircraft registration are discussed in further detail at 3.10.2.3 *infra*.

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<sup>101</sup> *Vide* 3.5.2.5 and 3.5.2.6 *infra*.

<sup>102</sup> 73 Fed. Reg. 10, 701 (proposed Feb. 28, 2008).

<sup>103</sup> Gerber D N, *Aircraft Finance Issues: The Blue Sky Ruling; The New ASU and the "Home Country Rule"; and Recent Developments at the FAA Registry*, a paper presented at the American Bar Association Air and Space Law Forum 2010 Annual Meeting in Seattle, Washington on 26 October 2010.

<sup>104</sup> *Ibid*.

The cost of a structure more complicated than that of a simple lease from the owner to the airline should be calculated in advance, and agreement reached as to how those costs are borne or shared, to determine their impact on the economics of the deal, before the parties are committed to proceeding with it. In this regard, the reason for the structure (to accommodate the lessor or the lessee) will play a role but, ultimately, the relative bargaining power of the parties will determine.

A useful source of reference in this regard is *Advanced Contract and Opinion Practices under the Cape Town Convention*<sup>105</sup> which assesses the implications of the Cape Town Convention<sup>106</sup> on a hypothetical but realistic transaction, from term sheet to closing.<sup>107</sup>

Having determined the structure of the lease, the parties are then in a position to enter into a letter of intent (which will be examined next) setting out the principal commercial terms of the desired leasing transaction. Alternatively, they may, if they so wish, reverse the order and agree the letter of intent first, leaving the precise structuring of the lease to be determined after the letter of intent is signed but before definitive lease documentation is agreed.

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<sup>105</sup> Legal Advisory Panel of the Aviation Working Group, *Advanced Contract and Opinion Practices under the Cape Town Convention*, Cape Town Paper Series, Volume 2, Unidroit, 2008.

<sup>106</sup> Considered at 3.1, 3.10, 3.15.3, *et al.*, *infra*.

<sup>107</sup> *Id.*, at vii.

### 2.3 *The letter of intent*

The lease is almost always preceded by a letter of intent<sup>108</sup> which sets out in summary form the principal terms. Legal issues here include the binding versus non-binding letter of credit and the issue of refundability of the deposit which is typically paid upon execution of the letter of intent so that the aircraft will be removed from the market pending negotiation and execution of the definitive lease.

With a non-binding letter of intent, or other letter of intent that does not include a deposit which is forfeitable in certain events, the lessor will have little motivation to remove the aircraft from the market.

The letter of intent is normally signed as soon as in principle commercial agreement is reached between the lessor and the airline with respect to the leasing of the aircraft. It will normally set out<sup>109</sup> the main commercial provisions, such as the parties, the aircraft, the target delivery date and lease term, the rent and other payment provisions (such as security deposit and maintenance reserves), any preapproved subleasing by the lessee, key insurance requirements (such as stipulated loss value, minimum liability coverage and maximum deductible), and delivery and redelivery locations and (to a greater or lesser degree) conditions.

It is very desirable for a letter of intent to be reviewed by legal counsel to both parties without slowing down the process unduly since other matters, such as the governing law and jurisdiction provisions, the timeline for requisite corporate approvals subject to which the letter is signed, and other legal matters such as those identified above should be set out.

The more detailed the letter of intent, the less negotiation, in theory, there should be when it comes time to negotiate the lease itself and other definitive legal documentation, although this is not always the case. For example, if the lessor has legal, financing or other restrictions on where it can permit the lessee to operate the aircraft, it would be prudent to raise the issue at the letter of intent stage rather than leaving it until the definitive documentation, since such particular requirements could run contrary to the lessee's immediate or potential future plans for the aircraft.

Having agreed the letter of intent, the matter of drafting the lease is then turned to the legal counsel for the parties, with counsel to the lessor normally providing the first draft (after technical and commercial review by his or her colleagues) for review by counsel to the lessee. This author has often noted that the lawyer's task at this point is to say in between 100 and 200 hundred pages what the parties had already agreed to in fewer than 20 pages in the letter of intent – the additional pages being accounted for in no small measure by consideration of the additional legal considerations which are the subject matter of this study.

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<sup>108</sup> Also commonly referred to as a term sheet or memorandum of understanding.

<sup>109</sup> See Bunker D H, *International Aircraft Financing, Volume 2: Specific Documents*, IATA, 2005 at 19-37.

For cases where the Cape Town Convention applies,<sup>110</sup> the *Advanced Contract and Opinion Practices under the Cape Town Convention*<sup>111</sup> published by the Legal Advisory Panel of the Aviation Working Group<sup>112</sup> recommends<sup>113</sup> that the letter of intent should be binding in order:

- “1. to constitute an “agreement for registration” if the intended nationality registration of the aircraft is to be the connecting factor under Article 3(3);<sup>114</sup> or
2. to create an enforceable obligation to remove prospective registrations<sup>115</sup> if the Transaction does not close or the beneficiary of such registration ceases to have an interest.”

That same publication also advises<sup>116</sup> that the letter of intent should make clear which international interests thereunder are to be registered pursuant to the Cape Town Convention but even if this is not done, it should be clear from the interests provided for in letter of intent and the provisions of the Cape Town Convention which interests are registrable thereunder and which are not.

Typically, with a binding letter of intent, the lessee will pay a deposit to the lessor in consideration of lessor’s removal of the aircraft from the market.

In *JSD Corporation PTE Ltd v Al Waha Capital PJSC and Second Waha Lease Limited*,<sup>117</sup> before Smith J in the English High Court, the plaintiff sought the return of a deposit paid by it under a letter of intent for the purchase by it of an aircraft where the sale did not proceed.

The letter of intent stated that the deposit was non-refundable except in case of total loss of the aircraft or a default by seller, either of which event would result in the deposit being returned to the buyer.

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<sup>110</sup> Considered *infra* at 3.1, 3.10, 3.15.3 and elsewhere.

<sup>111</sup> *Advanced Contract and Opinion Practices under the Cape Town Convention*, Cape Town Paper Series 2, Volume 2, The Legal Advisory Panel of the Aviation Working Group, 2008.

<sup>112</sup> An industry association of leading aircraft and aircraft engine manufacturers, lessor and financiers: see <http://www.awg.aero>.

<sup>113</sup> At 11.

<sup>114</sup> This provides for applicability of the Cape Town Convention where the aircraft is registered in the aircraft register of a contracting state or is to be so registered pursuant to an agreement for such registration in addition to Article 3(1) which provides for applicability of the Cape Town Convention where the lessee is situated in a contracting state.

<sup>115</sup> Prospective international interests may be registered under the Cape Town Convention pursuant to Article 6 but there should be a mechanism to remove them if the transaction does not close.

<sup>116</sup> At 12.

<sup>117</sup> [2009] EWHC 583 (Ch).

In its defence, the plaintiff argued that the defendant did not negotiate in good faith to finalise the documentation. Smith J was clear that there is no such obligation under English law. He held, however, that the defendant was in breach of the terms of the letter of intent because, however inadvertently, it continued to advertise the aircraft for sale on Speednews, a trade publication, and thus failed, as agreed, to remove the aircraft from the market.

But for this clause, the plaintiff would not have succeeded – thus, it is imperative that lessors as well as sellers of aircraft ensure that, where a deposit is accepted in consideration for their removal of the aircraft from the market, all marketing efforts immediately cease and all advertisements lined up be cancelled.

Consistent with this approach, in *Tandrin Aviation Holdings Ltd v Aero Toy Store LLC*,<sup>118</sup> the English Commercial Court upheld a seller's right to keep a deposit under a definitive sale agreement for the sale of an aircraft where a buyer failed to complete the purchase of an aircraft in a depressed market, holding on the facts that the amount of the deposit did not amount to a penalty and should be accepted in the circumstances as a true bargain between the parties as to a pre-estimate of seller's loss if buyer wrongly refused to complete the aircraft purchase.

Finally, if the obligation of either party to proceed is subject to its obtaining the approval of its board of directors, or to a satisfactory inspection of the aircraft by the lessee, or to any other condition or contingency, this should be made clear in the letter of intent, together with a clear deadline by which the conditions must be met, failing which the letter of intent should terminate and the deposit be returned to the lessee.

On the other hand, if the conditions are met, typically, the deposit paid under the letter of intent is applied towards the deposit payable under the lease once definitive lease documentation is signed.

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<sup>118</sup> [2010] EWHC 40.

## **2.4    *The jurisdictional questionnaire***

The jurisdictional questionnaire is a vital tool to help the lawyer assess the risk of leasing to an airline incorporated in a particular jurisdiction and allowing it to register the aircraft on that country's or another country's register.

Issues here include many of the items that will later be covered in the legal opinion to be given by the airline's lawyers to the leasing company but in general terms to help to identify jurisdictional risk and to determine any tax or legal issues which might affect the structuring of the deal.

For example, if the English courts are chosen as a forum for settlement of disputes under the lease, will the courts of the airline's jurisdiction enforce such judgment? If not, would they more readily enforce an arbitral award?

The lessor will usually obtain such questionnaire from its local counsel in the jurisdiction in question.

Typical areas covered in a jurisdictional questionnaire given by lessor's counsel include those set out at Annex 5.

## 2.5 *The legal opinion*

The legal opinion is typically not obtained until after the lease is signed and is a condition to the lessor's obligation to deliver the aircraft to the lessee. Nevertheless, the likely contents should be discovered beforehand pursuant to a draft opinion so as not to contain any unpleasant surprises. It typically covers many of the matters covered in both the jurisdictional questionnaire (as to which, see 2.4 *supra*) but is more specific, dealing with the lease in hand, rather than leases in general, and also the lessee's representations and warranties in the lease itself (as to which, see 3.4 *infra*).

The legal opinion should be addressed to the lessor and (if any) its financiers,<sup>119</sup> given by counsel to lessee acceptable to the lessor, and can be expected to contain various assumptions and qualifications which should be checked against typical practice for reasonableness.

The legal opinion should reference whether or not the Cape Town Convention is applicable. It is applicable where the lease constitutes an international interest under Article 2 thereof which may be registered if the airframe is registered as part of an aircraft in a contracting state, if the engine is registered as part of an aircraft in a contracting state or otherwise the engine is located in a contracting state<sup>120</sup> or if the lessee is situated in a contracting state.<sup>121</sup>

For transactions to which the Cape Town Convention is applicable, the Legal Advisory Panel of the Aviation Working Group<sup>122</sup> has made certain recommendations as to provisions dealing with the Cape Town Convention as well as assumption and qualifications. Interestingly, a footnote to its recommendation provides that:

“Law firms may give an opinion on the Convention as a matter of international law even though they are not counsel in the jurisdiction of any particular Contracting State. A legal opinion should cover the law of the Contracting State where the aircraft is registered... and also, if not the same, where the debtor<sup>123</sup> is situated...”

Typical areas covered in a legal opinion on a lease given by lessee's counsel include those set out at Annex 6.

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<sup>119</sup> Lessees may object to extension of the opinion to lessors' financiers with whom they have no direct relationship but lessor may respond that there is no additional cost involved and no additional obligation on the part of the airline.

<sup>120</sup> Article IV(1) of the Aircraft Protocol thereto.

<sup>121</sup> Article 3(1) of the Convention.

<sup>122</sup> *Advanced Contract and Opinion Practices under the Cape Town Convention*, Cape Town Paper Series 2, Volume 2, The Legal Advisory Panel of the Aviation Working Group, 2008, 25 *et seq.*

<sup>123</sup> Under Article 1(r) of the Cape Town Convention, the term “debtor” where used in the Convention includes “a lessee under a leasing agreement” *inter alia*.

## 2.6 *The layout of the lease*

Before examining the lease itself in detail, the overall typical layout of the lease will be examined first. Aircraft operating leases are typically fairly long documents, as noted, often between 100 and 200 pages in length, but, even if the order may differ somewhat,<sup>124</sup> typically, they may be seen as narratives with a start, pre-delivery (the period before the leasing of the aircraft begins), a middle, post-delivery (the period when the aircraft is on lease) and an end, post-lease term (the period after the leasing of the aircraft ends).

### Pre-Delivery

#### 2.6.1 Parties

The lease will, of course, need to state who are the parties to the lease so that the contract parties are clear. Often guarantors will be necessary also where the contract party is of insufficient credit, but the guarantee will normally be set out in a standalone document.<sup>125</sup>

#### 2.6.2 Recitals

Although not essential, it is useful to set out recitals showing the background to the lease as an aid to the reader in reading the substantive provisions of the lease itself.

For example, if the lease is part of a sale and lease back deal whereby the lessor purchases the aircraft from the lessee and then immediately leases it back to the lessee, setting forth this fact in the recitals will make apparent to the reader why, later on in the lease, there are no delivery conditions which must be met before the lessee is obliged to accept the aircraft from the lessor.<sup>126</sup>

#### 2.6.3 Definitions

Rather than setting out what is meant by terms each time they are used, or defining them in different places throughout the document, which may make reference difficult, it is also an aid to the reader to set out in one place, either here or in a schedule to the lease, the agreed meaning of certain terms, such as what is meant by an Engine Shop Visit, or a Business Day, where the meaning may not be completely clear simply by reference to industry usage.<sup>127</sup>

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<sup>124</sup> See, for example, Bunker D H, *International Aircraft Financing, Volume 2: Specific Documents*, IATA (2005) at 47-238.

<sup>125</sup> *Vide* 3.1 *infra*.

<sup>126</sup> *Vide* 3.2 *infra*.

<sup>127</sup> *Vide* 3.3 and Section 1 of the Supplement *infra*.

#### 2.6.4 Representations and Warranties

The representations and warranties actually fall both into the start and the middle in this view of the lease as narrative.

Although they are set out together, representations are pre-contractual inducements made by each party to the other to enter into the contract in the first place, with remedies for their breach, whereas warranties are part of the contract itself, with legally distinct remedies for their breach.<sup>128</sup>

#### 2.6.5 Conditions Precedent

Conditions precedent are those conditions which must be satisfied by one party before the obligations of the other party take effect. For example, a lessor may not want to be obliged to deliver the aircraft to the lessee until it has been paid the first month's rent and been assured that the aircraft is insured by the lessee. Likewise, a lessee may not want to be obliged to take delivery of the aircraft from the lessor until the lessor has title to that aircraft (a concern particularly for new aircraft orders where the lessor will want to conclude a lease for an aircraft which the manufacturer has not yet delivered to it).<sup>129</sup>

#### Post-Delivery

Having clarified who the parties are, the background to the lease, the meaning of the terms used in it, the inducements each party made to the other to enter into the lease, and the conditions which each party must first satisfy before the aircraft is delivered under the lease, the middle part of the lease in this narrative is next to be examined.

#### 2.6.6 Term and Delivery

This is the core of the lease contract where the lessor and lessee agree that the lessor shall lease the aircraft to the lessee, and the lessee shall lease the aircraft from the lessor, on and subject to the terms set out in the lease agreement. The lease will make clear what the term of the lease is, and any extension options or early termination options to that term. It will also set out the delivery procedures and (although this may also be seen as part of the start) the physical condition required of the aircraft at the time of delivery to the lessee.<sup>130</sup>

#### 2.6.7 Payments

The lease will also make clear what security deposit, if any, must be paid by the lessee to the lessor as security for its obligations, what rent must be paid and when throughout the term of the lease, and what maintenance reserves, if any, must be paid by the lessee to the

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<sup>128</sup> *Vide* 3.4 and Section 2 of the Supplement *infra*.

<sup>129</sup> *Vide* 3.5 and Section 3 of the Supplement *infra*.

<sup>130</sup> *Vide* 3.6 and Section 4 of the Supplement *infra*.

lessor. The obligation of the lessor to return the security deposit may be set out here or elsewhere, as will the obligation of the lessor to return any maintenance reserves to the lessee (or any third party designated by it) as it performs certain scheduled maintenance work to the aircraft during the term.<sup>131</sup>

#### 2.6.8 Taxes

The lease will set out the respective obligations of the parties for payment of taxes in connection with the leasing of the aircraft and which tax risks are borne by which party.<sup>132</sup>

#### 2.6.9 Manufacturer's Warranties

If the aircraft is still covered by manufacturer's warranties, the lease will make clear how these may be enforced if a problem covered by such warranties develops during the lease term.<sup>133</sup>

#### 2.6.10 Covenants

The lease will set out covenants from each party to the other. As the lessee will have operational control of the aircraft, most covenants will be made by the lessee in favour of the lessor. Such covenants may be positive covenants, such as to register the aircraft as agreed in the lease, to operate the aircraft lawfully, to maintain the aircraft as required by law and the lease contract, etc, or negative covenants, such as not to abandon the aircraft and not to hold itself out as owner of the aircraft.<sup>134</sup>

#### 2.6.11 Indemnities

The lease will also provide indemnification by the lessee of the lessor and its financiers for any claim brought against the latter as a result of the lessee's possession and operation of the aircraft during the lease term and (although this goes to the end part of the narrative) such indemnities should survive the termination of the leasing of the aircraft under the lease since a claim may not be brought against the lessor or its financiers until after the end of the lease period.<sup>135</sup>

#### 2.6.12 Insurances

The indemnities given by the lessee are only as good as its credit and as airlines tend to go into bankruptcy with greater frequency than lessors, and since the amount of claims may exceed that which even an airline in good condition could afford to pay, the prudent lessor

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<sup>131</sup> *Vide* 3.7 and Section 5 of the Supplement *infra*.

<sup>132</sup> *Vide* 3.8 and Section 5 of the Supplement *infra*.

<sup>133</sup> *Vide* 3.9 and Section 6 of the Supplement *infra*.

<sup>134</sup> *Vide* 3.10 and Sections 7 and 8 of the Supplement *infra*.

<sup>135</sup> *Vide* 3.11 and Section 10 of the Supplement *infra*.

will require that the lessee take out insurances satisfactory to the lessor which protect the lessor and its financing parties in the event of a claim.<sup>136</sup>

### Post-Lease Term

By now the parties have delivered the aircraft, and know their respective rights and obligations during the term of the lease. However, as we are here dealing with an operating rather than a finance lease, both sides must prepare for the end of the contractual relationship and the return of the aircraft by the lessee to the lessor. The termination of the relationship may take any of several forms: natural expiration as envisaged in accordance with the lease, early termination by mutual agreement or by lessor due to a breach of the lease by lessee, or an end to the particular contractual relationship due to a sale of the aircraft by the lessor to another owner during the lease term or (occasionally) due to the transfer (with the lessor's consent) of the lessee's rights and obligations<sup>137</sup> under the lease to another airline.

#### 2.6.13 Redelivery

Assuming an agreed redelivery in accordance with the lease, this section should set out the procedures required and the condition which the aircraft should meet at the time of redelivery.<sup>138</sup>

#### 2.6.14 Events of Default

Although these may not necessarily result in a termination of the contract, the parties will need to set out the events which, if they occur, give the lessor the right to terminate the lease or to take other remedial action.<sup>139</sup>

#### 2.6.15 Remedies

While a party will have rights at law in the event of a breach, it will want contractual certainty, insofar as applicable laws allow, to set out its remedies and claims against the other party in the event of a breach.<sup>140</sup>

#### 2.6.16 Assignment

This section will set out the agreement between the parties whereby either may assign its rights and the lessor may, in addition, cause its obligations to be assumed under certain

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<sup>136</sup> *Vide* 3.12 and Sections 9 and 11 of the Supplement *infra*.

<sup>137</sup> Rights may be assignable but obligations can only be transferred pursuant to a novation or assignment and assumption.

<sup>138</sup> *Vide* 3.13 and Section 12 of the Supplement *infra*.

<sup>139</sup> *Vide* 3.14 and Section 13 of the Supplement *infra*.

<sup>140</sup> *Vide* 3.15 and Section 13 of the Supplement *infra*.

conditions by a third party.<sup>141</sup> The lessor needs to keep flexibility to sell the aircraft with the benefit of the lease attached whereas the lessee will want to ensure that it is not materially prejudiced by this, whether by virtue of a transfer to a leasing company with a much lower net worth or otherwise.<sup>142</sup>

#### 2.6.17 Governing law

In the event of dispute which ends in litigation or other adversarial proceedings, the lease will set out what law has been agreed by the parties to govern the contract.<sup>143</sup>

#### 2.6.18 Dispute resolution

If the parties cannot agree on the correct interpretation of the lease, or the facts in hand, the lease should make clear in what jurisdictions any claim may be brought. Enforceability of a judgment against the lessee in particular will always be primarily a concern of the lessor.<sup>144</sup>

#### 2.6.19 Miscellaneous

These final clauses are sometimes called “boiler plate” since they appear in most leases but their importance should not be overlooked.<sup>145</sup>

#### 2.6.20 Execution

Finally, although this will normally only become an issue in the event of a dispute, the lease will need to be duly executed by both parties observing any formalities required and bearing in mind any stamp duty or other tax implications as to the place of execution.<sup>146</sup>

Thus, the typical aircraft lease can be seen simply as an agreement between two parties for one to deliver to the other possession of a specified aircraft for an ascertainable period in return for an ascertainable consideration, with certain obligations being placed on the parties during such period and in respect of the return of the property at the end, and with consequences for breach, and allocation of risk for damage by and to the aircraft being set out as between the parties.

Having such a rather high level overview of the layout of the typical aircraft operating lease, the heart of this study follows in Part 3 – a detailed examination of each of these parts of the lease with particular reference to the impact on each of them of the results of this author’s research into relevant case law, statutes and regulations, and international treaties, especially in the context of public and private international air law, which in turn is

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<sup>141</sup> Surely a lessee would never be allowed to rid itself of its obligations!

<sup>142</sup> *Vide* 3.16 and Section 14 of the Supplement *infra*.

<sup>143</sup> *Vide* 3.17 and Section 15 of the Supplement *infra*.

<sup>144</sup> *Vide* 3.18 and Section 15 of the Supplement *infra*.

<sup>145</sup> *Vide* 3.19 and Section 16 of the Supplement *infra*.

<sup>146</sup> *Vide* 3.20 *infra*.

followed by Part 4 – conclusions together with recommendations of this author in relation to issues that have come to light as a result of the research examined in Part 3.