

# IN FLIGHT BETWEEN GENEVA AND ROME: ABANDONING CHOICE OF LAW SYSTEMS FOR SUBSTANTIVE LEGAL PRINCIPLES IN INTERNATIONAL AIRCRAFT FINANCE

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## 1. INTRODUCTION

This paper briefly describes the author's view of the practical legal issues surrounding the current proposal to implement "one of the most significant international conventions ever to be made in the field of private transnational commercial law, the *Unidroit Convention on International Interests in Mobile Equipment*."<sup>1</sup> This paper is practical, rather than scholarly, in approach. The author believes that by addressing the practicalities of completing international transactions for the financing of aircraft, as well as their legal and theoretical touchstones, a workable and beneficial result will be obtained for an enhanced legal regime that reduces costs, enhances certainty in contracts, and is worthy of widespread support. This article first will identify the current practical legal framework for completing cross-border financings of large, inter-continental transport category aircraft and then will identify certain drawbacks with the current framework. Next, the article will compare the current framework with commercial practices

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<sup>1</sup> Roy Goode, *Transcending the Boundaries of Earth and Space: The Preliminary Draft Unidroit Convention on International Interests in Mobile Equipment*, 3 UNIFORM L. REV. 52 (1998).

extant in the international aircraft finance industry today. Finally, the article will briefly identify some of the principles addressed and currently being negotiated amongst governmental experts in connection with the proposed UNIDROIT Convention. The article concludes that aircraft investors, financial institutions, airlines, and the lawyers called upon to document and memorialize their respective agreements, would all be well-served by the implementation of the proposed UNIDROIT Convention.

## 2. COMMERCIAL REALITIES

The demand for intercontinental jet aircraft and for funds required to buy them continues in staggering proportions. Both the Airbus Consortium and the Boeing Company in their recent annual reports project the demand for thousands of aircraft over the next twenty years at a cost well in excess of several trillion U.S. dollars. This computes to billions of dollars worth of aircraft to be delivered weekly over the next two decades. When one considers that the current asking price for a new Boeing Model 747-400 is approximately \$175 million, and the cost of a new Airbus A340-200 is not far behind, one begins to appreciate the demand for money that the industry is facing.<sup>2</sup> Against the backdrop of innovative engineering and incredible cost, however, is the uncertainty of legal regimes all around the world when it comes to matters basic to cross-border finance, such as the enforceability of legal documentation, the attachment, perfection, and priority of security interests, the remedies available to the beneficiaries of legal contracts and security interests, and the manner in which domestic insolvency schemes interfere with all of the foregoing matters. Many air carriers must register aircraft they operate in their home country in order to comply with safety and airworthiness regulations. Therefore, given that the home jurisdiction is where public records about an aircraft usually are found, local laws are almost always relevant. As new, state-of-the-art equipment moves from the manufacturers in Toulouse and Seattle to destinations as diverse as Chile, Egypt, and Uzbekistan, the variation in legal rules and legal regimes facing the players in what has become a globally competitive industry—

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<sup>2</sup> See, e.g., Boeing Co., *Boeing Airplane Prices* (visited Sept. 26, 1999) <<http://www.boeing.com/commercial/prices/index.html>> (showing a range of prices for various airplane models).

with global commercial norms and practices— is adding unnecessary complexity, cost, and confusion to this dynamic business.

The cost of this dissonance, the legal uncertainties created, and the risks involved for manufacturers and their financiers all beg for the introduction of a unified substantive system of law that responds to the demands of a global industry. The UNIDROIT Convention appears to fit the bill.

### 3. CURRENT PRACTICAL LEGAL FRAMEWORK

There is a finite set of lawyers around the world who regularly deal in the transactional and contractual matters arising out of the sale and financing of large, intercontinental jet aircraft. They usually can be found attending meetings of the American Bar Association's ("ABA") Subcommittee on Aircraft Financing (falling under the auspices of the Business Law Section and the Committee on Commercial Financial Services) or at the meetings of Committee B (Aviation) of the International Bar Association. They come from all over the world and operate under different legal regimes, but they speak a common language. The common language is driven by the commercial realities of an industry that, since the close of World War II, has become increasingly global in scope, practice, and tradition. Whether they are speaking about "wet leases,"<sup>3</sup> "dry leases,"<sup>4</sup> "charters,"<sup>5</sup> or "cut-through clauses,"<sup>6</sup> they speak a global idiom.

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<sup>3</sup> These are arrangements whereby the aircraft, crew, maintenance, fuel, and insurance are provided by the aircraft operator for the benefit of a third party.

<sup>4</sup> These are arrangements whereby an aircraft owned or leased by one air carrier is turned over for operation to another air carrier, and the responsibility for maintenance, fuel, crew, and insurance is with the new air carrier receiving possession.

<sup>5</sup> These are arrangements whereby an air carrier maintains full responsibility for the operation of its aircraft (including maintenance, crew, insurance, and fuel), but where the use of the aircraft across various routes and frequencies is dictated by a third party.

<sup>6</sup> A cut-through clause, or "direct access," is the shorthand used by aviation finance lawyers to describe the circumstance in which their clients obtain direct access to reinsurance placed in Western European or U.S. company markets, instead of relying on primary insurance issued by a local, frequently government-mandated insurer of a foreign airline. This occurs particularly when the local insurer may be required to pay claims only in local currency, which may not be convertible into dollars or which may be subject to regulatory controls for conversion.

The issues that confront Lan Chile in a financing for newly-delivered Boeing aircraft are not very different from those facing United Airlines in the United States. In what country will the aircraft be registered for airworthiness and safety oversight? In what manner will mortgages, security interests, or other rights in the aircraft be recorded? What form will the documentation take in connection with financing the equipment— will it be an outright purchase, lease, conditional sale, or operating lease? In what manner will the businessmen and their lawyers work together to ensure that each party's obligations are legal, valid, and enforceable? Most importantly for the financiers, what rights will they have with respect to the equipment when the operator does not pay on time? In the parlance of the cross-border financier, the issues are three-fold: what is the best legal method I can employ to ensure that (a) my documents are enforceable in all relevant jurisdictions; (b) I have a perfected security interest or claim to the equipment in the event that my agreement, with respect to repayment, cannot be enforced through collection; and (c) I have the right to the proceeds of insurance in the unpleasant circumstance of a disaster in which the equipment is destroyed? In answering each of these three questions ("Three Questions"), the financier will turn to his or her legal adviser who will analyze the legal regime in place.

In this author's practical experience, there are three alternative choice of law paths to follow in answering the financier's Three Questions. The first method ignores all legal regimes except the regime of the country where the aircraft is registered as to nationality under the Chicago Convention<sup>7</sup> (usually for safety and airworthiness matters) and addresses what affirmative steps must be taken in the locale in which the aircraft is registered to answer the financier's questions. In the circumstance where a global financial institution headquartered in the United States finances equipment for United Airlines, this is a fairly straight-forward analysis; the customs, traditions, and expectations of both the business people and the lawyers will be in harmony. In the circumstance where

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<sup>7</sup> The Chicago Convention created the International Civil Aviation Organization, which, among other things, establishes global safety and airworthiness regimes and reciprocal recognition by the contracting states. It provides for the international recognition of domestic aircraft registration. Under the Chicago Convention, an aircraft may be registered in only one country, and that country is responsible for establishing the domestic safety and airworthiness regime for that aircraft.

financing is offered to an air carrier in India, Uzbekistan, or Hungary, however, analyzing the Three Questions may provide results that differ sharply from one another and from results obtained in an U.S. analysis. In addition, the customs, traditions, and expectations of the lawyers assisting the air carrier in what is, admittedly, a global industry, may nonetheless vary dramatically from those of the financiers. Accordingly, the lawyers work to resolve the issues to a degree that the financiers can accept. Often, increased legal risk leads to increased cost to the airline (e.g., more insurance, a different structure, or the loss of tax benefits).

The second alternative is a choice of law election based on the choice of law rules of the jurisdiction where the aircraft's nationality will be registered for purposes of the Chicago Convention. For example, if lawyers acting for American financiers that provide credit to a foreign air carrier were unhappy with the answers to the Three Questions, the parties might elect to document all of the financial arrangements, security interests, and leases of aircraft under New York law, assuming both choice of law rules and the laws of the country where the aircraft is registered would permit this. Unfortunately, this option usually leads to lingering concerns about the answers to the Three Questions. Are there public policy issues restricting the imposition of interest on interest or the payment of indemnities in the foreign country that might make the financier's breakage and currency indemnities unenforceable? Are there unique provisions of the bankruptcy regime in the foreign country that might allow the airline's creditors to gain priority over the financiers upon sale of the aircraft in the event of an enforcement? Is access available to reinsurance payments coming from the United States or London to the local insurers of a foreign air carrier for the benefit of the financiers, or will they have to take currency risks with local currency from the primary insurer? There is nothing more practical in life than dollars and cents, so when deals involve trillions of dollars, significant worries regarding the practicalities arise. Due to public policy, New York law may sometimes leave one in no better position than would a given country's local law.

Finally, many nations have adopted<sup>8</sup> the aviation financing community's current international treaty, the Geneva Conven-

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<sup>8</sup> As of January 1, 1998, there were over 60 signatories to the Geneva Convention. See DEPARTMENT OF STATE, TREATIES IN FORCE 337 (1998) (providing a list of the signatory states).

tion on the International Recognition of Rights in Aircraft ("Geneva Convention"),<sup>9</sup> opened for signature in 1948. The Geneva Convention is, in essence, a choice of law treaty. It provides that contracting states will recognize "rights in aircraft"<sup>10</sup> that are "regularly recorded"<sup>11</sup> in the jurisdiction of the aircraft's national registry (nationality as determined under the Chicago Convention), provided that the rights are "constituted in accordance with [such country's laws]."<sup>12</sup> The Geneva Convention mandates that authorities in the jurisdiction where an aircraft has been arrested for nonpayment of financing secured by the aircraft, or nonpayment of lease rentals due on the aircraft, must follow the laws of another jurisdiction if those laws govern the financing and if both countries adhere to the treaty.<sup>13</sup> It allows one to conduct a transaction in a jurisdiction that is a contracting state to the Geneva Convention with the certainty that, where an aircraft is arrested in another contracting state, the rights over the aircraft governed by the law of its place of registration will be respected, subject to specific exceptions and insolvency. This choice of law treaty sounds straight-forward, but it has notable weaknesses.

#### 4. THE SHORTCOMINGS OF THE GENEVA FRAMEWORK

One of the problems with the Geneva Convention is quite basic, namely: how does one interpret the words "constituted in accordance with the law of [registry]" in Article I of the Geneva Convention as a qualification to the types of Article I rights that will be protected in other contracting states? At first blush, a reading of this provision implies that if an aircraft to be financed will be registered in Egypt, then so long as the laws of Egypt acknowledge choice of law rules (which they do), one might complete a transaction over an Egyptian registered aircraft with a lease governed by New York law. Sounds promising. Yet there is some concern with this very first point in analyzing the Three Questions. While a discussion about the drafting history of this provision is beyond the scope of this article, there is a question as

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<sup>9</sup> Geneva Convention on the International Recognition of Rights in Aircraft, June 19, 1948, 4 U.S.T. 1833, 310 U.N.T.S. 151 [hereinafter Geneva Convention]. The Convention became effective on September 17, 1953.

<sup>10</sup> *Id.* art. I.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> See *Id.* art. I(1)-(2); art. II(2).

to whether the draftsmen of the Geneva Convention intended that the choice of law rules under each country's legal regime were intended to be swept into the Geneva Convention. In other words, it is not clear from the history of the Geneva Convention whether a transaction governing "rights" in aircraft are "constituted in accordance with the law of [registry]" when they are governed by a different nation's laws, notwithstanding that the law of registry would permit such an election. None of the U.S. cases construing the Geneva Convention have addressed this point. Legal advisors differ about how to interpret a lack of clarity in the drafting history. The cautious espouse the view that anything other than a mortgage or lease governed by the laws of Egypt, in the hypothetical set forth above, would not be entitled to the protection of the Geneva Convention, because those transactions may not be "constituted in accordance with the laws of [Egypt]." Others believe that the extent to which the law of registry, and its courts and advocates, are familiar with foreign legal regimes and choice of law selection will dictate the result where some foreign law, say New York, is preferable to the local law. Still others believe that an educated consumer is the best client, and allow their business colleagues to make these decisions.

The Geneva Convention perpetuates liens arising in any contracting state relating to immigration, customs, and air navigation. Accordingly, customs claims for contraband, air traffic claims for unpaid landing and navigation charges, and penalties for an operator's violations of immigration laws may all take precedence over a recorded "right," in any jurisdiction other than Egypt, even though such might not be the case in Egypt.

The Geneva Convention is entirely silent on the manner in which a domestic insolvency proceeding is to be balanced against "rights," like leases and mortgages, recorded against an aircraft. The Convention provides in Article VII that "(1) the proceedings of a sale of an aircraft in execution shall be determined by the law of the Contracting State where the sale takes place."<sup>14</sup> An execution sale is the process by which a contracting state enforces the judgment rendered with respect to a "right" in the aircraft and carries that judgment into action. This is usually accomplished by seizing the aircraft, selling it in a court-supervised proceeding, and distributing the proceeds to the holders of "rights" in the or-

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<sup>14</sup> *Id.* art. VII(1).

der of their priority, in accordance with the Geneva Convention. Unfortunately, the author has found no guidance either from the draftsmen of the Geneva Convention or various other commentators<sup>15</sup> as to how to address, in matters of airline insolvency, the conflict between the laws of the contracting state where the sale takes place with the various Article I rights of holders which may be subject to different insolvency schemes. Additionally, if the aircraft is seized by creditors in the country where it is registered as to nationality, the reviewing judicial authorities will ignore the overwhelming bulk of the Geneva Convention's protections for the holders of regularly recorded "rights."<sup>16</sup>

The issues for the financier get stickier in jurisdictions that do not give effect to choice of law selection, or where cautious businessmen elect not to test an interpretation of the Geneva Convention as to choice of law. In many jurisdictions, major, international financings for modern jet aircraft have been concluded where, upon insolvency, the local insolvency regime imposed as a lien, prior to all other liens (including Geneva Convention "rights"), liens securing a variety of local matters given preference under local law. The matter is further complicated by transnational insolvencies in which judges, sitting outside of the jurisdiction where the aircraft operator is organized, may be asked to adjudicate controversies regarding claims to the aircraft and "rights" in the aircraft, with varying results. Using the U.S. Bankruptcy Code as an example, a bankruptcy judge in the United States might, under current law, be required to enforce super-priority foreign liens ahead of a U.S.-law governed mortgage on a foreign-registered aircraft if, following commencement of the foreign-insolvency scheme, the aircraft was arrested and subjected to ancillary proceedings in the United States.<sup>17</sup> In short, the Geneva Convention provides no touchstone for organizing what is a confusing array of laws, rules, and customs that come into play when aircraft perform as expected (travel intercontinentally in the pur-

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<sup>15</sup> See, e.g., Legal Subcommittee of Air Coordinating Committee, *Annotated Text of Convention on International Recognition of Rights in Aircraft*, 16 J. AIR L. & COM. 70, 70-92 (1949).

<sup>16</sup> See Geneva Convention, *supra* note 9, art. XI (2).

<sup>17</sup> See 11 U.S.C. § 304 (1994) (requiring "the court to consider several factors in determining what relief, if any, to grant" and noting that "[p]rinciples of international comity and respect for the judgments and laws of other nations suggest that the court be permitted to make the appropriate orders").



suit of revenue for their operators) and businesses act like businesses (fail at times).

## 5. BACK TO BASICS

A study conducted under the auspices of INSEAD and New York University's Salomon Center ("Stern Study"), in September of 1998, concluded that both cross-border asset-based financing and leasing are efficient forms of credit extension where prompt recourse to the value of the underlying asset, in this instance the aircraft, is central to the analysis of overall risk in the transaction.<sup>18</sup> The study proposed that in circumstances where national rules are in conflict with business expectations as to the risks and rewards for an airline and a financier in a cross-border asset-based transaction, the remedy is not necessarily a choice of law, but a substantive legal change.<sup>19</sup> The results in terms of cost to the airline are significant.

The Stern Study found that "[n]ational legal rules which are inconsistent with the general principles underlying [asset-based transactions] impose [unnecessary] costs," and concluded that "financing is comparatively more costly or, where excessive risk is present, unavailable."<sup>20</sup> Micro-economic benefits include benefits to airlines— reduced financing costs, access to funds, and reduced transaction costs— as well as to other users of services provided by aircraft operators, including passengers and governments. In addition, such benefits include increased revenue to commercial aircraft manufacturers and lower costs and losses for aviation industry investors.

Key among the methodologies envisaged by the Stern Study and carried through into the UNIDROIT Convention are a set of "asset-based financing principles" against which it is proposed that the UNIDROIT Convention must be benchmarked.<sup>21</sup> These three principles are laid out as "[1] the *transparent priority principle* (clarity on the ranking of competing property interests), [2]

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<sup>18</sup> See Anthony Saunders and Ingo Walter, Proposed Unidroit Convention on International Interests in Mobile Equipment as Applicable to Aircraft Equipment Through the Aircraft Equipment Protocol: Economic Impact Assessment, at i-iv (1998) [hereinafter Stern Study] (unpublished study, on file with the *University of Pennsylvania Journal of International Economic Law*).

<sup>19</sup> See *id.*

<sup>20</sup> *Id.* at i.

<sup>21</sup> See *id.* at i-iv.

the *prompt enforcement principle* (ability to promptly enforce rights against assets generating proceeds and revenues), and [3] the *bankruptcy law enforcement principle* (ability to enforce [the rights of the financier against an aircraft] in the context of bankruptcy).<sup>22</sup> The similarity of these principles to the Three Questions should not be lost on the reader.

The UNIDROIT Convention attempts to deal squarely with the three principles identified by the Stern Study as central to the availability of cheap finance, lower transaction costs, and legal certainty. While an analysis of the UNIDROIT Convention is beyond the scope of this article and is covered elsewhere in materials presented in this publication, the author believes that the adoption and implementation of these three, key principles—which dovetail neatly into how one answers the Three Questions—would greatly enhance the ability of the world aviation industry to achieve the goals contemplated by the Stern Study: cheaper finance for airlines, airline competition based on a level playing field rather than legal dissonance, higher output and employment for manufacturers, and cheaper costs for travelers.<sup>23</sup>

## 6. THE CURRENT LEGAL FRAMEWORK IS AT ODDS WITH COMMERCIAL REALITY

The current legal framework, which exposes aircraft financiers to the vagaries of foreign legal systems—vagaries implicit in interpreting the Geneva Convention and transnational insolvencies of air carriers—contrasts starkly with the commercial reality of how businessmen involved in international aircraft financing assess risk and reward, and conclude transactions for the asset-based sale and financing of large, commercial aircraft. For example, trade magazines are replete with their editors' current views as to the monthly lease rental for well-known aircraft models. Additionally, these publications print current interest rates, swap rates, and other key indicators of finance used by asset-based lenders and export credit agencies to price the financial component of transactions for the world's air carriers. Sale prices for aircraft are regularly quoted in trade newsletters and are occasionally reported in the trade press. They are easily expressed irrespective of the nature of the underlying purchaser or the financ-

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<sup>22</sup> *Id.* at ii.

<sup>23</sup> *See id.* at i-iv.

ing that may be required to ensure a timely sale. Terms for leasing, insuring and operating aircraft in legal documentation are fairly universal among the cognoscenti. Few of the uniform approaches taken by businessmen and airline executives as to how asset-based transactions for aircraft are concluded across borders take into account the exigent circumstances driven by the conflicting principles arising under law in the jurisdiction where the airline operator is located, where the aircraft is registered, and where the financiers normally conduct business. Only when term sheets have been concluded, financial terms agreed upon, and general deal points understood, do the lawyers in each jurisdiction ordinarily address the unique issues driven by the conflicting legal principles inherent in any cross-border, asset-based, international aircraft financing. The UNIDROIT Convention would alleviate the problems that result from these unique issues.

While the Geneva Convention is helpful in some respects, it is generally (and correctly) perceived as a choice of law tool to address a set of given circumstances. Unfortunately, the modern business challenges facing cross-border aircraft financing—principally international insolvencies and conflicting legal principles—have highlighted issues where the rules and the answers are based not on businessmen's expectations of risk and reward, but rather on where an aircraft is arrested or, even more disturbing, on antiquated systems of law invented prior to the invention of the aircraft. All of this generates a call for order out of this legal chaos and uncertainty.

## 7. CONCLUSION

By focusing on substantive legal rules to be adopted in contracting states, rather than merely employing a choice of law regime that perpetuates antiquated legal doctrines that were not contemplated for intercontinental jets, the proposed UNIDROIT Convention would significantly reduce the risk and the cost of concluding asset-based international aircraft financings. The maxim of "less risk, less cost" is borne out by the Stern Study, which concluded that the proposed UNIDROIT Convention would reduce risk applicable to these types of transactions by establishing a substantive international framework that would implement domestic legal regimes where necessary to enhance,

rather than detract from, asset-based financing and leasing.<sup>24</sup> As a result, in the Stern Study's view, the availability of credit for these cross-border deals will increase and the cost of credit in the aviation sector will lessen, thus broadening general consumer welfare and making more aircraft available to more operators at a more reasonable cost.<sup>25</sup> The Stern Study analyzes micro-economic benefit to airlines, passengers, shippers, governments, commercial aircraft manufacturers and their suppliers, and aviation industry investors. Specifically, it indicated a savings for the world's airlines "on the order of \$5.0 billion annually based on 20 year projected aircraft deliveries."<sup>26</sup> While, no doubt, statistics are easily subject to interpretation, the general magnitude of the cost savings is impressive and the result warrants worldwide attention. One of the benefits attested to in the Stern Study, which this author can certainly confirm,<sup>27</sup> is reduced transaction costs through documentation standardization and simplification.

The proposed UNIDROIT Convention, and specifically the Aircraft Protocol thereto, would address the modern demands of aircraft financiers and airline operators and would level the playing field substantially, so that unanticipated occurrences— such as where an aircraft is found when arrested by creditors or when insolvency proceedings are commenced— will have less of an impact on the trillions of dollars worth of transactions to be concluded than will common sense and the mirroring of commercial business practices. When the law is out of step with business, the law should endeavor to catch up. The proposed UNIDROIT Convention does just that.

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<sup>24</sup> See *id.*

<sup>25</sup> See *id.*

<sup>26</sup> *Id.* at iii.

<sup>27</sup> The author makes his living answering the Three Questions.