Journal of Air Law and Commerce

Volume 72 | Issue 2 Article 4

2007

Overcoming U.S. Citizenship Hurdles for Aircraft Financiers

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OVERCOMING U.S. CITIZENSHIP HURDLES FOR AIRCRAFT FINANCIERS

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ABSTRACT:

A business even partially owned by a non-U.S. person or entity wishing to lease or provide debt financing for an aircraft in the United States can face many hurdles. Often, the principal hurdle is the requirement that an aircraft registered in the United States be registered in the name of a U.S. citizen. This Article discusses issues facing an aircraft owner, lessor, or secured lender that is partially or wholly owned by a non-U.S. person or entity, and options for overcoming those hurdles.

This Article was developed from research and analysis conducted for a U.S. subsidiary of a foreign bank, facing just this situation as part of its ongoing business. The author also counseled non-financial institutions that wished to lease or lend against an airplane in special, non-recurring situations. Accordingly, this Article should interest and benefit many readers.

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A BUSINESS EVEN partially owned by a non-United States (U.S.) person or entity wishing to lease or provide debt financing for an aircraft in the U.S. can face many hurdles. Often, the principal hurdle is the requirement that an aircraft registered in the U.S. be registered in the name of a U.S. citizen.[1] This Article discusses issues facing an aircraft owner, lessor, or secured lender that is partially or wholly owned by a non-U.S. person or entity (a Foreign Financier), and options for overcoming those hurdles. Parts I through III describe the general rules and exceptions with respect to U.S. citizenship and aircraft registration. Part IV applies those rules with respect to a Foreign Financier acting as an operating lessor. Part V applies those rules with respect to a Foreign Financier acting as a secured party or finance lessor. Finally, Part VI summarizes the options available to a Foreign Financier in each case, and suggests how those options should be evaluated and selected for each transaction.

I. GENERAL RULES REGARDING AIRCRAFT REGISTRATION AND U.S. CITIZENSHIP

The overriding general rule, other than for military aircraft or aircraft registered in foreign countries, is that in order to operate an aircraft in U.S. airspace, the owner must register the aircraft with the Federal Aviation Administration (the FAA).[2] The second general rule is that in order to register an aircraft with the FAA, the aircraft must be owned by: (a) a citizen of the U.S.

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[1] 49 U.S.C.A. § 44102(a)(1)(A) (West 1997).

[2] 49 U.S.C.A. §§ 40103(d), 41703, 44101 (West 1997); FAA Aircraft Registration, 14 C.F.R. § 47.3(b) (2006).

(the U.S. Citizenship Requirement);[3] (b) an individual who is a permanent resident U.S. alien (the "Resident Alien Exception");[4] or (c) "a corporation not a citizen of the United States when the corporation is organized and doing business under the laws of the United States or a State, and the aircraft is based and primarily used in the United States" (the Based and Primarily Used Exception).[5] The following Parts II and III describe the U.S. Citizenship Requirement and the Based and Primarily Used Exception. Because this Article relates to foreign-owned entities rather than individuals, the Resident Alien Exception will not be discussed.

II. U.S. CITIZENSHIP REQUIREMENT

A. Organization, Ownership and Management

To qualify under the U.S. Citizenship Requirement, a corporation (or other association) must be organized under the laws of the U.S. or a State; the president and at least two-thirds of the board of directors and other managing officers must be individual U.S. citizens; the corporation or association must be under the actual control of U.S. citizens; and at least seventy-five percent of the voting interests must be owned or controlled by persons that are U.S. citizens.[6]

B. Voting Trusts

A corporation failing to meet the requirement that at least seventy-five percent of the voting interests be owned or controlled by U.S. citizens may still register an aircraft with the FAA by using a voting trust for which an independent U.S. citizen serves as voting trustee.[7] Using a voting trust, however, requires the corporation to turn over full voting control of at least seventy-five percent of its stock for all purposes—a requirement that could be considered unacceptable to many foreign owners. Accordingly, this structure is typically used, if at all, with special-purpose entities for which the parent does not need to maintain control.

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[3] § 44102(a)(1)(A).
[4] § 44102(a)(1)(B).
[5] § 44102(a)(1)(C).
[6] 49 U.S.C.A. § 40102(a)(15) (West 1997); 14 C.F.R. § 47.2.
[7] *See* FAA Aircraft Registration, 14 C.F.R. § 47.8 (2006) (setting forth requirements for using voting trusts to "qualify a domestic corporation as a U.S. citizen").

C. Owner Trusts

A more popular approach for entities that do not otherwise satisfy the U.S. Citizenship Requirement is to transfer legal title to a U.S. citizen–trustee while maintaining beneficial ownership. The owner-trustee then registers the aircraft in its name.[8] Two institutions that regularly act as owner-trustees for aircraft are Wells Fargo Bank Northwest, NA (Wells Fargo) and Wilmington Trust Company.

The main risk with an owner trust is that the non-U.S. citizen beneficiary must relinquish control of the aircraft to an independent party for most ownership and operational purposes.[9] The practical reality is that these institutions typically depend on this business and their reputations in the aviation community and, although remaining independent, will consult the beneficiary before making decisions. Further, actual trust agreements that this author has seen filed with (and presumably approved by) the FAA specifically provide that the trustee will not sell, mortgage, pledge or otherwise dispose of the aircraft without the beneficiary's prior written consent.

III. BASED AND PRIMARILY USED EXCEPTION

The Based and Primarily Used Exception would be available to a Foreign Financier in many transactions, but the Foreign Financier would have to analyze each case and comply with ongoing reporting and record-keeping requirements of the FAA. To be "based and primarily used in the United States," at least sixty percent of the aircraft's flight hours for each six-month period must be accumulated in the United States.[10] At the end of each period, the owner-registrant is required to submit a report to the FAA either: (a) stating that all flights during that period have been conducted only in the United States; or (b) setting forth the total time of the airframe in service during that period and the total flight hours conducted in the United States during that period.[11] In addition, the owner-registrant must maintain, and make available for inspection upon the FAA's request, records of the aircraft's flight hours within the

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[8] *See* 14 C.F.R. § 47.7(c).

[9] 14 C.F.R. § 47.7(c)(2)(iii), (c)(3).

[10] 14 C.F.R. § 47.9(b).

[11] 14 C.F.R. § 47.9(f).

United States for three years after the hours were accumulated.[12]

IV. APPLICATION: FOREIGN FINANCIER AS LESSOR UNDER OPERATING OR "TRUE" LEASES

An aircraft lessor under an operating lease would be considered the owner, and therefore would be required to register the aircraft in its name.[13] Accordingly, a Foreign Financier that does not satisfy the U.S. Citizenship Requirement must follow one of the methods described above to register an aircraft with the FAA.

A. Based and Primarily Used Exception

In cases where the Foreign Financier can be comfortable (through pre-closing and post-closing diligence and monitoring, representations, covenants, defaults and indemnities) that a lessee will operate the aircraft in compliance with the Based and Primarily Used Exception, a Foreign Financier may own, register and lease an aircraft in its own name. As the records and reports described in Part III *supra* are required to be maintained and submitted by the owner-registrant, the Foreign Financier would therefore have to rely on its lessee's reports or the Foreign Financier's ongoing inspections of the aircraft's records, and would be assuming the risk that those reports would be provided and would be accurate. Again, ongoing diligence, reaffirmations of warranties and covenants linked to default, and indemnities for noncompliance would help mitigate that risk. Although the reports to the FAA would still have to come from the Foreign Financier, the Foreign Financier could lessen that burden somewhat by requiring in its leasing agreement that the lessee prepare and deliver those reports to the Foreign Financier for the Foreign Financier's subsequent delivery to the FAA.

B. Voting Trusts

If the President and at least two-thirds of the board of directors and other managing officers of a Foreign Financier are U.S. citizens, the Foreign Financier could register an aircraft by using a voting trust. This is presumably not an option for the typical operating lease, however, because this requires that the Foreign

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[12] 14 C.F.R. § 47.9(e).

[13] *See* 14 C.F.R. § 47.5.

Financier's parent turn over full voting control of at least seventy-five percent of the Foreign Financier. This option may be practical, however, in larger, complex leases involving multiple foreign parties and cross-border operations where it may be cost-effective and appropriate to set up a special-purpose entity.

C. Owner Trusts

Maintaining beneficial interest of an aircraft but transferring legal title to a U.S. citizen-trustee for registration would work for most true leases where a Foreign Financier is the lessor. As explained in Part II C, *supra*, there is the risk and uncertainty of turning over control of the aircraft, but that risk is typically small, and it is an industry standard.

V. APPLICATION: SECURED LOANS AND FINANCING LEASES

Unlike operating leases, the lessee under many finance leases is considered the owner and is therefore required to register the aircraft in its name.[14] The FAA treats such finance leases as "conditional sales," which are actually secured transactions.[15] Similarly, a borrower who uses loan proceeds to purchase an aircraft (*i.e.* take title in its name) and who secures the loan with the aircraft, would register the aircraft in its name.[16] Accordingly, the discussion in this Part V applies to situations where a Foreign Financier wishes to lease an aircraft pursuant to such a finance lease, or to make a secured aircraft-acquisition loan. In each case, the citizenship of the Foreign Financier would not be an issue unless and until that Foreign Financier sought to repossess the aircraft.

A. Repossession, Foreclosure and Re-Registration

The procedures to repossess, foreclose, and re-register an aircraft will depend on whether the aircraft and interest involved are subject to the international treaty commonly known as the

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[14] 14 C.F.R. § 47.5(d); Treatment of Leases with an Option to Purchase for Aircraft Registration, 55 Fed. Reg. 40,502, 40,503 (Oct. 3, 1990) [hereinafter Aircraft Registration Opinion] (legal opinion); Whether the Lessee of an Aircraft Conveyed Under a Finance Lease is the Owner of the Aircraft for Purposes of United States Aircraft Registration, 46 Fed. Reg. 18,877, 18,877 (Mar. 26, 1981) (legal opinion).

[15] *See* Aircraft Registration Opinion, 55 Fed. Reg. 40,502, 40,503 (Oct. 3, 1990).

[16] 14 C.F.R. § 47.5(b) ("An aircraft may be registered only by and in the legal name of its owner.").

Cape Town Treaty or Cape Town Convention.[17] Regardless of whether the Cape Town Treaty applies, the process will generally involve: (1) self-help or judicial repossession; (2) foreclosure (private or judicial); and (3) unless attempting to deregister from the United States entirely for export to another country,[18] application to the FAA for registration in the name of the new owner (if the secured lender/finance lessor does not keep title in its name).[19]

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[17] Convention on International Interests in Mobile Equipment ch. I, Nov. 16, 2001, S. Treaty Doc. No. 108–10 [hereinafter Cape Town Treaty], *available at* http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf; Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment arts. I–IV, Nov. 16, 2001, S. Treaty Doc. No. 108–10 [hereinafter Protocol], *available at* http://www.unidroit.org/english/conventions/mobile-equipment/aircraftprotocol.pdf. *See also* Cape Town Treaty Implementation Act of 2004, Pub. L. No. 108-297, 118 Stat. 1095 (codified in scattered sections of 49 U.S.C.) (implementing the Cape Town Treaty and the Protocol in the United States); SIR ROY GOODE, UNIDROIT OFFICIAL COMMENTARY ON THE CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND PROTOCOL THERETO ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT (2002). Because this Article relates specifically to U.S.–registered aircraft, debtors/lessees situated in the United States, and security interests or leases, the issue of whether an aircraft and its engines are subject to the Cape Town Treaty depends on the size of the aircraft and the power of the engines.

[18] In such a case, the applicability of the Cape Town Treaty could provide a substantial difference. 14 C.F.R. § 47.47 (setting forth separate procedures, depending on whether aircraft is subject to Cape Town Treaty, to de–register for export purposes). *See* Protocol, *supra* note 17, art. XIII (setting forth specific advance approval and procedures for deregistration and export requests). This Article, however, focuses on a Foreign Financier's ability to register an aircraft or have one registered (including after default and repossession) in the United States and, accordingly, will not explore that path.

[19] *See* Cape Town Treaty, *supra* note 17, ch. III; Protocol, *supra* note 17, art. IX; 14 C.F.R. § 47.11(b) (required evidence of ownership for aircraft repossessor wishing to register); Certificate of Repossession of Encumbered Aircraft (AC Form 8050-4), 65 Fed. Reg. 15,188, 15,188 (Mar. 21, 2000); FAA, Certificate of Repossession of Encumbered Aircraft, AC Form 8050-4 (2-00) (2000), *available at* http://forms.faa.gov/forms/ac8050-4.pdf; Susan Jaffe Roberts et al., *International Secured Transactions and Insolvency*, 40 INT'L LAW. 381, 390-91 (2006); John I. Karesh, *Repossession and Foreclosure of Aircraft from the Perspective of the Federal Aviation Act and the Uniform Commercial Code*, 65 J. AIR L. & COM. 695, 701–03 (2000); David G. Mayer & Frank L. Polk, *Cape Town Convention: Complex Questions and Significant Opportunities*, LJN's EQUIP. LEASING NEWSL., Oct. 2005, at 1, 2–3; *see also* Cape Town Implementation Act, Pub. L. No. 108–297, § 2(a)(4), 118 STAT. 1095 ("Only technical changes to United States law and regulations are required since the asset-based financing and leasing concepts embodied in the Cape Town Treaty are already reflected in the United States in the Uniform Commercial Code.").

B. U.S. Citizenship Not Required

Under the repossession, foreclosure and re-registration procedures just described, a Foreign Financier may serve as a secured lender or finance lessor and, as long as it transfers ownership during that process to a third–party U.S. citizen, it will not face U.S. registration issues due to its status as a non-U.S. citizen. That will limit choices somewhat, but the limitations may be acceptable in many cases.

A Foreign Financier acting as a secured party could even, in enforcing its security interests, purchase an aircraft itself under UCC § 9-610(c) or take title itself without a sale under the "strict foreclosure" remedy options of UCC § 9-620 or Article 9 of the Cape Town Treaty. The Foreign Financier would then, however, face the same foreign owner-registrant problems and options discussed in Part IV *supra.* Until that Foreign Financier either transferred title to a U.S. citizen (including through an owner trust arrangement as discussed in Part II C *supra*), decided to comply with the Based and Primarily Used Exception (as described in Part III *supra),* or placed at least seventy-five percent of its stock in a voting trust with a U.S. citizen (as described in Part II B *supra),* the aircraft could not be re-registered with the FAA and, accordingly, could not be operated in U.S. airspace. Once any of those steps were taken, however, the aircraft could again be registered in the United States by filing the registration application, together with the appropriate evidence of repossession and bills of sale showing the chain of title from the defaulting debtor to the Foreign Financier to the new U.S. citizen-owner (if such a final transfer occurred and the Foreign Financier did not rely on the Based and Primarily Used Exception or enter into a voting trust). Although the aircraft could not be operated during that gap, no adverse effect would otherwise occur with respect to registration.

C. U.S. Citizen Security Agent Optional

Alternatively, a Foreign Financier may contemplate in advance that it would likely not want to transfer title to a third–party purchaser upon default, to escape the risk of aircraft downtime after a default while it made arrangements to place title in an owner trust or otherwise establish the aircraft's eligibility for registration. In such cases, where the economies of the transaction permitted, the author has structured an arrange-

ment so that a U.S. citizen–entity,[20] acting as the security agent for the benefit of the Foreign Financier, was the secured party or finance lessor. That way, upon default, the security agent is able to take title to the collateral and immediately register the aircraft in its name (again, for the benefit of the Foreign Financier).[21] Because the Foreign Financier would have to pay for this service regardless of whether it was ever needed (presumably by passing the costs to the borrower as long as the borrower is able to pay), the Foreign Financier would want to be comfortable with this post-default route from the beginning of the transaction (*e.g.*, if the Foreign Financier also had a blanket lien on the borrower's assets and wanted to step into its shoes immediately after default and keep operations continuing without interruption) *and* that the borrower or, in default, the Foreign Financier, could absorb the cost.

VI. CONCLUSIONS

A. Operating Leases

With the choices discussed in Part IV *supra*, it would make sense, at the early stages of putting together an operating lease, to determine whether the Based and Primarily Used Exception could apply. If not, an owner trust arrangement is often the best option. If the Based and Primarily Used Exception could apply, the Foreign Financer would need to conduct a cost/benefit analysis of the burdens, risks and projected costs of complying with the Based and Primarily Used Exception against the burdens, risks and projected costs of setting up an owner trust for that transaction.

B. Secured Loans and Finance Leases

A Foreign Financier may act as the finance lessor and secured party in its own name without facing U.S.–citizenship issues. To maximize flexibility and to decrease aircraft downtime after a default, a Foreign Financier also has the option of engaging a

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[20] For example, Wells Fargo or Wilmington Trust Company. *See supra* Part II C.

[21] Note that this is not required by or based upon any FAA regulations relating to U.S. citizenship or otherwise. Rather, it is a pre-default mechanism to provide in advance for the post-default requirement that the new owner-registrant be a U.S. citizen. Thus, there would be no requirement that the Foreign Financier relinquish control as secured party/finance lessor to the security agent (until the security agent took title in its name after default and became owner-trustee).

security agent to perform that role. As with operating leases, an analysis should be made at the early stages of each transaction to determine the desirability of that post-default flexibility and low downtime, and whether it is worth the cost and burden of engaging a security agent and working with the security agent from the beginning of the transaction through repossession and re-registration.

Case Notes


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