The Sale, Leasing and Financing of Aircraft

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I. Introduction

This paper reviews the principal methods by which aircraft are acquired and financed, and comments on related business and legal issues. While many of the observations set forth in this presentation apply to aircraft generally, including light business and pleasure aircraft, the primary emphasis is on the sale and financing of large commercial transport aircraft operated by air carriers, both domestic and foreign.

The topic is particularly timely since the world's airlines are currently in the process of making major decisions concerning the composition of their fleets for the coming decades. As the older jets (e.g., 707s, DC-8s, Caravelles) reach the end of their useful lives, new types of aircraft (e.g., 757s, 767s, DC-9-80s, A-310Bs) which meet changing requirements must be designed, manufactured, purchased, financed and put into service. The amounts of capital which will be required are staggering. A recent market study estimates that United States air carriers alone will purchase over $42 billion worth of commercial jet aircraft in the decade.

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The author wishes to express his appreciation for assistance in the preparation of this paper provided by Heather Howard and Stephen M. Graham of the Washington State Bar.

1 During 1977, The Boeing Company (Boeing), the leading manufacturer of commercial aircraft, reported it received orders for 228 commercial jet transports, with a total value of approximately $4.1 billion. (1977 Annual Report of The Boeing Company, at 7). During 1978, Boeing reported orders for 490 aircraft, with a total value of approximately $11 billion, of which 146 were 737s, 131 were 727s, 6 were 707s, 83 were 747s, 40 were 757s and 84 were 767s. The Boeing News, Feb. 8, 1979, at 1, col. 3.
commencing in 1979; foreign carriers' requirements will be even
greater—approximately $59 billion worth of aircraft. The sums
involved, even for the purchase of a single aircraft, are immense;
the airlines face a difficult and challenging decade.

II. THE SALE OF AIRCRAFT

A. Purchase Agreements

Commercial aircraft are usually manufactured and sold pursuant
to the terms of long, complex purchase agreements which are the
result of extensive negotiations between teams of technical and
contract specialists representing the seller and the buyer. Each
manufacturer normally has a pro forma purchase agreement
which is made part of the proposal submitted to a customer; the
pro forma reflects the manufacturer's experiences over the years
in manufacturing and selling aircraft throughout the world. In
general, most purchase agreements signed by domestic and foreign
buyers are consistent with the "boilerplate" of the pro forma.
Considered individually, however, each sale is a complex business
transaction, involving considerable arm's length bargaining. The
details of each negotiated agreement will vary from the pro forma
as may be required to fit the particular needs and concerns of
each purchaser.

The negotiated documents are normally composed of a basic
purchase contract, supplemented by exhibits and appendices. The
principal terms of sale are commonly set forth in the basic contract
which describes the aircraft to be manufactured in accordance
with the detail specification (usually attached as an exhibit to the
contract), and specifies the price, terms of payment (including
progress payments) and the delivery schedule for the aircraft. The
basic contract also covers the certification and inspection of the
aircraft and establishes procedures for making changes in the air-
craft's specification during the course of production. Other key

5 The estimates were measured in 1978 dollars, excluding the Soviet Union
and the People's Republic of China. Study furnished to the author by The Boeing
Company.

6 A Boeing 747-200B sells for approximately $50-65 million, a 747SP for
approximately $45-55 million, a 767 for approximately $35-40 million, a 707
for approximately $21-24 million, a 727-200 for approximately $14-17 million
and a 737-200 for approximately $10-12 million. Information furnished to the
author by The Boeing Company.
clauses define the rights and obligations of the parties with respect to taxes and delays. The contract usually provides that the aircraft will be delivered in the state in which it is manufactured and that the purchase agreement will be governed by the law of that state.

Warranties and patent indemnities may be incorporated either in the basic contract or in exhibits or appendices to the basic contract. Detailed descriptions of the manuals, drawings and other technical data to be furnished by the manufacturer, as well as the extensive product assurance and support commitments of the manufacturer with respect to the aircraft, are usually set forth in exhibits or appendices.

Special agreements, such as financing, which are part of the bargain between seller and buyer are commonly set forth in side letters to the purchase agreement. Agreements for the sale of spare parts and support equipment are frequently set forth in general terms agreements which may apply to all aircraft in the airline's fleet which have been produced by the manufacturer.

Agreements with foreign buyers occasionally present special problems in negotiation, particularly when the parties' legal, economic and political systems have few principles in common. Such agreements, however, are substantially similar to those with United States carriers, with the exception of aircraft certification and other requirements of the importing country which vary from United States requirements.

B. Certain Issues

Aircraft purchase agreements raise a number of significant legal issues; however, three subjects perennially receive particular attention: (i) the nature and scope of the warranties and product assurance commitments of the manufacturer, (ii) the agreements of the parties with respect to the nature and effect of delays in delivery of aircraft, and (iii) Federal Aviation Administration (FAA) certification requirements.

1. Warranties

A manufacturer's warranties and product assurances for aircraft contain detailed provisions designed to set forth as clearly as pos-

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*The sale of ten Boeing 707s to the People's Republic of China in 1972 required three months of negotiations over a six-month period.*
sible the manufacturer's commitments to the airline and the limitations on the manufacturer's liability if the aircraft does not conform to those commitments. The manufacturer typically warrants that on delivery a new aircraft will conform to its specification and be free of defects in design, material and workmanship, but excludes all other warranties or guarantees. The warranty prescribes the buyer's remedies for nonconformance or defects; such remedies are commonly limited to the repair or replacement of a defective part and the correction of any defect in design within specified warranty periods. In a warranty exculpatory clause, the warranty typically disclaims all other damages, liabilities and obligations, including tort claims.\(^5\)

The following is a representative warranty exculpatory clause:

THE WARRANTIES, OBLIGATIONS AND LIABILITIES OF SELLER AND REMEDIES OF BUYER SET FORTH IN THIS ARTICLE ARE EXCLUSIVE AND IN SUBSTITUTION FOR, AND BUYER HEREBY WAIVES, RELEASES AND RENOUNCES, ALL OTHER WARRANTIES, OBLIGATIONS AND LIABILITIES OF SELLER AND RIGHTS, CLAIMS AND REMEDIES OF BUYER AGAINST SELLER, EXPRESS OR IMPLIED, ARISING BY LAW OR OTHERWISE, WITH RESPECT TO ANY NONCONFORMANCE OR DEFECT IN ANY AIRCRAFT OR OTHER THING DELIVERED UNDER THIS AGREEMENT, INCLUDING BUT NOT LIMITED TO (A) ANY IMPLIED WARRANTY OF MERCHANTABILITY OR FITNESS, (B) ANY IMPLIED WARRANTY ARISING FROM COURSE OF PERFORMANCE, COURSE OF DEALING OR USAGE OF TRADE, (C) ANY OBLIGATION, LIABILITY, RIGHT, CLAIM OR REMEDY IN TORT, WHETHER OR NOT ARISING FROM THE NEGLIGENCE OF SELLER, ACTUAL OR IMPUTED, AND (D) ANY OBLIGATION, LIABILITY, RIGHT, CLAIM OR REMEDY FOR LOSS OF OR DAMAGE TO ANY AIRCRAFT, FOR LOSS OF USE, REVENUE OR PROFIT WITH RESPECT TO ANY AIRCRAFT, OR FOR ANY OTHER DIRECT, INCIDENTAL OR CONSEQUENTIAL DAMAGES.

Warranty exculpatory clauses are a substantial source of litigation and dispute, particularly in our legal system in which products liability doctrines are heavily influenced by cases involving ordi-

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\(^5\) The clauses do not purport to nor do they have any effect on the rights of passengers and other third parties against the manufacturer or the airline.
AIRCRAFT FINANCING

In the context of agreements for the sale of aircraft between major corporations, disputes should not arise if the business purpose for such clauses is understood. The purpose of such clauses (and indemnity clauses which present similar issues) is to define the rights and obligations of the parties so that each may know the risks he assumes. He may then, in the exercise of business judgment, purchase insurance or elect to self-insure. The parties may thus allocate the risks between themselves and avoid or minimize the costs of double insurance coverage. While much of the litigation following aircraft accidents is nominally between aircraft manufacturers and air carriers, the insurance carriers are the real parties in interest.

Aircraft exculpatory clauses have been upheld in cases involving allegations of breach of warranty, negligence and strict liability. In such cases the courts have stressed the right of parties with relatively equal bargaining power to allocate risks between themselves in a commercial transaction.

Sections 2-316, 2-718 and 7-719 of the Uniform Commercial Code permit a seller by appropriate language to exclude or modify warranties, to agree on exclusive and limited remedies and to limit or exclude damages, including consequential damages.

Delta Air Lines, Inc. v. McDonnell Douglas Corp., 503 F.2d 239 (5th Cir. 1974), cert. denied, 421 U.S. 965 (1975) (allegations of strict liability in tort and negligence); S.A. Empresa de Viacao Aerea Rio Grandense (Varig Airlines) v. Boeing Co., [1975-1977 Transfer Binder] PROD. LIAB. REP. (CCH) ¶ 8028 (W.D. Wash. 1977) (allegations of strict liability in tort, negligent misrepresentations and post-delivery negligence); Scandinavian Airlines System, Inc. v. United Aircraft Corp., No. 74-2609-DWW (C.D. Cal., Dec. 4, 1975) (allegation of defective design, failure to warn, strict liability in tort, and breach of warranties); Delta Air Lines, Inc. v. Douglas Aircraft Co., 238 Cal. App. 2d 95, 47 Cal. Rptr. 518 (1965) (allegations of active negligence); cf. Pakistan International Airlines Corp v. Boeing Co., 575 F.2d 1268 (9th Cir. 1978) (upholding an agreement of the buyer to indemnify and holding harmless the seller with respect to special services provided under a purchase agreement against allegations of negligent inspection by a survey team following an accident). In the foregoing cases the courts were satisfied that the language of the clauses adequately reflected the intent of the parties to exclude the liability which was asserted. But see, Keystone Aeronautics Corp. v. R. J. Enstrom Corp., 499 F.2d 146 (3d Cir. 1974) (stressing the requirement that the contract express the parties' intent with particularity); cf. Jig The Third Corp. v. Puritan Marine Insurance Underwriters Corp., 519 F.2d 171 (5th Cir. 1975), cert. denied, 424 U.S. 954 (1976) (failure to mention negligence, tort or similar cognates).

2. Delivery Delays

The impact of delays in delivery of aircraft is a matter of serious concern to both manufacturer and buyer. Because of the financial consequences of delays, neither party is willing to rely solely upon the provisions of statute and common law which, in the absence of agreement, would define the parameters of *force majeure* or impracticability of performance and would prescribe the remedies for such delays. Accordingly, purchase agreements typically include extensive provisions which define excusable delays, specify the consequences of such delays, and allocate the risks of such delays between the parties. In addition to causes of delay such as fires or accidents, excusable delay clauses will identify other causes, such as strikes or governmental allocations, which experience has indicated may occur during production. The following is a typical excusable delay clause in an aircraft contract:

Seller shall not be responsible for nor be deemed to be in default under this Agreement on account of any delay in delivery of an Aircraft or other performance hereunder due to any of the following causes: acts of God; war, warlike operations, insurrections or riots; fires, floods or explosions; serious accidents; epidemics or quarantine restrictions; any act of government, governmental priorities, allocation regulations or orders affecting materials, facilities or completed aircraft; strikes or labor troubles causing cessation, slow-down or interruption of work; delay in transportation; or inability after due and timely diligence to procure materials, accessories, equipment or parts; or due to any other cause to the extent it is beyond Seller's control or not occasioned by Seller's fault or negligence. Delays resulting from any of the foregoing causes are referred to as 'Excusable Delays.'

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9 U.C.C. § 2-615 relates to excuse by failure of presupposed conditions.

10 U.C.C. § 2-616. Note that the version of U.C.C. § 2-616(3) in effect in most states places limitations upon the ability of a seller and a buyer to allocate the consequences of an excusable delay: "The provisions of this section may not be negated by agreement except in so far as the seller has assumed a greater obligation under the preceding section." While this prohibition (which is a departure from the normal U.C.C. principle of freedom of contract—U.C.C. § 1-102) may make some sense in consumer transactions, it is unreasonable when applied to negotiated contracts for the manufacture and sale of specially manufactured goods. Accordingly, it has not been adopted or has been modified in several major industrial states. See, e.g., CONN. GEN. STAT. ANN. § 42a-2-616(3); WASH. REV. CODE § 62A.2-616.

11 For a comprehensive analysis of the effects of a similar clause, see the discussion of the court in Eastern Air Lines, Inc. v. McDonnell Douglas Corp., 532 F.2d 957 (5th Cir. 1976). At issue were delays in the delivery of 90 DC-8s
3. Federal Aviation Administration Certification Requirements

The manufacture and sale of aircraft are subject to regulation by a variety of governmental agencies. Among the most significant are the requirements of the FAA with respect to the production and certification of aircraft. Specifically, Part 21 of the Federal Aviation Regulations governs the issuance by the FAA of type certificates, and of standard airworthiness certificates required for operation of aircraft under United States registry. It further provides for the issuance of export certificates of airworthiness for aircraft which will be exported and registered in other countries. In general, to be eligible for an export certificate of airworthiness an aircraft must meet the requirements for a standard United States certificate of airworthiness, as modified or supplemented by the special requirements of the importing country. Since the importing country's requirements are incorporated by reference in the FAA's regulations, the export certificate will serve as the basis for the issuance to a foreign air carrier of an airworthiness certificate (or equivalent) by the aeronautics authority of the country in which the aircraft will be registered.

A manufacturer must design and build aircraft to comply with applicable governmental requirements. Compliance with laws, regulations and interpretations known to be in effect at the time and DC-9s (averaging 80 days per aircraft) which McDonnell Douglas asserted were caused by its compliance with United States Government policies relating to military priorities.


an agreement is signed is a difficult but manageable problem. If
laws and regulations, or interpretations thereof, change, however,
or if new laws or regulations become applicable after a purchase
agreement is signed but prior to delivery of the aircraft, a manu-
ufacturer must make changes so that the aircraft will comply with
the new requirements. The lead time for delivery of aircraft cur-
cently in production is usually twelve to twenty-four months after
the order date; for new models, it may be four years or more. Ac-
cordingly, the risk of increased costs incurred in complying with
applicable laws and regulations is substantial and must be allocated
between the manufacturer and the buyer on a rational basis. The
following is a typical clause used to allocate that risk:

**Federal Aviation Administration Requirements**

1. **Certificates.** Seller shall:
   (a) obtain from the Federal Aviation Administration (FAA)
a Type Certificate (transport category) issued pursuant to Part 21
of the Federal Aviation Regulations for the type of aircraft pur-
chased under this Agreement, and
   (b) obtain for each Aircraft at the time of delivery a Standard
Airworthiness Certificate [Export Certificate of Airworthiness] is-
sued pursuant to Part 21 of the Federal Aviation Regulations.
   Buyer shall cooperate with Seller in complying with the fore-
going requirements. Seller shall not be obligated to obtain any
other certificates or approvals for the Aircraft.

2. **Installation Provisions.** Seller shall deliver each Aircraft with
installation provisions suitable for all equipment required to be
incorporated on such Aircraft to meet those additional require-
ments of the Federal Aviation Regulations which (i) are generally
applicable with respect to transport category aircraft to be used
in United States certificated air carriage and (ii) are required to
be complied with on or before the date of delivery of such aircraft.
Buyer shall also cooperate with Seller in complying with the fore-
going requirements.

3. **Changes.** If any change, addition or modification (in this Article
individually and collectively called 'change') to any Aircraft is
required, pursuant to any law or governmental regulation or re-
quirement or interpretation thereof by any governmental agency,
whether promulgated prior to or subsequent to the date of this
Agreement, in order to meet the requirements of Paragraph 1 or
2, such change shall be made to such Aircraft prior to delivery.

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17 A notable (and expensive) example of such changes is the FAA's noise
If such change is necessary to meet the requirements of Paragraph 1, such change shall be made without additional charge to Buyer [unless such change is necessary to comply with any requirement of the importing country which varies from or is in addition to the airworthiness requirements of the FAA for the issuance of a Standard United States Airworthiness Certificate, in which case Buyer shall pay Seller's reasonable price for such change including any charges by any governmental agency of the importing country associated with such change.] If such change is necessary to meet the requirements of Paragraph 2, Buyer shall pay Seller's reasonable price for such change. [Buyer also agrees to pay Seller's reasonable price to obtain validation of the Aircraft for export to the importing country including but not limited to reasonable amounts for data, studies and testing as may be required by any governmental agency of the importing country and any charges by such agency associated therewith.]

4. Special Changes. Notwithstanding the provisions of Paragraph 3, if any change to any Aircraft is required, pursuant to any law or governmental regulation or requirement or interpretation thereof by any governmental agency, promulgated subsequent to the date of this Agreement and effective with respect to any Aircraft scheduled for delivery on a date 18 months or more after the date of this Agreement, in order to meet the requirements of Paragraph 1, such change shall be made to such Aircraft prior to delivery and Buyer shall pay Seller's reasonable price for such change.

5. Delay and Change Order. If delivery of any aircraft is delayed by the incorporation of any changes required to be made under Paragraph 3 or 4, such delay shall be an Excusable Delay within the meaning of this Agreement. Seller shall issue and Buyer shall accept a Change Order reflecting any change required to be made under Paragraph 3 or 4, which Change Order shall specify the effect, if any, of such change on design, performance, weight, balance, time of delivery and purchase price of the affected Aircraft.

6. Discontinuance. If the use of Type Certificates or Airworthiness Certificates is discontinued during the performance of this Agreement, thereafter such terms shall be deemed to refer to any other certificate or instrument issued by the FAA which corresponds to such certificate or, if there should not be any such other certificate or instrument then Seller shall be deemed to have obtained such certificates upon demonstrating that each Aircraft complies substantially with the performance guarantees set forth in the Detail Specification.18

18 Provisions applicable to the sale of aircraft to foreign air carriers are indicated in brackets.
III. FINANCING THE ACQUISITION OF AIRCRAFT

A. Historical Review.

From the end of World War II through the 1950s, domestic air carriers usually financed aircraft purchases by using a mixture of retained earnings, depreciation, commercial bank loans and offerings of equity securities. In general, loan terms ranged from three to seven years. Some domestic carriers obtained financing by providing security in the form of chattel mortgages and conditional sales contracts. Foreign air carriers, most of which are government-owned, financed their equipment acquisitions through capital contributed by their governments, commercial bank loans and loans from the Export-Import Bank of the United States (Eximbank).

The introduction of expensive jet aircraft forced domestic carriers to supplement bank loans repayable over five to seven years with long-term debt from insurance companies and other institutional lenders. To keep debt/equity ratios in balance, many domestic carriers issued convertible subordinated debentures. Other carriers arranged syndicated loans involving both banks and institutional lenders, some of which were secured by mortgage indentures on flight equipment and on other assets of the carrier.

For most domestic carriers the 1960s were profitable years marked by appreciation in the market value of their securities, an expanding availability of bank and institutional credit and the issuance of convertible debentures. Asset financing, in the form of conditional sales contracts, chattel mortgages and similar security interests, played a significant role for carriers which were unable to finance aircraft purchases on an unsecured basis.

During the decade of the 1960s, foreign air carriers made increasing use of loans which were made or guaranteed by Eximbank (and its foreign equivalents). The decade was also marked by a limited but growing number of aircraft loans by United States lenders to foreign carriers which were secured by mortgages, hypotheces and conditional sales agreements.

The creation of the investment tax credit in the early 1960s provided an additional incentive for acquisition of new equipment.

by domestic carriers. By the mid-1960s, however, many domestic carriers did not have sufficient earnings to use all of the investment tax credit and accelerated depreciation benefits generated by their heavy purchases of new aircraft. This led to the widespread use of leases as financing vehicles by which the benefits of the investment tax credit and depreciation deductions were taken by an owner-lessee who essentially passed such benefits through to the lessee-carrier in the form of a lower lease rate. Such leases also allowed carriers to finance aircraft acquisitions over lease terms of fifteen to sixteen years; the longer terms were justified by the longer useful life of jet aircraft as compared to piston aircraft.

A natural development of the "financing lease" was the leveraged lease in which the equipment leased to the carrier was purchased by a trustee from the proceeds of a 20-40 percent equity investment by an owner-participant (who received the tax benefits), with the balance provided in the form of loans to the trustee by loan participants who were secured by first priority security interests in the equipment and in the lease rentals. The leveraged lease attracted a broader range of institutional lenders into equipment leasing, in part because the priority of their secured position qualified the loan participants' investments under restrictive investment laws applying to financial institutions. In the early 1970s, when it became increasingly difficult to obtain long-term loans from institutional participants, many carriers were able to meet their needs by obtaining the debt component of leveraged leases through public issues of equipment trust certificates.

In recent years, as airline earnings have improved, leasing has become less prevalent among domestic air carriers. The ability of air carriers to use their own tax benefits, combined with a desire to retain for themselves the substantial residual values of modern aircraft, has led to greater reliance on conventional corporate financing techniques. These factors have also led to a revival in the industry of equipment trust financing techniques long popular with railroads. Under an equipment trust, a trustee purchases an aircraft with the proceeds of a public issue or private placement of equipment trust certificates (typically up to 80 percent of the price), with the airline advancing the balance of the price. The trustee leases the aircraft to the carrier at a rental sufficient to amortize principal, interest and expenses. At the end of the lease,
Foreign carriers have continued to finance aircraft primarily through conventional bank, governmental and Eximbank sources. An innovative development in recent years has been the acquisition by some European airlines (and at least one African carrier) of United States registered aircraft under long-term leases (some leveraged) from United States investors.

B. Financing Methods.

Following is a discussion of some of the principal methods utilized to finance the acquisition of commercial aircraft with particular emphasis on asset financing, in which the lender or lessor primarily looks to the security in the asset itself, Eximbank financing, and government guarantees. As noted in the preceding review, carriers have also financed and will continue to finance equipment purchases through the use of earnings, depreciation, and the issuance of equity and other securities as well as from revolving and term loans by commercial banks and long-term loans by institutional lenders.


a. Conditional Sales Contracts and Chattel Mortgages. Conditional sales contracts and chattel mortgages have been traditional techniques used by sellers and lenders to secure obligations incurred by domestic air carriers for the purchase of aircraft. Of the two, the chattel mortgage has been somewhat more flexible for major lenders since it has permitted them to obtain the broad security of a "fleet mortgage," covering newly purchased aircraft, other flight equipment and spare parts. On the other hand, the conditional sales contract has often been preferred by lenders because of the preferential rights of repossession accorded a conditional vendor in a Title X proceeding under Section 116(5) of the Bankruptcy Act, a right which did not extend to the holders of chattel mortgages. The Uniform Commercial Code (UCC) has now essentially eliminated the distinctions between the title retention and lien forms of security interests for purposes of the law of

secured transactions but the forms continue to have meaning under other statutes.

In some instances, lenders financing a carrier's acquisition of aircraft will provide financing for progress payments to be made to the manufacturer during production. In such cases, the lenders may secure their loans by taking an assignment of the carrier's rights under the purchase agreement with the consent of the manufacturer. On delivery, the security provided by the purchase agreement assignment will be succeeded by a security interest in the aircraft itself.

b. Equipment Trust Financing. As noted, the equipment trust method of financing has been used increasingly by domestic airlines in recent years. Such techniques have been successfully developed and used by railroads to finance a major portion of their rolling stock. One of these techniques is the "Philadelphia Plan," which, with variations, is most commonly used in aircraft transactions. Under the Philadelphia Plan a trustee issues equipment trust certificates to investors pursuant to a public offering or a private placement. The certificates may be issued in one or more

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21 U.C.C. §§ 9-102 and 1-201(37) (1976); see In re Yale Express System, Inc., 370 F.2d 433 (2d Cir. 1966).

22 In addition to § 116(5) of the Bankruptcy Act, (11 U.S.C. § 516(5) (1976)), which will soon expire, the Federal Aviation Act (FAA Act) and regulations adopted pursuant thereto continue to refer to contracts of conditional sale and mortgages or chattel mortgages, see, e.g., 49 U.S.C. § 1403(a)(2) (1976); 49 U.S.C. § 1301(16) (1976); 14 C.F.R. §§ 47.11 and 49.17 (1979). Notwithstanding the separate references in the FAA Act and the FAA Regulations to contracts of conditional sale and to chattel mortgages, the substantive treatment accorded by the FAA Act and FAA Regulations is substantially the same, although some substantive procedural differences continue to exist. For example, 14 C.F.R. § 49.17(d)(3) (1979) requires that the "conditional vendee" of an aircraft must obtain the assent of his conditional vendor to an assignment of the interest of the conditional vendee under a contract of conditional sale. No such requirement is imposed with respect to chattel mortgages. The FAA has proposed to eliminate the distinction by deleting the requirement for assent by the conditional vendor. 42 Fed. Reg. 55,897 (1977).

23 See generally D. STREET, RAILROAD EQUIPMENT FINANCING (1959).

24 Another variation of the equipment trust technique commonly used in rail car financing is the "New York Plan". The New York Plan or conditional sale method varies from the Philadelphia Plan in that one of its basic instruments is a conditional sale contract entered into between the manufacturer and the railroad. A trustee, acting on behalf of investors, pays the price of the equipment to the manufacturer from the proceeds of equipment trust certificates issued to the investors and takes an assignment of the manufacturer's interest as conditional vendor.
series with varying maturities and interest rates. With the proceeds of the sale (commonly up to 80 percent of the price of the equipment) and a downpayment for the balance from the air carrier, the trustee purchases the aircraft from the manufacturer pursuant to an assignment to the trustee from the carrier of its rights under the purchase agreement with the manufacturer. The trustee, acting on behalf of the holders of the certificates, retains title to the aircraft and leases it to the carrier for a term of years (typically up to 16 years). The carrier pays a periodic rental which is sufficient to pay the principal of and interest on the certificates and all expenses of the trust. The carrier assumes all obligations with respect to the aircraft itself, including maintenance, repair, insurance and taxes. At the end of the lease term, title to the aircraft is transferred by the trustee to the carrier without any further payment or for a nominal payment. The "lease" is not a true lease and the carrier is treated as the owner for tax, accounting and aircraft registration purposes, among others.

Equipment trust financing currently has considerable appeal to the investment community. This appeal may be due in part to the excellent reputation for security such techniques have enjoyed in rail car financing for the troubled railroad industry. The flexibility of the trust concept which permits the issuance of equipment trust certificates to a broad range of investors in a public offering or a private placement is also a significant advantage. As a secured transaction, however, its principal legal advantage over the chattel mortgage form of security interest is the right of repossession currently provided by Section 116(5) of the Bankruptcy Act in a reorganization proceeding.

For the airline industry, the popularity of equipment trust certificates in the investment community has allowed some carriers to finance aircraft over repayment terms approximately equivalent to those in equipment leases while obtaining the benefits of ownership, including the investment tax credit, accelerated depreciation allowances and the residual value associated with the acquisition of new equipment.

2. Leasing

a. Short-Term Leases. Short-term leases, which may be from a few weeks to several years, play only a limited role in new aircraft
acquisitions. Most short-term leases are between airlines and are made to accommodate seasonal increases in passenger traffic. Short-term leases of older aircraft are often used to make equipment available to small airlines in foreign countries that do not yet have either the resources or the financing to purchase equipment. Manufacturers may also lease aircraft to carriers for short periods to provide "interim lift" pending delivery of new aircraft. Short-term leases (often coupled with options to purchase) occasionally may be offered by manufacturers as an introduction to an aircraft model and as an inducement to purchase such aircraft (as well as by airlines disposing of used equipment).

b. Financing Leases. A major factor in airline financing, particularly for domestic carriers, has been the use of long-term financing leases. Under such leases, an air carrier-lessee acquires an aircraft for a lease term which reflects the useful life of the aircraft (less an assumed residual) and the investor-lessee recovers his investment in the cost of the aircraft plus his expected yield.

(1) Reasons for Leasing. There are a variety of reasons why airlines have preferred to lease rather than to buy equipment. Traditionally, leasing has permitted a company with limited resources to obtain needed equipment, paying for it over an extended period of time, without making downpayments and heavy capital outlays required by conventional financing. Leasing further allowed "off-balance sheet" financing in which non-current liabilities under a lease were not entered on a lessee's balance sheet. It also per-

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25 Short-term leases may be either "dry" leases in which the lessee assumes responsibility for operation and maintenance of the aircraft, or "wet" leases in which the lessor provides the equipment plus crews and/or maintenance services.


27 For discussions of equipment leasing generally, see, e.g., PRACTICING LAW INSTITUTE, LEVERAGED AND SINGLE-INVESTOR LEASING, (Course Handbook Series No. 184, 1978); Coogan, Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of U.C.C. Section 1-201 (37) and Article 9, 1973 DUKE L.J. 909; Gritta and Lynch, Aircraft Leasing—Panacea or Problem? 5 TRANSP. L.J. 9 (1973); Riordan and Duffy, Lease Financing, 24 BUS. LAW. 763 (1969).

28 Material lease obligations are, however, commonly footnoted. Under current accounting practice, the accounting treatment of a lease depends upon whether the lease is characterized as a "capital" lease or as an "operating" lease. See note 31 infra.
mitted some carriers to acquire equipment without violating restrictive covenants limiting the incurring of long-term debt or the creation of liens on, and security interests in, the carriers' property. In addition leases usually did not contain the extensive and restrictive financial covenants which were common in credit agreements with financial institutions.

The principal reason for the expanded use of leasing in financing aircraft during the past fifteen years, however, has been the availability of the seven percent (now 10 percent) investment tax credit and accelerated depreciation with respect to new equipment. Carriers whose earnings have not been consistently high enough to absorb such tax benefits have been able to finance the acquisition of new aircraft at a lower effective cost than they would otherwise have paid by leasing the equipment from leasing companies and financial institutions which could use such benefits. From the viewpoint of investors, leasing has offered the security of ownership of the property and an enhanced yield resulting from a composite of available tax benefits, the assumed residual value of the property at the end of the lease term, and an interest factor calculated on the amount of the investment.

(2) Forms of Leases. In the typical lease-financing transaction, the air carrier negotiates the terms of the purchase agreement with the manufacturer and the terms of the lease with the lessor (or a representative of the beneficial owners of the lessor's interest if more than one investor is involved). The air carrier assigns its

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29 I.R.C. §§ 38 and 46-48 currently allows a credit, against 60% or more of a taxpayer's income tax liability, of 10% of the taxpayer's "qualified investment" (usually his cost basis) in "New Section 38 Property" placed in service during the taxable year. In effect, this almost immediately reduces the actual investment by 6% or more of the equipment cost. The investment tax credit was increased from 7% to 10% by the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975). Property qualifying for an investment tax credit also qualifies for application of the most rapid forms of depreciation available. I.R.C. § 167(b), (d), (f) and (m). The principal economic benefit of accelerated depreciation is a deferral of taxes on income, with resultant cash flow benefits to the taxpayer.

30 The residual value of the equipment must be reasonably estimated to be at least 20% of original cost for tax purposes, but for purposes of pricing a lease, the residual is often more conservatively estimated. However, residual values of aircraft often exceed even the most liberal assumptions. Some used jet aircraft sell at prices equal to or higher than their original costs. Kelliher, Used Jet Prices Soar on Air Travel Boom; McDonnell DC9-30 Is Most Popular Plane, Wall St. J., Dec. 27, 1978, at 5, col. 1.
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rights to purchase the aircraft to the lessor—commonly a trustee for the beneficial owners of the lessor's interest. The air carrier usually retains all other rights under the Purchase Agreement unless the lease is declared in default. The lessor pays the purchase price to the manufacturer and leases the aircraft to the air carrier. The lessee is obligated to pay all taxes, insurance, and operating and maintenance costs, so that the lease and rentals will be net to the lessor.

A financing lease will typically take one of two forms—a "single-investor" lease or a "leveraged" lease.

(a) Under a typical "single-investor" lease, one or more investors, who provide all the financing, acquire the aircraft directly or through a trustee. The investors directly or beneficially own the aircraft, receive all of the rentals and are entitled to the investment tax credit and accelerated depreciation tax benefits and the residual value associated with the ownership of the equipment. (By agreement, the investors may elect to permit the lessee to take the investment tax credit directly.) For tax purposes the lessee will deduct the rental payments. For financial accounting purposes, the lessee usually will prefer to treat the lease as an "operating" lease and the lessor (depending on its status) will treat it as a "direct financing" or "sales" lease.\footnote{The complexities of accounting for leases by lessors and lessees is beyond the scope of this paper. The principal requirements are set forth in Statement of Financial Accounting Standards No. 13, Accounting for Leases, (Nov. 1976) [hereinafter referred to as FASB 13]. FASB 13 prescribes the rules for determining whether a lessee must treat a lease as a "capital" lease or as an "operating" lease and whether a lessor must treat a lease as a "sales-type" lease, a "direct financing" lease, a leveraged lease, or as an operating lease. Generally, a "capital" lease is one in which the lessee is regarded as having substantially all of the benefits and risks incident to ownership of the property.}

(b) Under a typical "leveraged" lease\footnote{For comprehensive discussions of leveraged leasing, see Practising Law Institute, Equipment Leasing—Leveraged Leasing (1977); Gallagher, Tax Consequences of a Leveraged Lease Transaction, 52 Taxes 356 (1974); Schmidt & Larsen, Leveraged Lease Arrangements: Tax Factors that Contribute to Their Attractiveness, 41 J. Tax 210 (1974); Stiles & Walker, Leveraged Lease Financing of Capital Equipment, 28 Bus. Law. 161 (1972).} an owner trustee acquires the aircraft with the proceeds of (i) an equity investment by owner participants of 20 percent or more of the equipment cost and (ii) non-recourse debt for the balance of the equipment cost, evidenced by loan or equipment trust certificates issued to
loan-participants under a private placement or to the public under a public offering. Since the debt is without recourse to the owner-participants, the loan-participants look to the credit of the lessee; however, the debt is secured by a first priority security interest in favor of a loan- or indenture-trustee on behalf of the loan-participants in the equipment and in the lessor's interest in the lease and the rentals thereunder. The rentals payable by the carrier under the lease will be calculated in an amount sufficient to service the interest and principal on the debt and to repay the investment of the owner-participants.

As with the single-investor lease, the owner-participants will claim the investment tax credit (unless they elect to pass through the credit to the lessee) and take the depreciation deductions; in addition they will be entitled to deduct their interest payments on the debt payable to the loan-participants. The effective lease rate to the carrier under a leveraged lease is usually less than it would be under a single-investor lease because (i) the owner-participants' "at-risk" investment is smaller in relation to the tax benefits and the residual value of the aircraft than the investment made by the investors in a single-investor lease and (ii) the debt portion of the investment bears a lower interest rate due to its priority secured position.

It is essential that a financing lease be treated as a "true" lease for tax and accounting purposes as well as for purposes of perfecting and enforcing the rights of the lessor (and of loan participants under a leveraged lease).\(^{33}\) If a lease is treated as a conditional sale or as a lease intended as security\(^ {34}\) and not as a true lease, it may result in several adverse consequences, including the following:

(i) The lessor and owner-participants may not be entitled to the tax benefits on which their participation was premised and the lessee may not be entitled to deductions for rental payments.

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\(^{33}\) A "lease" may, of course, also be structured with a lease term, rental payments and an option for the lessee to purchase at the end of term which effectively provides the lessor with the return of his investment plus his yield and the lessee with the residual in the aircraft. Although such transactions may be characterized as leases, for convenience or otherwise, they are in fact conditional sales in which the lessee claims the investment tax credit, takes depreciation and deducts the interest portion of the rental payments and the lessor treats the transaction as a loan.

\(^{34}\) See U.C.C. § 1-201(37).
(ii) The accounting treatment adopted by the lessor and lessee (and their reported income and financial condition) may be incorrect.

(iii) The lease will be treated as a security interest governed by the provisions of Article 9 of the UCC and must have been perfected accordingly; in addition, the remedies specified in the lease may not be enforceable.\[1\]

There are a number of tests for determining whether a lease is a conditional sale or a true lease.\[2\] A basic economic question is whether the purported lease in fact evidences an intent to transfer substantially all of the risks and benefits of ownership to the lessee. Other significant tests are whether the property can be expected to have a reasonable residual value at the end of the lease term and whether the lessee has an option or right to acquire the property through a nominal or bargain purchase. Most "true" leases of aircraft are careful to establish purchase options at not less than fair market value.

Although there is no legal requirement for lessors or lessees of aircraft to obtain advance rulings from the Internal Revenue Service as to the tax treatment to be accorded their leases, air carriers and lessors or participants will commonly request favorable rulings before proceeding with a lease, particularly in leveraged transactions.\[3\]

\[1\] For example, under U.C.C. § 9-504(2), a debtor is entitled to any surplus remaining after application of the proceeds of any sale to the indebtedness secured. If a lessee's liability were limited to the "indebtedness" (i.e., the present value of the rentals), a lessor could lose his anticipated residual.


\[3\] Rev. Proc. 72-3, 1972-1 C.B. 698, specifies the procedures for the issuance of advance rulings by the Internal Revenue Service. Rev. Proc. 75-21, 1975-1 C.B. 715, sets forth the guidelines used by the Internal Revenue Service for advance ruling purposes in determining whether transactions purporting to be leases of property are in fact leases for federal income tax purposes. Rev. Proc. 75-28, 1975-1 C.B. 752, sets forth the information and representations required to be furnished by a taxpayer in a request for an advance ruling under Rev. Rul.
(3) **Lease Terms.** Many of the terms and conditions set forth in leases are similar to those in security agreements. Because the lessor’s investment is typically a higher percentage of the value of the asset than loans made by a secured party, however, many covenants, particularly those relating to the equipment, are often more comprehensive than similar covenants in a security agreement. Leases (and related agreements) commonly contain provisions similar to the following:

(a) The carrier will indemnify the lessor and participants against the imposition of certain domestic and foreign taxes arising out of the lease and operation of the aircraft and against loss or unavailability of the investment tax credit and depreciation benefits on which the lease is premised. Tax indemnities are, of course, subject to detailed bargaining and usually take an inordinate amount of time to negotiate.

(b) The lessor will disclaim any liability with respect to the condition of the aircraft and will be indemnified by the carrier for liability arising out of the transaction and the operation of the aircraft. The lessor (and participants) will be named as additional insureds under the carrier’s aviation liability policy.

(c) The carrier will bear all risk of loss of or damage to the aircraft. If the aircraft is lost or destroyed, the lessee will be required to pay an amount, as a stipulated loss value, which is sufficient to repay the outstanding balance of the investment and to compensate the participants for agreed losses sustained (including

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55-540 and Rev. Procs. 72-3 and 75-28. The criteria for a favorable tax ruling include the following:

a. At the beginning of the lease and at all times during the lease term, the lessor has a minimum unconditional “at risk” investment equal to at least 20% of the cost of the leased property.

b. The lessee has no right to purchase or re-lease the property at the end of the term or at any other time at a price which is less than the then fair market value or fair market rental value.

c. At the beginning of the lease (i) the estimated fair market value of the property at the end of the term will equal or exceed 20% of the original cost of the property (excluding inflation and any cost to the lessor for removal), and (ii) the estimated remaining useful life of the property at the end of the initial term will equal or exceed 20% of the original estimated useful life of the equipment and, in any event, be at least one year.

d. No part of the cost of the property may have been borne by the lessee.

A failure to meet the above criteria will not necessarily result in a disallowance on audit.
ing any recapture of investment tax credit).

(d) The carrier will maintain all-risk hull and war-risk insurance in a stipulated amount on the aircraft, naming the lessor as loss payee and the lessor and participants as named insureds. The insurance will usually provide for payment in dollars in the United States, will contain a breach of warranty clause (protecting the lessor and participants against invalidation of the policy by reason of action or inaction by the carrier) and will require notice to the lessor and participants before cancellation of the policy.

(e) The lease will contain a “hell or high water” clause requiring the lessee to make payments under the lease without set-off or counterclaim and regardless of the condition of the equipment or other circumstances which might otherwise relieve the lessee of its obligations under the lease.

(f) The lessee will be required to maintain the aircraft in accordance with FAA standards and other standards set forth in the lease and the condition of the aircraft and engines upon return at the end of the lease or upon repossession will be specified in detail.

(g) The lease will set forth the conditions under which the carrier may sublease or transfer possession of the aircraft, usually subject and subordinate to the lessor’s interest under the lease, and may require that the carrier’s interest in any sublease be assigned as security for its obligations under the lease.

(h) The lease may accord the lessee one or more fair market value purchase options as well as renewal options at fair market rental value. The carrier may also have the right to terminate the lease if the aircraft becomes economically obsolete or surplus to the carrier’s needs by selling it to the highest bidder and remitting to the lessor the sales price plus any additional amount required to equal a stipulated termination value.

(i) The lease will define events of default and specify the remedies for default; remedies will typically include one or more liquidated damage alternatives.

3. Asset Financing—Some Problems and Observations.


Under the reorganization provisions of Chapter X of the Bankruptcy Act, a court has broad powers to preserve the debtor’s busi-
ness pending reorganization and to enjoin the efforts of secured creditors to repossess their property. Section 116(5) of the Bankruptcy Act, however, has permitted lessors and conditional vendors of, and trustees under an equipment trust relating to, aircraft, engines, propellers and spare parts under leases, conditional sales, and equipment trust agreements with air carriers certificated by the Civil Aeronautics Board to reclaim such property in a Chapter X reorganization proceeding, if the terms of the agreements so provided. This right did not extend to chattel mortgages. Under Section 1110 of the Bankruptcy Reform Act of 1978, this ana-

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(5) (N)otwithstanding any other provision of this chapter, the title of any owner, whether as trustee or otherwise, to aircraft, aircraft engines, propellers, appliances, and spare parts (as any of such are defined in the Civil Aeronautics Act of 1938, as now in effect or hereafter amended) leased, subleased, or conditionally sold to any air carrier which is operating pursuant to a certificate of convenience and necessity issued by the Civil Aeronautics Board, and any right of such owner or of any other lessor to such air carrier to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of this chapter if the terms of such lease or conditional sale so provide.

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(a) The right of a secured party with a purchase-money equipment security interest in, or of a lessor or conditional vendor of, whether as trustee or otherwise, aircraft, aircraft engines, propellers, appliances, or spare parts, as defined in section 101 of the Federal Aviation Act of 1958 (49 U.S.C. 1301) . . . that are subject to a purchase-money equipment security interest granted by, leased to, or conditionally sold to, a debtor that is an air carrier operating under a certificate of convenience and necessity issued by the Civil Aeronautics Board . . . to take possession of such equipment in compliance with the provisions of a purchase-money equipment security agreement, lease, or conditional sale contract, as the case may be, is not affected by section 362 or 363 of this title or by any power of the court to enjoin such taking of possession, unless—

(1) before 60 days after the date of the order for relief under this chapter, the trustee, subject to the court's approval, agrees to perform all obligations of the debtor that become due on or after such date under such security agreement, lease, or conditional sale contract, as the case may be; and

(2) any default, other than a default of a kind specified in section 365(b)(2) of this title, under such security agreement, lease, or conditional sale contract, as the case may be—

(A) that occurred before such date is cured before the expiration of such 60-day period; and

(B) that occurs after such date is cured before the later of—

(i) 30 days after the date of such default; and
chronistic distinction between the title-retention and lien forms of security (which has been essentially abolished by the UCC) will be eliminated as of October 1, 1979, the effective date of the Section. Under the new act, the protection given lessors and conditional vendors of aircraft operated by certificated air carriers is preserved to a limited extent and such protection is also extended to "the right of a security party with a purchase-money equipment security interest." The act also gives a trustee in bankruptcy a right to continue in possession so long as he agrees to perform the obligations of the debtor or lessee and cures defaults within specified periods after the date of the order of relief issued by a bankruptcy court.

b. Liability of Lessors and Secured Parties.

A fundamental assumption in lease financing, secured transactions and other forms of asset financing is that the lessor or lender will not have liability either to the carrier or to third parties arising out of the acquisition, condition, use or possession of the equipment. Aircraft potentially present substantial risks of liability.

In most cases, a lessor or secured party will not exercise control over the aircraft and should not be liable if proof of his fault is required. Liability can be imposed, however, under doctrines of strict and imputed or vicarious liability. In the past, concern was focused on the potential liability of conditional vendors, trustees and lessors of aircraft, rather than mortgagees and other lienholders, because of common law and statutory provisions which imposed strict liability on "owners" of aircraft for tort damages.

In recent years, attention has focused on two related developments: (i) cases in which some courts have held lessors liable for breach of warranty to lessees, primarily by applying the principles of Article 2 of the UCC, either directly, indirectly by analogy, or

(ii) the expiration of such 60-day period.

(b) The trustee and the secured party, lessor, or conditional vendor, as the case may be, whose right to take possession is protected under subsection (a) of this section may agree, subject to the court's approval, to extend the 60-day period specified in subsection (a)(1) of this section.

40 Id. § 402(a), 92 Stat. 2682.


42 See U.C.C. §§ 2-313-2-318.
because the lease in question was regarded as essentially a sale; and (ii) cases in which courts have imposed strict liability on lessors of equipment without regard to fault. With respect to claims by a carrier, such problems can be adequately covered by the use of well-drafted warranty disclaimers, indemnities and no-set-off clauses. With respect to third party liability, however, the problem is more complicated.

The adoption of § 504 of the Federal Aviation Act of 1958, as amended, has substantially limited the risk that lessors and secured parties will be held liable for injuries to and death of persons or damage to or loss of property within the United States:

No person having a security interest in, or security title to, any civil aircraft, aircraft engine, or propeller under a contract of conditional sale, equipment trust, chattel or corporate mortgage, or other instrument of similar nature, and no lessor of any such aircraft, aircraft engine, or propeller under a bona fide lease of thirty days or more, shall be liable by reason of such interest or title, or by reason of his interest as lessor or owner of the aircraft, aircraft engine, or propeller so leased, for any injury to or death of persons, or damage to or loss of property, on the surface of the earth (whether on land or water) caused by such aircraft, aircraft engine, or propeller, or by the ascent, descent, or flight of such aircraft, aircraft engine, or propeller or by the dropping or falling of an object therefrom, unless such aircraft, aircraft engine, or propeller is in the actual possession or control of such person at the time of such injury, death, damage, or loss.

Although § 504 provides substantial comfort to lessors and secured parties with respect to claims subject to the jurisdiction of United States courts, there is no comparable international treaty or convention. Aircraft may be operated in other countries which may impose strict or vicarious liability on persons holding interests in aircraft.

43 For collected cases in which the courts have dealt with the question of the application of Article Two of the U.C.C. to leases, see Annot., 48 A.L.R.3d 668 (1973).


45 49 U.S.C. § 1404 (1976). Compare U.C.C. § 9-317, which is apparently derived from § 12 of the prior Uniform Trust Receipts Act: "The mere existence of a security interest or authority given to the debtor to dispose of or use collateral does not impose contract or tort liability upon the secured party for the debtor's acts or omissions."
Although the potential tort liability of lessors and secured parties is a matter of concern, the problem is normally resolved in a very practical fashion. Leases and security agreements in major aircraft transactions will uniformly contain comprehensive indemnities by the carrier and will require that the carrier maintain adequate public, passenger and property damage liability insurance, naming the lessor or secured parties as additional insureds.

c. Asset Financing of Aircraft Acquired by Foreign Carriers—Some Special Problems.

Although asset financing of aircraft is most common in the United States, in recent years foreign carriers have made increasing use of leases and secured transactions in financing their aircraft. A major portion of such transactions has involved United States lenders and lessors, often in cooperation with European and Japanese financial institutions. While it is not possible to generalize with respect to foreign financing transactions, which must conform to the laws of individual countries, some issues in international aircraft transactions should be noted:

(1) *Form of Transaction.* Normally, a lease or security interest should be valid and perfected under the law of the country in which the carrier is certified. In most cases, this requires that the instrument creating or evidencing the interest of the lessor or secured party in the aircraft comply with the formal and substantive requirements of the law of that country. As a matter of local conflicts law, it may be possible to provide that the obligations under a lease or obligations which are secured by a security interest will be governed by the law of another jurisdiction (such as New York); in some countries, it may also be possible to specify the application of such law for leases and (less commonly) for security instruments as well. In such cases, the parties should be satisfied that the documents will indeed be enforceable under the local law (as well as under the governing law), which may require that they contain substantive provisions conforming to local requirements and policies.

Leases are generally recognized throughout the world. The forms of secured transactions, however, will vary from country to country and may include chattel mortgages or equivalents such as the hypotheque and *gage sans depossession*, title-retention devices
such as conditional sale contracts and hire purchase agreements, or floating charges applicable to the carrier and its assets generally. In some countries, alternative forms will be available; in others, one or more devices may be unknown. In some countries, it may even be questionable whether adequate nonpossessory security interests in aircraft are feasible.

(2) Indebtedness Secured. The laws of some countries may place limitations on the indebtedness and obligations which may be secured. For example, a security interest may secure only principal and unpaid interest accrued for a specified and limited period. Further, the security instrument may have to specify the amounts secured or at least establish a "reasonable" limit on such amounts. Amounts not capable of determination at the time the instrument is registered (such as expenses and additional interest charges) may not be fully secured.

(3) Scope of Property Interest. The extent of an ownership or security interest in aircraft and related property may be a problem. Obviously such an interest should cover the aircraft, its components, and substitutions and accessions thereto which are owned by the airline. A security interest might not, however, continue to apply to engines and other equipment removed from an aircraft (at least for more than a "temporary" period). The laws of many countries do not provide for individual registration or recordation of engines by serial number, but rather treat the engines as com-

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46 For a comprehensive and pioneering review of the subject of aircraft security in North and South America, see S. Bayitch, AIRCRAFT MORTGAGE IN THE AMERICAS (1959). For a more contemporary examination of aircraft security interests in Europe, see Kaplan, Legal Aspects of Aircraft Finance in Europe, 9 J. WORLD TRADE L. 136 (1975).

47 See, e.g., The Convention on the International Recognition of Rights in Aircraft, Article V, done June 19, 1948, 4 U.S.T. 1830, T.I.A.S. No. 2487, 310 U.N.T.S. 151 [hereinafter cited as Mortgage Convention] which provides that, for purposes of the Mortgage Convention, "the amount of interest included shall not exceed that accrued during the three years prior to the execution proceedings together with that accrued during the execution proceedings." The French Civil Aviation Code Article L.122-10 appears to limit coverage of an aircraft mortgage to three years accrued interest plus the "current year."

48 Article XVI of the Mortgage Convention, supra note 47, defines aircraft to include "the airframe, engines, propellers, radio apparatus, and all other articles intended for use in the aircraft whether installed therein or temporarily separated therefrom." (emphasis added.) Many national mortgage laws which have adopted the principles of the Mortgage Convention use similar language. See, e.g., French Civil Aviation Code, Art. L. 122-1.
ponents of the aircraft. Engines for wide-body aircraft may cost as much as $2 million each and, therefore, will represent a substantial part of the collateral. Pooling agreements are common among international carriers. Thus, a situation could occur in which all of an aircraft's original engines are installed in aircraft operated by other airlines throughout the world, and the debtor's aircraft is equipped solely with engines owned by third persons. In such a case, the secured party may not have an enforceable interest in either set of engines.

Local law may permit a "fleet mortgage" covering more than one aircraft, or it may require that separate instruments apply to each aircraft. In addition, it may not be possible to obtain a satisfactory security interest in spare parts under the laws of some countries. If such an interest can be obtained, the secured party may be required to segregate and exercise administrative control over the parts, a requirement which may be costly and impractical.

(4) Preferred Claims. Although a lease or security interest may be validly created and perfected, the rights of an owner or secured party may be subject to other claims having priority under local law. Typical of such preferred claims are claims by laborers and materialmen, salvage claims, taxes, and claims for property damage and personal injury arising out of operation of the aircraft.

(5) Government Approvals. The transaction may require specific approvals from one or more government agencies. Typical requirements include (in addition to those required for certification and operation of the aircraft): (i) approvals by the national aeronautics authority (or other agency with jurisdiction over the carrier) of the acquisition by the carrier of the aircraft and the existence of any ownership or security interests retained or created in favor of a lessor or secured party, (ii) approval by the fiscal authorities, ministry of finance (or equivalent) of the financial obligations to be incurred by the carrier in connection with the transaction, and (iii) foreign exchange approvals and assurances with respect to payment in United States dollars of the carrier's obligations under the agreements. If approvals are required, experience suggests they will usually take longer to obtain than estimated.

(6) Citizenship. If the transaction involves a lease or title-retention agreement under which the secured party is regarded as the owner, it may be difficult to register the aircraft and record
the interest of the lessor or vendor therein. As is generally the case in the United States, many other countries permit aircraft to be registered only by citizens.\(^4\) Although exceptions may be made in some cases by decree or administrative ruling, in some countries such transactions cannot be concluded if they involve foreign ownership.

(7) Enforcement. Enforcement of a lease or security agreement after default is a major concern. Many foreign jurisdictions do not permit self-help remedies, but rather require that foreclosure, repossession or other enforcement action be taken only under judicial auspices. Summary procedures may not always be readily available, even for egregious breaches such as failure to maintain insurance. In addition, procedural delays are not unique to the United States; in some countries it may take months or years to accomplish repossession and/or sale of an aircraft. If an aircraft is distrained during judicial proceedings, there may be no procedure for keeping the aircraft productively employed to offset its custodial costs.

(8) Sovereign Immunity. Since most foreign airlines are government-owned, there is often concern that they may be entitled in an enforcement proceeding to raise the defense of sovereign immunity. As a general rule, the conduct of air commerce by airlines and the purchase and financing of aircraft by them are considered to be commercial transactions. Accordingly, the defense of sovereign immunity is unlikely to prevail in most countries.\(^5\) It is of course customary to obtain waivers of sovereign immunity and an agreement on the part of the carrier to subject itself to the jurisdiction of the courts of a specified jurisdiction. A related de-

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\(^4\) The basic United States citizenship requirements of the FAA have been modified by amendments to § 501(b) of the Act. Act of November 9, 1977, Pub. L. No. 95-163, § 14, 91 Stat. 1253; Act of March 8, 1978, Pub. L. No. 95-241, 92 Stat. 119. Section 501(b) is discussed in the text accompanying notes 70 through 80 infra.

fense which might be raised by a foreign airline is that the enforcement of a lease or a security interest will violate public policy since it interrupts national air service which the carrier is mandated by law to provide.

(9) **Currency Exchange Problems.** Foreign transactions may raise complex currency exchange problems if payments are to be made in United States dollars or currencies other than that of the country in which the aircraft is registered. If the underlying obligation is enforced in a local court, local law may require that judgment be rendered in the national currency and not in foreign currencies. In addition, the law governing the creation or perfection of security interests in a foreign jurisdiction may require that the agreements specify, in local currency, the amount of the indebtedness secured. Further, if a security interest is foreclosed, the proceeds of sale may be received or converted into local currency prior to distribution to the creditor. Each of the foregoing may result in exchange losses if currency fluctuations occur after the date the exchange rate is established.

(10) **Doing Business.** Problems of doing business are common to any international transaction. The existence of an ownership or security interest in an aircraft registered in another country may alone or in combination with other activities of a lessor or secured party subject such person to the jurisdiction of local courts, require registration or result in the imposition of taxes.

(11) **Political Risks.** The transaction may present political risks—either in the country in which the aircraft is registered or in those to which it will be customarily operated. Such risks, which are often a factor in international transactions, may be magnified by the presence of the collateral in such jurisdictions. In addition to risks of war and hijacking, which can be covered by commercial war risk insurance, they include risks of requisition, nationalization, expropriation or confiscation, nonconvertibility of local currencies into dollars and action or inaction on the part of governmental authorities preventing or delaying the realization of the creditor's rights of repossession and export of the assets from the jurisdiction.

Coverage against many of these risks is often available to exporters in foreign countries from agencies of their governments.
The Export-Import Bank of the United States has in the past offered certain political risk coverage (usually in conjunction with other credit or guarantee programs), but presently does not appear to have an active program independently providing political risk insurance for major aircraft transactions.\textsuperscript{1} It is not uncommon for lenders and lessors to obtain an endorsement to the standard Lloyds aviation war-risk hull policy covering certain risks of governmental confiscation, nationalization, seizure, restraint, detention, appropriation and requisition for title or use. This confiscation endorsement, however, usually excludes from such coverage the state in which the aircraft is registered. Commercial coverage against the risk of confiscation by the "flag" state and other political risks is available in the London market on a specialized basis, but is expensive.

(12) Leases of United States Registered Aircraft. A number of lease financings have involved the lease to foreign carriers of aircraft registered in the United States. In some of these transactions, the lease rates have reflected the use by American owner-participants of the tax benefits provided by the investment tax credit and depreciation deductions. Although investment tax credit benefits are normally available only to property which is not used predominantly outside the United States,\textsuperscript{2} an exception is made for aircraft registered with the FAA.\textsuperscript{3} A major complication in such transactions is that the carrier must comply with or obtain waivers with respect to United States regulatory requirements relating to the maintenance and operation of the aircraft, crew

\textsuperscript{1} See note 62 \textit{infra}, and accompanying text.

\textsuperscript{2} I.R.C. § 48(a)(2)(A). In general, property is used predominantly outside the United States if it is physically located outside the United States during more than 50% of the taxable year. Treas. Reg. § 1.48-1(g)(1)(i) (1979); see Rev. Rul. 71-178, 1971-1 C.B. 6 for rules relating to aircraft.

\textsuperscript{3} See I.R.C. § 48(a)(2)(B)(i). Treas. Reg. § 1.48-1(g)(2)(i) (1979) sets forth the requirement that an aircraft return to the United States with "some degree of frequency". Rev. Rul. 73-367, 1973-2 C.B. 8 suggests that the regular return of an aircraft approximately once every two weeks complies with the "some degree of frequency" test. Note also that, in a lease to a foreign airline, the income of the lessor may be foreign-source income within the meaning of I.R.C. § 862, thus causing the deductions applicable to the lessor's interest in the lease to be allocated to foreign-source income, and thereby potentially affecting the foreign tax credit available to the lessor. See I.R.C. § 904(a). For the availability of a special election to treat income from aircraft as U.S. source income (an election not available where the lessee is not a United States citizen), see I.R.C. § 861(e).
American lessors and lenders are accustomed to relative certainty in asset financing. Certainty may not be possible in other countries; even though they may have laws providing for the creation and registration of interests in aircraft, they may have little or no experience and few commentaries or other legal guidance to interpret the ambiguities and uncertainties that exist with any statute. Further, there may be little or no statutory or other legal provision for, or judicial or administrative experience with, enforcement of leases or security interests. Counsel in such countries may be unable to provide answers to questions with the assurance that American financiers have come to expect. A transaction which may be prudent as a practical matter may not, in fact, be consummated unless the legal uncertainties are resolved.

4. FAA Guaranteed Loans.

In 1957, Congress authorized the Civil Aeronautics Board to guarantee loans made to certain local or feeder air carriers for the purchase of commercial transport aircraft. Under the Aircraft Loan Guarantee Program which is now administered by the FAA, guarantees were limited to 90 percent of the unpaid principal, plus interest, of eligible loans. Eligible loans could not exceed 90 percent of the purchase price of the aircraft and spare parts and the repayment period could not be more than ten years. Outstanding loans to any one carrier which were guaranteed by the FAA could not exceed $30 million. The FAA's authority, which was utilized intermittently, expired in September, 1977. By that time, the Aircraft Loan Guarantee Program had provided guarantees for more than $300 million in loans to eligible carriers, including a number


55 Act of September 7, 1957, Pub. L. No. 85-307, 71 Stat. 629. These functions of the Civil Aeronautics Board under the FAA Act were transferred to the Secretary of Transportation by the Department of Transportation Act, Pub. L. No. 89-670, § 6(d), 80 Stat. 931 (1966). 49 C.F.R. § 1.47(e) (1978) delegates the Secretary of Transportation's authority to the Administrator of the FAA. The FAA's regulations implementing the FAA Act are set forth in 14 C.F.R. § 199 (1978). The FAA typically has required as a condition to its guarantee that such loans be secured by a first priority security interest in the aircraft.
of major regional airlines.  

Section 42 of the Airline Deregulation Act of 1978 reinstated, for a period of five years following enactment, the FAA's authority to guarantee loans for the purchase of modern aircraft and equipment. The act expanded the categories of eligible carriers to include charter, intrastate and commuter air carriers, extended the repayment term of guaranteed loans to fifteen years and increased the maximum amount of guaranteed loans to any one carrier to $100 million. The FAA has indicated that, in conformity with administration policy emphasizing air service to smaller communities, priority will be given to applications for guarantees from commuter air carriers.

5. Eximbank Financing.

Eximbank is an independent United States government agency whose statutory purpose is to provide support for the financing of exports and imports of goods and services between the United States and foreign countries. Historically, Eximbank has participated in financing a major portion of United States manufactured aircraft purchased by foreign air carriers.

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59 12 U.S.C. § 635(b)(1)(A) (1976) states that:

It is the policy of the United States to foster expansion of exports of . . . goods and services, thereby contributing to the promotion and maintenance of high levels of employment and real income and to the increased development of the productive resources of the United States. To meet this objective, the Export-Import Bank is directed, in the exercise of its functions, to provide guarantees, insurance, and extension of credit at rates and on terms and other conditions which are competitive with the Government-supported rates and terms and other conditions available for the financing of exports from the principal countries whose exporters compete with United States exporters. . . .

60 Eximbank has played a crucial role in supporting exports of United States manufactured aircraft. For example, during 1977, Eximbank authorized approximately $1.2 billion in long-term direct credits and financial guarantees; more than 36% was for commercial jet aircraft. 1977 Annual Report of Export-Import Bank of the United States, at 6. During the period from 1968 through 1977, Eximbank participated in approximately $6.7 billion (or 66%) of Boeing's commercial export sales of aircraft and related equipment and services. Study furnished by The Boeing Company to the author. Eximbank's support is
Eximbank provides a wide range of services for United States exporters under short-term (up to 180 days), medium-term (181 days to five years) and long-term (five years and longer) programs.\footnote{For descriptions of Eximbank's programs, see Export-Import Bank of the United States, \textit{Export Financing for American Exporters, Overseas Buyers, Banks} (April 1978); see also Export-Import Bank of the United States, \textit{Eximbank Programs}, Vol. II (Sept. 1973).} The coverage of these programs includes insurance and guarantees against commercial credit risks and political risks, a discount loan program, direct loans and financial guarantees. Many Eximbank services for smaller value exports are provided in conjunction with the Foreign Credit Insurance Association, a group of leading United States casualty and property insurance underwriters.

For commercial aircraft exports, Eximbank provides two major forms of financing support: (1) direct loans to foreign carriers and (2) guarantees of loans made by commercial lenders. In each case, Eximbank's policy is to encourage participation by banks and other commercial lenders in export financing and to make its own participation available as a supplement to financing provided by private sources.

It is the author's understanding that Eximbank's current loan and guarantee policies for commercial aircraft include the following principles:

(a) Loans in which Eximbank participates (as a lender or guarantor) may be made for up to 85 percent of the price of an equipment package (aircraft and related spare parts, support equipment and services). The borrower must pay 15 to 20 percent of the price from its own resources or from the proceeds of unrelated loans.

(b) The loan term for new aircraft is ten years from date of delivery of the aircraft. For used aircraft, the loan term is seven to eight years. Loan payments are typically made in semiannual installments commencing six months after delivery.

(c) The loans must be unconditionally guaranteed by host gov-
not limited to the export of new aircraft; during the period from 1970 to September 1977, Eximbank participated in the financing of 130 used aircraft with a total value of over $636 million sold by U.S. carriers. \textit{To Amend and Extend the Export-Import Bank Act of 1945: Hearings on H.R. 11384 Before the Subcomm. on International Trade, Investment and Monetary Policy of the House} (statement of J. B. L. Pierce); \textit{Export Policy Hearings Before the Subcomm. on International Finance Comm. on Banking, Housing and Urban Affairs, 95th Cong., 2d Sess. 562} (1978) (statement of J. B. L. Pierce).
ernments or central banks, except in unusual circumstances. Commercial lenders or Eximbank may in some circumstances require a security interest in the aircraft or other property in addition to the guarantee. Eximbank has not been willing, historically, to rely solely on security interests in lieu of acceptable guarantees.

(d) If Eximbank makes a direct loan, the interest rate currently ranges from 8-3/8 to 9 percent per annum depending on the term of the loan and the commitment period. If Eximbank provides a guarantee, it will charge a guarantee fee of 1/2 to 1 percent per annum. In either case, the borrower will also be required to pay a commitment fee.

(e) The form of Eximbank's participation will depend upon the type of aircraft involved and the degree of competition offered by manufacturers and sellers of foreign-built aircraft. In general, if the aircraft is of a type which is in direct competition with an aircraft offered by a foreign manufacturer, *i.e.*, short and medium range aircraft, Eximbank may participate by directly loaning up to 42-1/2 percent of the price of the equipment package, representing the later maturities of the loans. The balance of the financing will be provided by commercial lenders who will take the early maturities. If the transaction requires, Eximbank may provide a guarantee of all or a portion of the commercial bank loan. On the other hand, if the aircraft is a type which is not subject to direct foreign competition, *e.g.*, long-range aircraft, the loans will be made by commercial lenders, with Eximbank providing a guarantee of the later maturities for up to 30 percent of the price of the equipment package.

If foreign competition is severe, Eximbank is prepared to vary the amount, form and terms of its participation as necessary to meet the competition.

In the past Eximbank offered two additional programs in support of aircraft exports. The first was a lease guarantee program providing guarantees of payment against certain credit and/or political risks to lessors of equipment leased outside the United States. The second was a guarantee against certain political risks associated with security interests and lessors' interests in equipment located in another country, including the risks of war, expropriation and confiscation, nonconvertibility of currencies and inability to enforce the security interest or lease by reason of action or inaction on the part of the government of that country. Neither program was actively promoted or used, and both appear to be dor-

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AIRCRAFT FINANCING

mant at this time, although Eximbank may be willing to provide such coverage in connection with transactions it guarantees or in which a full credit guarantee is provided by the host government. Each program would provide a valuable service to United States exporters; with respect to political risk insurance, in particular, foreign competitors of United States lenders and exporters appear to be more readily able to obtain such coverage from agencies of their respective governments.

6. Private Export Funding Corporation (PEFCO).

PEFCO is a private corporation established in 1970 and owned by fifty-four commercial banks, seven industrial corporations and one investment banking firm. Its principal purpose is to make loans to public and private borrowers located outside the United States who require medium and long-term financing for the purchase of United States goods and services. The principal of and interest on all of its loans must be unconditionally guaranteed by Eximbank. PEFCO raises funds by selling its debt obligations in the public markets through major securities underwriters; it also has available a line of credit from Eximbank.

PEFCO typically participates as one of a group of lenders which includes one or more commercial banks and Eximbank (acting as a guarantor and often as another lender). PEFCO's share of individual loans ranges from 8 percent to 45 percent of the total; it usually takes the latter maturities that are payable after the commercial bank loans.

PEFCO's interest rates are based in part on its cost of money at the time of PEFCO's offer to the borrower and have varied from 7-1/4 percent to 10 percent per annum. The borrower pays commitment fees and Eximbank's guarantee fees. Since PEFCO relies on Eximbank guarantees, its loan covenants are generally identical to those required by Eximbank.

IV. PERFECTION AND RECOGNITION OF INTERESTS IN AIRCRAFT

As the preceding survey confirms, asset-financing has played and will in the future play an increasingly important role in the acqui-

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sition of aircraft by United States and foreign carriers. Asset-financing of mobile goods like aircraft is feasible only if financial institutions providing the money have confidence that the security accorded by ownership and security interests in aircraft will be respected against competing claims. The prevalence of aircraft asset-financing in the United States is due in large part to the existence of a flexible, sophisticated and uniform body of law governing the creation and validity of interests in personal property generally and to the confidence and relative certainty engendered by a national system for the perfection and recordation of interests in aircraft.

The following discussion: (i) examines some of the principal features of the federal system for registration of aircraft and for recordation of interests in aircraft and related equipment established by the Federal Aviation Act of 1958, as amended, (the FAA Act), (ii) considers the substantive provisions of state law (including the UCC) governing the creation and priority of interests in personal property and (iii) considers the extent to which interests in aircraft perfected in one country will be recognized in other countries under principles of international law, with particular emphasis upon the Convention on the International Recognition of Rights in Aircraft (the Mortgage Convention).

A. Registration of Aircraft.

1. Registration. Title V of the FAA Act establishes two related filing systems applicable to all civil aircraft of the United States: a system for registration of aircraft and a system for recordation of conveyances affecting title to and interests in aircraft. Registration serves a number of governmental purposes not directly related to the validity or perfection of property interests in aircraft, including identification, operation, navigation, safety and taxation. Registration of an aircraft with the FAA does not by itself perfect title to or any security interests in such aircraft. Indeed, the FAA Act provides that while registration is conclusive evidence of nationality for international purposes, registration is not evidence of

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64 49 U.S.C. § 1301 et seq. (1976); 14 C.F.R. §§ 47 and 49 (1979) set forth the regulations issued by the FAA with respect to registration of aircraft and recordation of conveyances pursuant to the FAA Act.

ownership in any proceeding in which ownership is an issue. Registration is, however, a prerequisite to perfecting interests in aircraft by recording.

An aircraft must be registered in the name of its owner. The term "owner" is not defined in the FAA Act. For purposes of registration, the FAA will treat a qualifying trustee and "a buyer in possession, a bailee, or a lessee of an aircraft under a contract of conditional sale" as the owner of an aircraft.

2. Citizenship. Section 501 (b) of the FAA Act provides that:

An aircraft shall be eligible for registration if but only if—

(1) (A) it is—

(i) owned by a citizen of the United States or by an individual citizen of a foreign country who has lawfully been admitted for permanent residence in the United States; or

(ii) owned by a corporation (other than a corporation which is a citizen of the United States) lawfully organized and doing business under the laws of the United States or any State thereof so long as such aircraft is based and primarily used in the United States; and

(B) is not registered under the laws of any foreign country.

Section 101 (16) defines a "citizen of the United States" as:

(a) an individual who is a citizen of the United States or of one

68 49 U.S.C. § 1401(f) (1976) provides: "Such certificate shall be conclusive evidence of nationality for international purposes, but not in any proceeding under the laws of the United States. Registration shall not be evidence of ownership of aircraft in any proceeding in which such ownership by a particular person is, or may be, in issue." Chapter III of the Chicago Convention on International Civil Aviation, December 7, 1944, 61 Stat. 1180, T.I.A.S. No. 1591, 15 U.N.T.S. 295 (governing the nationality of aircraft) provides that (i) aircraft have the nationality of the state of registration, (ii) aircraft may not hold dual registration, and (iii) the law of the state of registration governs registration and the transfer of registration. Chapter V requires that aircraft operated in another state must carry registration and airworthiness certificates, crew licenses and radio licenses, duly issued by the state of registration. The Chicago Convention is the basic international agreement governing international civil aviation and has been almost universally adopted.

67 49 U.S.C. §§ 1401(a) and 1403(a) (1976). Conversely, the FAA Act does not require registration of an aircraft unless it is operated.

68 See 14 C.F.R. § 47.11(h) (1979). See also the FAA's proposed amendments to 14 C.F.R. § 47 discussed at note 78 infra with respect to the qualification of trustees.

69 14 C.F.R. § 47.5(c) (1979).


of its possessions, or (b) a partnership of which each member is such an individual, or (c) a corporation or association created or organized under the laws of the United States or of any State, Territory, or possession of the United States, of which the president and two-thirds or more of the board of directors and other managing officers thereof are such individuals and in which at least 75 per centum of the voting interests is owned or controlled by persons who are citizens of the United States or of one of its possessions."

Prior to the 1977 and 1978 amendments to Section 501(b), only United States citizens were eligible to register aircraft in this country. The amendments now formally permit registration of aircraft by permanent resident aliens and by corporations which do not otherwise qualify as citizens of the United States, but which are organized and doing business in this country, so long as the aircraft are based and primarily operated in this country."

Issues relating to citizenship have arisen in the past and will continue to arise with respect to certain leases of aircraft which are intended to be registered with the FAA:

(1) If a United States registered aircraft is leased to a foreign carrier, it is apparent that the lease cannot contain purchase options or other terms which would cause it to be characterized as a

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72 Determining whether 75% of the voting shares in a large publicly held corporation are owned or controlled by United States citizens is a difficult task. There is no statutory or regulatory FAA counterpart to the elaborate provisions of the "fair inference rule" adopted by the Maritime Administration in 46 C.F.R. § 355.2 (1978). This regulation has engraved in stone the holding in Collier Advertising Serv., Inc. v. Hudson River Day Line, 14 F. Supp. 335 (S.D.N.Y. 1936), aff'd, 93 F.2d 457 (2d Cir. 1937), by requiring that a domestic corporation prove that 95% of its shareholders are recorded on its books with United States addresses in order to establish that 75% of the shares of a corporation are owned by United States citizens. While the Maritime Administration's codification of the rule may be severe, in any judicial or other proceeding in which the citizenship of a corporation is at issue, some reasonable variation of the fair inference rule may well be applicable.

73 See Immigration and Nationality Act of 1972, 8 U.S.C. § 1101(15) and (20) (1976), which defines "lawfully admitted for permanent residence" as the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant. See also 8 C.F.R. § 101.3 (1979).

74 The FAA has recently proposed to amend Part 47 of the FAA Regulations to provide that an aircraft will be "based and primarily used in the United States" if 60% of total flight hours accumulated within any 180-day period are flown within the United States (including hours accumulated in flight over non-United States territory in the course of flight from one point in the United States to another). Proposed § 47.9, 44 Fed. Reg. 67 (1979).
conditional sale.\textsuperscript{25} If it is a conditional sale, the foreign citizen will be regarded as the owner and the aircraft will be ineligible for registration.

(2) A foreign-owned aircraft cannot be leased to a United States carrier for operation on its routes unless it can be registered with the FAA.\textsuperscript{26} It would appear that under the recent amendments to the FAA Act, if a foreign owner were to transfer ownership of an aircraft to a United States subsidiary qualified under Section 501(b)(1)(A)(ii), the subsidiary could register the aircraft and lease it to a carrier with domestic routes which could permit it to meet the requirement that the aircraft be based and primarily used in the United States.\textsuperscript{27}

(3) The citizenship requirements of the FAA Act restrict the participation by foreign investors in lease financing of United States registered aircraft. Under current FAA practice, an aircraft owned by a trustee (who qualifies as a citizen or individual permanent resident alien) for beneficiaries, of whom one or more are non-citizens (or qualifying alien residents) may be registered if the terms of the trust comply with FAA requirements restricting

\textsuperscript{25} 49 U.S.C. § 1301(19) (1976) defines a conditional sale as:
(a) any contract for the sale of an aircraft, aircraft engine, propeller, appliance, or spare part under which possession is delivered to the buyer and the property is to vest in the buyer at a subsequent time, upon the payment of part or all of the price, or upon the performance of any other condition or the happening of any contingency; or (b) any contract for the bailment or leasing of an aircraft, aircraft engine, propeller, appliance, or spare part, by which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to the value thereof, and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming, the owner thereof upon full compliance with the terms of the contract. The buyer, bailee, or lessee shall be deemed to be the person by whom any such contract is made or given.

\textsuperscript{26} See 49 U.S.C. § 1401(a) (1976). Of course, if the “lease” is actually a conditional sale, the United States carrier, as the owner, would be eligible to register the aircraft.

\textsuperscript{27} Citizenship problems relating to leases to American carriers arise in short-term leases proposed by foreign carriers. If an aircraft could not qualify as being based and primarily used in the United States because of operation outside the United States, it is still possible that it could be registered by transferring ownership from the foreign owner to a subsidiary of the foreign owner, provided that the subsidiary qualifies as a United States citizen corporation by reason of 75% of its voting interest being subject to an FAA-approved voting trust. The FAA’s proposed regulations (proposed § 47.7(e), 44 Fed Reg. 67 (1979)) appear to reflect, in general, its current practices in this regard.
exercise of control by non-citizens (or qualifying alien residents). Although the owner of a United States aircraft must qualify under the requirements of Section 501(b), the FAA Act does not require that mortgagees and holders of security interests in United States registered aircraft be United States citizens or otherwise be eligible under Section 501(b). 79

If an aircraft’s registration is invalid, one possible consequence is that security interests or other interests in the aircraft recorded under the FAA Act might not be validly perfected and therefore might be subject to other claims. An aircraft is ineligible for FAA registration if, for example, it is not registered in the name of the “owner,” if it is not actually owned by a U.S. citizen (or permanent resident alien), or if it is registered in another country. Under such circumstances the FAA registration would be invalid.80

3. Engines.

In addition to the registration system for aircraft, the FAA Act authorizes the FAA to establish “regulations for registration and identification of aircraft engines, propellers and appliances, in the interest of safety.” 81 The FAA has not established such regulations, however, and no registration system exists comparable to that for aircraft.

B. Recordation of Title to and Interests in Aircraft.

Section 503 of Title V of the FAA Act establishes a comprehensive, but incomplete, recording system for conveyances and instruments affecting interests in aircraft and related equipment.82

78 In the FAA’s proposed amendments to Part 47 of the FAA Regulations, 44 Fed. Reg. 63 (1979), the FAA takes the position that a trustee cannot be subject to direct or indirect control by persons who are not citizens or qualifying aliens and that at least 75% of the aggregate power of the beneficiaries of the trust “to give direct to, or effect removal of,” the trustee must remain vested in United States citizens or qualifying aliens. Id. at 65, 66-67.

79 Compare the stringent citizenship requirements of 46 U.S.C. §§ 835 and 961, related to shipping and ship mortgages.

80 See 14 C.F.R. § 47.43 (1979).


82 49 U.S.C. § 1403 (1976) provides in part:

(a) The Secretary of Transportation shall establish and maintain a system for the recording of each and all of the following:

(1) Any conveyance which affects the title to, or any interest in, any civil aircraft of the United States;
Professor Gilmore has aptly observed that the provisions in Title V of the FAA Act "amount to a good deal more than a recording system . . . but are still a good deal less than a comprehensive coverage of security interests in aircraft." In contrast, the detailed provisions of the Ship Mortgage Act, as well as the comprehensive

(2) Any lease, and any mortgage, equipment trust, contract of conditional sale, or other instrument executed for security purposes, which lease or other instrument affects the title to, or any interest in, any specifically identified aircraft engine or engines of seven hundred and fifty or more rated takeoff horsepower for each such engine or the equivalent of such horsepower, or any specifically identified aircraft propeller capable of absorbing seven hundred and fifty or more rated takeoff shaft horsepower, and also any assignment or amendment thereof or supplement thereto;

(3) Any lease, and any mortgage, equipment trust, contract of conditional sale, or other instrument executed for security purposes, which lease or other instrument affects the title to, or any interest in, any aircraft engines, propellers, or appliances maintained by or on behalf of an air carrier certificated under section 1424(b) (§ 604(b)) of this title for installation or use in aircraft, aircraft engines, or propellers, or any spare parts maintained by or on behalf of such an air carrier, which instrument need only describe generally by types the engines, propellers, appliances, and spare parts covered thereby and designate the location or locations thereof; and also any assignment or amendment thereof supplement thereto.

(c) No conveyance or instrument the recording of which is provided for by subsection (a) of this section shall be valid in respect of such aircraft, aircraft engine or engines, propellers, appliances, or spare parts against any person other than the person by whom the conveyance or other instrument is made or given, his heir or devisee, or any person having actual notice thereof, until such conveyance or other instrument is filed for recordation in the office of the Secretary of Transportation.

(d) Each conveyance or other instrument recorded by means of or under the system provided for in subsection (a) or (b) of this section shall from the time of its filing for recordation be valid as to all persons without further or other recordation, except that an instrument recorded pursuant to subsection (a)(3) of this section shall be effective only with respect to those of such items which may from time to time be situated at the designated location or locations and only while so situated: Provided, That an instrument recorded under subsection (a)(2) of this section shall not be affected as to the engine or engines, or propeller or propellers, specifically identified therein, by any instrument theretofore or thereafter recorded pursuant to subsection (a)(3) of this section.

83 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 423 (1965).

system for secured transactions established by Article 9 of the UCC, are essentially complete in themselves. The FAA Act, however, establishes a national filing system, superseding state recording procedures; although it contains some substantive provisions, it is dependent upon state law for the creation and validity of substantive rights in aircraft.

Title V of the FAA Act raises numerous questions of interpretation. The statute and its predecessor have not received the benefit of definitive opinions by the Supreme Court. Accordingly, there remain significant uncertainties and conflicts, particularly with respect to priorities among competing interests and the relationship of the FAA Act to state law.

1. Recordation of Aircraft Conveyances.

Section 503(a)(1) applies broadly to any "conveyance" which "affects the title to, or any interest in" United States aircraft. A "conveyance" is defined in the FAA Act as "a bill of sale, contract of conditional sale, mortgage, assignment of mortgage, or other instrument affecting title to, or interest in, property." Section 503(a)(1) applies only to an interest in a "civil aircraft of the United States," a term that is defined as "any aircraft registered as provided in this chapter."

2. Engines, Propellers and Spare Parts.

Sections 503(a)(2) and (3) of the FAA Act are narrower than Section 503(a)(1) in that they apply only to leases and instruments executed for security purposes that affect the title to or interest in certain engines, propellers, appliances and spare parts. Unlike aircraft, there is no provision for recordation of title to

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85 Civil Aeronautics Act of 1938, ch. 601, § 503, 52 Stat. 1006.
89 49 U.S.C. § 1301(18) (1976). Neither the FAA Act nor the cases provide much assistance in determining what constitutes an aircraft. The definition in § 101(5) of the FAA Act (49 U.S.C. § 1301(5) (1976)) is not helpful. It would seem that the hull of an aircraft otherwise capable of flight, with or without engines, is within the definition.
such equipment.

a. Engines and Propellers. Section 503(a)(2) of the FAA Act permits the recordation of leases and security instruments against specifically identified engines capable of 750 or more rated takeoff horsepower and against specifically identified propellers capable of absorbing 750 or more rated takeoff horsepower. Interests in engines and propellers which do not meet requirements of Section 503(a)(2) but which are maintained as spare parts may be recorded under Section 503(a)(3). Section 503(d) provides that an interest in specifically identified engines and propellers recorded pursuant to Section 503(a)(2) will have priority over a competing interest in the same equipment recorded under Section 503(a)(3). 91

b. Spare Parts. Section 503(a)(3), the so-called "basket clause," providing for recordation of certain leases of and security interests in spare parts, is one of the least satisfactory parts of the FAA recording system. 92 It applies only to engines, propellers, appliances and spare parts maintained by or on behalf of an air carrier certificated under Section 604(b) of the FAA Act by the Civil Aeronautics Board. It does not apply to intrastate carriers or to operators of private or business aircraft. Further, the benefits of FAA recording are accorded to such property only while physically located at the locations specified in the recorded instrument. 93

3. Recordation of Conveyance and Interests.

Section 503 provides for the recordation of "conveyances" and "instruments." There is some authority that it applies only to consensually created interests or to claims created or evidenced by documentary instruments. 94 Certainly if there is a reasonable basis for concluding that a document is a conveyance or an instrument executed for security purposes that affects an interest in aircraft

93 Compare the parallel, but more complicated, provisions of Article X of the Mortgage Convention discussed infra at note 136.
or related equipment, consideration should be given to filing it. Airworthiness documents, inspection reports and similar documents which may have been inserted into the FAA aircraft file, however, are not conveyances and are not recordable as such.

The FAA Act and FAA Regulations also provide for filing of assignments, amendments and supplements, as well as releases, cancellations, discharges and satisfactions. Although the cases are divided in deciding whether an assignment of an aircraft lease is a conveyance and must be recorded, prudence suggests that such an assignment should be filed with the FAA as well as being perfected under Section 9 of the UCC by filing a financing statement and by taking possession of the lease.

Section 503 requires that the conveyance or instrument be filed; there is no counterpart to the simple notice filing adopted by the UCC. There has been some concern (fueled by memories of Draconian decisions under early state mortgage and conditional sale statutes) with respect to how complete the FAA record must be. The safest practice is to ensure that all fundamental provisions be incorporated in the recorded instrument and that all amendments and supplements be filed.

See International Atlas Serv., Inc. v. Twentieth Century Aircraft Co., 251 Cal. App. 2d 434, 59 Cal. Rptr. 495 (1967), cert. denied, 389 U.S. 1038 (1968), which held that the term “lease” under the FAA Act is broad enough to include a bailment of personal property.


See, e.g., 49 U.S.C. § 1403(b) (1976); 14 C.F.R. §§ 49.17(d) and (e), 49.55 (1979).


Under U.C.C. § 9-105(b), a lease is chattel paper. Any sale or transfer of the lessor's interest in a lease, whether or not for security purposes, is a transfer of a security interest. U.C.C. §§ 1-201(37) and 9-102(1)(b). The interest in the lease, the rentals and other obligations thereunder may be perfected by filing in the state in which the lessor has his principal place of business or executive offices, as well as by taking possession of the original copy of the lease (or if there is more than one signed copy, the copy that is distinctively endorsed, e.g., "Lessor's Copy"—with a statement in the agreement that only "Lessor's Copy" will constitute chattel paper). U.C.C. §§ 9-304(1) and 9-305. If possible, each copy of the lease should also be endorsed to identify the assignment.

U.C.C. § 9-402.
Section 503, while requiring the filing of conveyances affecting title or interests in aircraft, is not fully comprehensive. There is conflicting authority as to whether statutory liens created by state law are recordable, although the FAA apparently accepts documents evidencing such liens for recording. Further, FAA records will normally not disclose seizures, attachments, filings of bankruptcy petitions, or federal tax liens and ERISA liens which are filed elsewhere.

4. Effect of Recordation.

The operative paragraph of Section 503 is Section 503(c); it provides that no conveyance or instrument subject to recordation under the FAA Act "shall be valid . . . against any person other than the person by whom the conveyance or other instrument is made or given, his heir or devisee, or any person having actual notice thereof" until it is filed for recordation. The language of Section 503(c) is less than precise, particularly in its use of the term "valid" which is susceptible to several meanings. With respect to an interest in aircraft, "valid" can be read as referring to the perfection of the interest, to its enforceability or to its priority as against competing claims. The case law interpreting the section, although conflicting and confusing (particularly as to priorities) has made it clear that a failure to timely record an eligible document under the FAA Act can result in the subjection of the interest evidenced by such document to competing claims.

Under Section 503(d), recordation is effective from the time of filing, i.e., the time of receipt of the document by the FAA Aircraft Registry. While the UCC permits a secured party to pre-file a financing statement prior to the time that security interest attaches, no predelivery filing with the FAA of security instru-

\[101\] A proposed amendment to the FAA regulations setting forth a formal public procedure for recordation of such liens, 40 Fed. Reg. 2445 (1975), has not been adopted.

\[102\] 14 C.F.R. § 49.17(a) (1979); notices of federal tax liens are filed in accordance with § 6323(f) of the Internal Revenue Code of 1954. Liens imposed pursuant to the Employee Retirement Insurance and Security Act are required to be filed in the places designated for notices of federal tax liens. 29 U.S.C. § 1368 (1976).


\[105\] U.C.C. § 9-303.
ments in new aircraft is possible, because a bill of sale or other evidence of title to an aircraft must be filed with the application for registration prior to filing any security instrument. Accordingly, closings in major aircraft transactions commonly involve filing at the FAA Registry in Oklahoma City concurrently with delivery of the equipment.\textsuperscript{106}

5. Choice of Law

Section 506 of the FAA Act\textsuperscript{107} was adopted in 1964 to eliminate uncertainty concerning choice of law. It provides:

The validity of any instrument the recording of which is provided for by section 1403 [§ 503] of this title shall be governed by the laws of the State, District of Columbia, or territory or possession of the United States in which such instrument is delivered, irrespective of the location or the place of delivery of the property which is the subject of such instrument. Where the place of intended delivery of such instrument is specified therein, it shall constitute presumptive evidence that such instrument was delivered at the place so specified.\textsuperscript{108}

The section achieves certainty by arbitrarily applying the law of the place of delivery, whether or not such jurisdiction has any other connection with the transaction. It stresses formality over substance by requiring that the parties ensure that actual delivery of documents be made in the jurisdiction which they have chosen. It would have been preferable and less complicated to have permitted the parties to specify the governing law in the instrument\textsuperscript{109} and to have applied the law of the place of delivery only if the choice of law were not set forth in the instrument.

6. Federal and State Law; Preemption.

The boundaries between the federal recording system established by the FAA Act and substantive state law are not well defined.

\textsuperscript{106} It may well be possible to file instruments with respect to engines, propellers and spare parts under § 503(a)(2) and (3) of the FAA Act (49 U.S.C. § 1403(a)(2) and (3) (1976)), since there is no system for registration of title to such equipment. For a summary of the recording process from the FAA's point of view in 1972, see Robinson, The Aircraft Registry and Its Operation, 39 INS. COUNSEL J. 238 (1972).


\textsuperscript{108} Id.

\textsuperscript{109} Compare U.C.C. §§ 9-103 and 1-105, discussed infra at note 144.
It is clear from the language of the FAA Act and cases decided under it that Section 503 establishes an exclusive national recording system for conveyances, leases and security instruments affecting title to or interests in aircraft (including those used solely in intrastate commerce) and that the FAA Act preempts state filing requirements. Further, as a matter of state law, Sections 9-104 and 9-302 of the UCC (in carefully phrased language) preclude the application of the filing provisions of the UCC to security interests in property subject to the FAA Act's recordation requirements. On the other hand, it is reasonably clear that state law governs the creation and substantive "validity" of interests in aircraft and related equipment and that an instrument that is not valid under state law does not become effective merely because it is filed with the FAA. Between these two premises lies a troublesome "grey area". It results from conflicts between those decisions which hold that the priority accorded by FAA filing must prevail and those which defer to state priority rules.

7. Priority Questions.

Unlike the elaborate and specific priority rules of the UCC, Section 503 expressly states only two priority rules: (i) an unrecorded interest is accorded priority against the grantor or maker thereof, his "heir or devisee" and any other person with actual notice of the conveyance or instrument creating the interest; and (ii) an interest in specifically identified engines and propellers recorded under Section 503(a)(2) has priority over prior or subsequently recorded interests in such equipment under Section 503(a)(3), the spare parts "basket clause".

114 U.C.C. §§ 9-301 to 9-316.
115 49 U.S.C. § 1403(c) and (d) (1976).
The cases present a wide variety of fact situations involving contests between competing claimants in which neither has filed, both have filed or only one has filed. Generally, and subject to certain exceptions:

(1) A person acquiring an interest without knowledge of a prior unrecorded interest will prevail over the unrecorded interest.\(^{116}\)

(2) A recorded interest will have priority over an interest acquired subsequent to such recordation, whether or not the subsequent interest is recorded.\(^{117}\)

(3) Although the statute is not explicit, courts have logically interpreted the FAA Act as imposing a "race-notice" requirement; the first interest filed will prevail over a competing interest subsequently filed, regardless of when the interests were created. Thus, in a contest between two chattel mortgages in the same aircraft, the first to file prevailed, even though at the time the second obtained his chattel mortgage, the first mortgage was unrecorded and, under the FAA Act, could therefore be regarded as "not valid" \textit{at that time} as to the second mortgage.\(^ {118}\)

The principal issues which have divided courts have arisen in cases in which, under state law, perfected interests are nevertheless subordinated to the claims of certain categories of claimants, such as buyers in the ordinary course of business, bona fide purchasers, statutory lienholders and suppliers of accessories.

Under Section 9-307 of the UCC, a buyer in the ordinary course of business from a merchant takes free of a security interest in favor of a third party created by the seller even if such interest is perfected and the buyer has knowledge of its existence, as long as he is not aware that the sale is in violation of the third party's rights.\(^ {119}\)

The great majority of the cases which have considered issues involving buyers have concluded that (i) the recording provisions.

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\(^{117}\) See, e.g., Dawson v. General Discount Corp., 82 Ga. App. 29, 60 S.E.2d 653 (1950) (assignee of recorded conditional sale contract over subsequent purchaser of aircraft).


\(^{119}\) U.C.C. §§ 9-307(1) and 1-201(9).
of the FAA Act do not supersede the priorities accorded by state law under these circumstances, and (ii) since the buyer would prevail over a prior interest recorded under state law, he should also prevail over a prior interest recorded with the FAA (which is a national substitute for state filing provisions). A contrary result was reached by the California Supreme Court in *Dowell v. Beech Acceptance Corp.* In a controversial opinion, the court held that the policy of the FAA Act in favor of protecting the recorded interests must prevail over state priorities and that a security interest granted by a dealer in an aircraft and recorded with the FAA has priority over the rights of a subsequent buyer in the ordinary course of business, even though the buyer would have priority under state law. If a prior security interest has not been recorded, the buyer in the ordinary course has prevailed over the unrecorded prior security interest.

The decisions are also divided in their treatment of statutory liens. Section 9-310 of the UCC accords possessory liens priority over perfected interests unless the state lien statute provides otherwise. As noted, some cases have held that such liens are not "con-

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183 *See also* J. C. Equipment, Inc. v. Sky Aviation, Inc., 498 S.W.2d 73 (Mo. Ct. App. 1973) (buyer with "constructive notice" of federally recorded interests not a buyer in the ordinary course of business).

veyances” or “instruments” required to be recorded under the FAA Act and are entitled to priority accorded by state law without FAA recording. In a contrary group of cases, courts have held that the FAA Act preempts state priorities accorded by lien statutes and that unrecorded liens are subordinate to interests recorded with the FAA.

Priorities issues are also raised in connection with claims by suppliers who furnish components which become accessions to an aircraft subject to a security interest. UCC Section 9-314 generally accords priority to a supplier's unperfected security interest over a prior security interest if the supplier's interest attaches before installation of the component; if the supplier's interest attaches after installation, the prior security interest prevails.

Attaching creditors have generally not fared well against consensual interests in aircraft, often on the grounds that they obtain no better rights than those of the debtor.

C. Perfection of Interests in Aircraft Registered in Other Countries.

A United States lessor or secured party who has an ownership or security interest in an aircraft should ensure that the interest is valid under, and perfected in accordance with, the laws of the flag country in which the aircraft is registered. Even if an interest

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127 The priority is qualified in that a subsequent purchaser for value of an interest in the aircraft and a subsequent judicial lien creditor, without notice of the supplier's interest, will have priority, and a creditor with a prior perfected security interest who makes subsequent advances without knowledge of the supplier's statement will also have priority. U.C.C. § 9-314(3). But see, International Atlas Serv., Inc. v. Twentieth Century Aircraft Co., 251 Cal. App. 2d 434, 59 Cal. Rptr. 495 (1967), cert. denied, 389 U.S. 1038 (1968), which held that a recorded conditional sale contract prevailed over the unrecorded title of a maintenance company to bailed engines and components; in so holding, the court interpreted the Act to require this conclusion.

is subject to agreements governed by the law of an American jurisdiction, enforcement of the interest may well take place in the flag country or in another country which will look to the law of the flag country to determine its validity and perfection.

A discussion of the varying methods of perfecting interests in aircraft throughout the world is beyond the scope of this paper. It should be noted that the nations that have ratified the Mortgage Convention, as well as many others that have not adopted it, have established central registries for the registration and recordation of interests in aircraft. Other countries may not have central registries, but rather provide for recordation of such instruments in local property registers, in public offices or with quasi-public officials such as notaries. Even if a nation has a central registry, it may well be appropriate to file in more than one place, particularly if spare parts or other property covered by the lease or security interest are located in that country. In some countries, it may be necessary to make separate filings in each province or state in which the aircraft or other property is located.

D. International Recognition of Rights in Aircraft.

The recording system established by the FAA Act directly protects an interest in aircraft against competing claims only while the aircraft and other equipment subject to the interest are located in the United States. Aircraft or other equipment operated in or removed to other countries may be subject to foreign law that may adversely affect the priority or validity of such interest. Adverse effects are substantially minimized by the Mortgage Convention (if applicable) and, to a lesser extent, by the conflict of laws rules

129 See Senate Comm. on Commerce, 89th Cong., 1st Sess., Air Laws and Treaties of the World, Vols. I & II (Comm. Print 1965) (prepared by the staff of the Library of Congress) which contains a comprehensive compilation of laws and regulations relating to aviation, including those relating to registration of aircraft and recordation of interests in aircraft in effect in most countries of the world as of 1965. For further descriptions of recordation and perfection of interests in North and South America and Europe, respectively, see S. Bayitch, Aircraft Mortgage in the Americas, (1960), and Kaplan, Legal Aspects of Aircraft Finance in Europe, 9 J. World Trade L. 136 (1975).

adopted by foreign jurisdictions in dealing with competing interests in aircraft. Practical measures, such as placarding an aircraft and engines to give public notice of existing interests, also provide some security.

1. The Mortgage Convention.¹²¹

The Mortgage Convention (to which 39 countries, including the United States, were parties as of January 1, 1979)¹²² obligates each contracting state to recognize certain rights in aircraft that have been "constituted" and "regularly recorded" in a public record in accordance with the law of the country in which an aircraft was registered at the time such rights were constituted. Such rights, enumerated in Article I of the Convention, include:

(a) rights of property in aircraft;
(b) rights to acquire aircraft by purchase coupled with possession of the aircraft;
(c) rights to possession of aircraft under leases of six months or more;
(d) mortgages, hypotheques and similar rights in aircraft which are contractually created as security for payment of an indebtedness.¹²³

Accordingly, ownership and security interests in aircraft and rights to possession of aircraft under leases of six months or more, which are perfected by recording with the FAA and which are valid under United States law, will be recognized and (subject to some

¹²¹ The annotated text of the Mortgage Convention is printed in 16 J. AIR L. & COM. 70 (1949). Although the Mortgage Convention has received the benefit of explanation, interpretation and commentary in legal journals, published judicial application of its terms is notably lacking. For commentaries, see, e.g., S. BAYITCH, AIRCRAFT MORTGAGE IN THE AMERICAS 69-86 (1960); Conlen, The Aircraft Mortgages Convention: The United Kingdom Moves Toward Ratification, 43 J. AIR L. & COM. 731 (1977); Johnston, Legal Aspects of Aircraft Finance (pt. 2), 29 J. AIR L. & COM. 299, 306-14 (1963).

¹²² DEPARTMENT OF STATE, TREATIES IN FORCE 252-53 (1979). The parties to the treaty as of January 1, 1979 were: Algeria, Argentina, Brazil, Cameroon, Central African Empire, Chad, Chile, Cuba, Denmark, Ecuador, Egypt, El Salvador, France, Gabon, Federal Republic of Germany, Greece, Haiti, Iceland, Italy, Ivory Coast, Laos, Lebanon, Libya, Luxembourg, Mali, Mauritania, Mexico, Netherlands, Niger, Norway, Pakistan, Paraguay, Philippines, Rwanda, Sweden, Switzerland, Thailand, Tunisia and the United States. Unfortunately, the Mortgage Convention has not been adopted by Canada and, because of Mexican reservations is not regarded as being in force between the United States and Mexico. Id.

exceptions) accorded priority over competing claims to such aircraft in countries which are parties to the Mortgage Convention. To be entitled to the benefits of the Mortgage Convention security interests must be "contractually created"; accordingly, statutory, common-law and judicial liens are not covered. A contracting state may recognize rights other than those specified in Article I but may not allow such other rights to take priority over the rights enumerated in the Mortgage Convention. 134

Security interests recognized by the Mortgage Convention secure "payment of an indebtedness." There is no requirement that the indebtedness relate only to the aircraft. Although the priority of a security interest extends to "all sums thereby secured," Article V provides that "the amount of interest included shall not exceed that accrued during the three years prior to the execution proceedings together with that accrued during the execution proceedings." While this limitation is inconsistent with American law, its practical effect is probably not significant since a secured creditor is unlikely to wait more than three years to commence an enforcement proceeding.

The Mortgage Convention defines an "aircraft" as including "the airframe, engines, propellers, radio apparatus, and all other articles intended for use in the aircraft whether installed therein or temporarily separated therefrom." 135 The text does not explain the phrase "temporarily separated," although there is a suggestion that it is intended to cover situations in which a part is "temporarily removed from the aircraft for purposes of repairs where that part is to be replaced on the airplane immediately." 136 If this interpretation is correct, the priority accorded by the Mortgage Convention would probably not continue for engines and parts which are removed for repairs and which are replaced by substitute engines or parts. If the substitutions are owned by the carrier, they should become subject to the protected interest. However, engines and components are often subject to pooling agreements with other carriers and the substitutions may not be owned by the carrier.

134 Id., Art. I.
135 Id., Art. XVI.
Unlike the FAA Act, the Mortgage Convention does not provide for recognition of security interests in specifically identified engines, except as components of an aircraft or as part of a store of spare parts.

Article X recognizes security interests in aircraft that extend in accordance with the law of the flag state to spare parts maintained for installation in such aircraft and stored in specified places, subject to complex public notice provisions.137 Security interests in spare parts independent of interests in aircraft are not accorded protection.

Article VII of the Mortgage Convention provides that proceedings for the sale in execution of an aircraft are subject to the law of the state where the sale takes place.138 It further prescribes certain procedures that must be observed in connection with an execution sale, including a requirement for at least one month's public notice of sale and for notification to holders of recorded rights.139 Execution and sale in accordance with the law of the forum is the only enforcement procedure recognized. Many of the remedies afforded secured parties by the UCC (including self-help) would presumably not be available under the Convention. Note also that no reference is made in the Mortgage Convention to rights of re-

137 Article X provides:

(1) If a recorded right in an aircraft of the nature specified in Article I, and held as security for the payment of an indebtedness, extends, in conformity with the law of the Contracting State where the aircraft is registered, to spare parts stored in a specified place or places, such right shall be recognized by all Contracting States, as long as the spare parts remain in the place or places specified, provided that an appropriate public notice, specifying the description of the right, the name and address of the holder of this right and the record in which such right is recorded, is exhibited at the place where the spare parts are located, so as to give due notification to third parties that such spare parts are encumbered.

(2) A statement indicating the character and the approximate number of such spare parts shall be annexed to or included in the recorded document. Such parts may be replaced by similar parts without affecting the right of the creditor.

Compare § 503(a)(3) of the FAA Act (49 U.S.C. § 1403(a)(3) (1976)), which also limits the perfection provided by recordation to parts located in a specific place (without requirements for placarding) (§ 503(d)), but which permits filing only with respect to air carriers certificated under § 604(b) (49 U.S.C. § 1424(b) 1976).


139 Id., Art. VII, ¶ 2.
possession or other remedies customary in leases. Since these rights arise out of ownership, the draftsmen of the Mortgage Convention may have regarded them as self-evident.

The Mortgage Convention accords priority to certain privileged claims over interests specified in Article I. These include claims for salvage and "extraordinary expenses indispensable for the preservation of the aircraft." When proceeds of an execution sale are disbursed, they will be applied first, to costs of the execution proceedings; second, in an amount up to 20 percent of the sales price, to third persons for injuries or damages on the "surface of the Contracting State where the execution sale takes place" caused by an aircraft which is not adequately insured; third, to salvage and preservation claims; fourth, to the indebtedness secured by an Article I security interest; and last, to other claims.

The Mortgage Convention does not apply to proceedings within the country in which an aircraft is registered. Such proceedings are governed solely by the internal law of that country.

2. Recognition of Interests under Local Law.

If the Mortgage Convention does not apply to an interest in aircraft, the validity and priority of conflicting interests will normally depend upon the laws, including the conflicts laws, of the country in which a proceeding or action is instituted. Obviously, it is not possible to reach definitive conclusions respecting the position that would be taken by one or more foreign countries with respect to competing interests created under the laws of other countries. Nations have historically adopted varying conflict of laws principles, including the application of the law of the jurisdiction where the property is located at the time of execution of the instrument creating the interest, the law of the owner's domicile or the law of the forum. The Mortgage Convention, however, reflects a growing tendency to apply conflict of laws principles which respect rights perfected under the law of the country in which the aircraft is registered, even though such countries may, as a matter of policy, accord priority to certain specified interests

139 Id., Art. IV.
140 Id., Art. VII, §§ 4-6.
arising under local law. While it would undoubtedly be beneficial to record or otherwise perfect interests in all countries not parties to the Mortgage Convention to which an aircraft may be operated, such action would be expensive, time consuming, and usually impractical, if not impossible.

In the United States, the issue of priorities among competing interests in foreign registered aircraft is subject to a variety of conflicts rules that may be applicable to enforcement proceedings in this country. If the United States and the flag state are both parties to the Mortgage Convention, the Mortgage Convention will apply, of course; in accordance with its provisions, American courts will look to the law of the country of registration.

If the Mortgage Convention does not apply and the aircraft is characterized as equipment or inventory, Section 9-103 of the 1972 version of the UCC provides generally that the perfection of security interests and the effect of perfection or nonperfection will be governed by the law of the jurisdiction where the debtor's chief executive office is located. In most circumstances, this pro-

143 Indeed, subject to some exceptions, this is the approach taken by U.C.C. § 9-103 generally with respect to aircraft and "mobile goods" of a type normally used in more than one jurisdiction. Section 9-103(2) of the 1966 version looks to the jurisdiction in which the debtor has his principal place of business; § 9-103(3) of the 1972 version looks to the jurisdiction in which the debtor is located (for most purposes, where the debtor has his chief executive office).

144 U.C.C. § 9-103(3)(b). The provision reads as follows: "(b) The law (including the conflict of laws rule) of the jurisdiction in which the debtor is located governs the perfection and the effect of perfection or non-perfection of the security interest." U.C.C. § 9-103(3)(d) provides in part: "(d) A debtor shall be deemed located at his place of business if he has one, at his chief executive office if he has more than one place of business, otherwise at his residence." Note that § 9-103(2) of the 1966 version of the U.C.C. provides that:

If the chief place of business of a debtor is in this state, this Article governs the validity and perfection of a security interest and the possibility and effect of proper filing with regard to general intangibles or with regard to goods of a type which are normally used in more than one jurisdiction (such as automotive equipment, rolling stock, airplanes, road building equipment, commercial harvesting equipment, construction machinery and the like) if such goods are classified as equipment or classified as inventory by reason of their being leased by the debtor to others. Otherwise, the law (including the conflict of laws rules) of the jurisdiction where such chief place of business is located shall govern (emphasis added).

The choice of law rule imposed by the 1966 version has been eliminated in the 1972 version as being inconsistent with the general choice of law provisions specified in U.C.C. § 1-105.
vision would probably require the application of the law of the
country in which the aircraft is registered, with results similar to
those contemplated by the Geneva Convention. However, if the
debtor is a "foreign air carrier" (as defined in the FAA Act), an
optional sentence in Section 9-103 provides that perfection and
the effect of perfection or nonperfection are governed by the law
of the jurisdiction in the United States in which the carrier main-
tains an agent for service of process under the FAA Act.

The optional provision was added at the instance of United
States banks which wanted to minimize the application of "uncer-
tain" foreign law to loan transactions with foreign carriers operat-
ing to and from the United States and to ensure perfection and
priority of security interests created by such transactions in the
United States. The provision is subject to criticism because (i)
it mandates a policy that applies the law of the forum (i.e., a state
of the United States) in direct conflict with the principles reflected
in the Mortgage Convention and the UCC principles regarding
mobile goods generally; (ii) it does not relieve an American lender
from complying with foreign law; since the UCC provision is un-
likely to be recognized outside the United States, a prudent lender
must at least meet the requirements of the law of the state of regis-
tration if he expects to enforce his interests outside the United
States; and (iii) it adversely affects the claims of foreign creditors
who may have neglected to make a precautionary filing under the
UCC but may have validly perfected interests in the aircraft under
the law of a country that is not a party to the Mortgage Con-
vention.

147 See Official Comment 6 to the 1966 version of U.C.C. § 9-103 and Official
Comment 5(f) to the 1972 version of U.C.C. § 9-103. Note the provisions of
U.C.C. § 9-103(4) (1966 version), which relate to security interests noted on a
certificate of title. Under the 1972 version of the U.C.C., perfection under the
law of the jurisdiction issuing a certificate of title would be effective only "until
four months after the goods are removed from that jurisdiction and thereafter
until the goods are registered in another jurisdiction, but in any event not beyond
surrender of the certificate. After the expiration of that period, the goods are
not covered by the certificate of title within the meaning of this section." In
countries which require that a mortgage or security interest be endorsed on an
aircraft's certificate of title or registration certificate, this provision would prob-
ably supersede the "foreign air carrier" provision of the U.C.C.
V. Conclusion

The magnitude of the equipment choices which are being made by the world's airlines for the coming decades is immense; the task will call for the maximum use of available sources of financing and for legal ingenuity in developing methods of securing such financing.