

Running an airline is like having a baby: fun to conceive, but hell
to deliver.

— *C. E. Woolman, principal founder Delta Air Lines*

Rinat R. Gareev

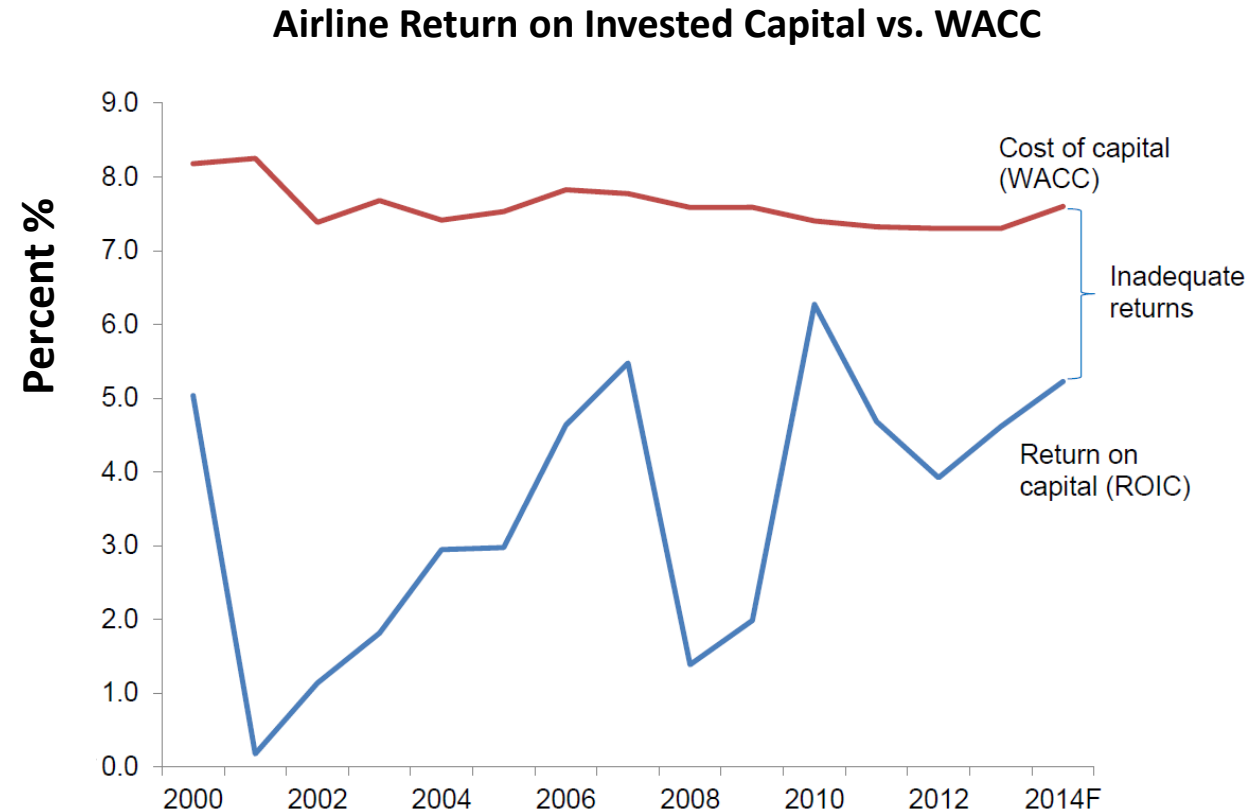
LL.B., LL.M., ACI Arb

Aircraft decision factors

Network Requirements	Aircraft Operations	Finance Strategy	Market Conditions
			
<ul style="list-style-type: none">▪ Mission needs▪ New markets▪ Competitive response▪ Product upgrades	<ul style="list-style-type: none">▪ Maintenance and fuel cost▪ Aircraft reliability▪ Aircraft utilization▪ Impact on commonality	<ul style="list-style-type: none">▪ Capex▪ Return on invested capital▪ Financing▪ New vs. used aircraft	<ul style="list-style-type: none">▪ Aircraft availability▪ Cost of fuel▪ Residual value▪ Next generation aircraft timing

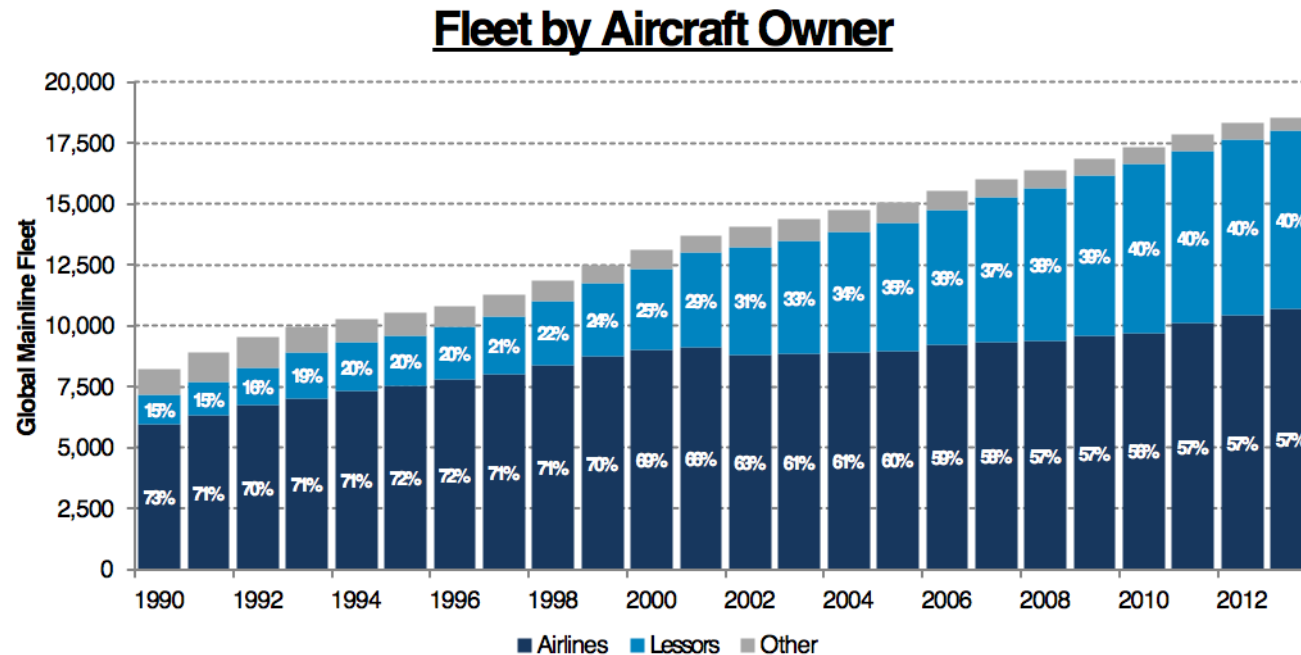
Why Operating Leasing is Growing

- ❑ Top lessors have lower funding costs and better capital markets access than most airlines
- ❑ Leasing provides airlines with fleet plan flexibility over time
- ❑ Lessors are better equipped to manage residual values
- ❑ *Airlines are not covering their cost of capital*



Lessors Account for a Growing Share of Market

- ▣ Lessors now own 40% of world's fleet of mainline jets
 - ▣ Number of aircraft owned by lessors increased over 6x since 1990
 - ▣ Lessors responsible for 60% of new incremental aircraft added to world fleet since 1990
- ▣ Total mainline (>100 seats) fleet grew from 8,200 aircraft in 1990 to 18,500 today
 - ▣ Represents a 4% CAGR



- Aircraft leasing law:
 - Contract & personal property law
 - Cape Town Convention (Aircraft Protocol)
 - Regulation (EC) 1346/2000 on insolvency proceedings
- Key issues: ownership, possession, rights and liabilities re aircraft
- Common terminology in aircraft leases:
 - Dry lease / wet lease
 - Operating lease
 - Finance lease
 - sale – lease back (Sunrock v SAS (2007))

Leasing: Finance Leases vs. Operating Leases

- Legal, tax and accounting differences, with large impact on economics
- Finance (Capital) Lease: Really a security device used for a loan
 - Lender (Lessor) “owns” aircraft; “Rent” payments benchmarked on LIBOR
 - Usually long-term, based on useful life; purchase option (lease balance or bargain)
 - Economic ownership rests with Lessee; aircraft goes on its balance sheet
- Operating (True) Lease: Economic ownership rests with Lessor
 - Capital cost not fully amortized over term of lease, so residual/remarketing risk
 - Shorter term; FMV purchase option is a possibility
 - Aircraft goes on balance sheet of Lessor; rentals are an “expense” for lessee
- Operating leasing has grown from 5%-35% of fleet in last 25 years
 - Flexibility for airlines in terms of fleet planning; requires less capital
 - Lessors require security to protect asset value: deposits, reserves, letters of credit

Protections: Perfecting Security in Aircraft

- The operator needs freedom to monetize assets, whereas the lender requires that it remain accessible and in good condition
- An aircraft is an item of personal property, can be subject to mortgage, conditional sale, lease, trust, possessory liens etc.
- Many countries have special registries for title and security interests
 - Canada: no central registry for security interests, must make provincial filings
 - US: FAA registry, for recording any instrument affecting title to or interest in A/C
 - Until recorded with FAA, the interest is effective only as to parties, their relatives and heirs and persons with knowledge of the agreement
- Geneva Convention on recognition of rights in aircraft
 - Basic questions of international law arise – where to file?
 - Contracting states recognize interest recorded in state where aircraft registered
- Cape Town Convention: Creates a central international registry of interests in aircraft (see handout)

Lessor/Lessee relationship

- Key documents
 - Aircraft lease agreement
 - Acceptance/ return certificates
- Courts' approach to aircraft leases: Sunrock v SAS (2007)
 - Faithful reading, business-like interpretation of bargain, common sense
 - Background knowledge of parties

Areas of dispute

- Representations and Warranties
 - Contractual estoppel
 - Condition of Aircraft – ACG v Olympic (2013)
 - Lessee's internal authorizations & regulatory approvals - Wallis v Air Tanzania (2020)
- Return conditions
- Events of default
 - non-payment, unremedied breaches, insolvency, cross-defaults
 - Repudiatory breach (damages for future loss of profits)

Areas of Dispute

- Remedies
 - Separate remedies: ILFC v Olympus (2020)
 - Aircraft recovery, damages
 - Termination of «leasing»
 - Self help remedies / court orders
 - Impact of insolvency
- Damages
 - Principles – TWC v Jetline (2020)
- Law and jurisdiction clauses / 2 AM clauses (force majeure)

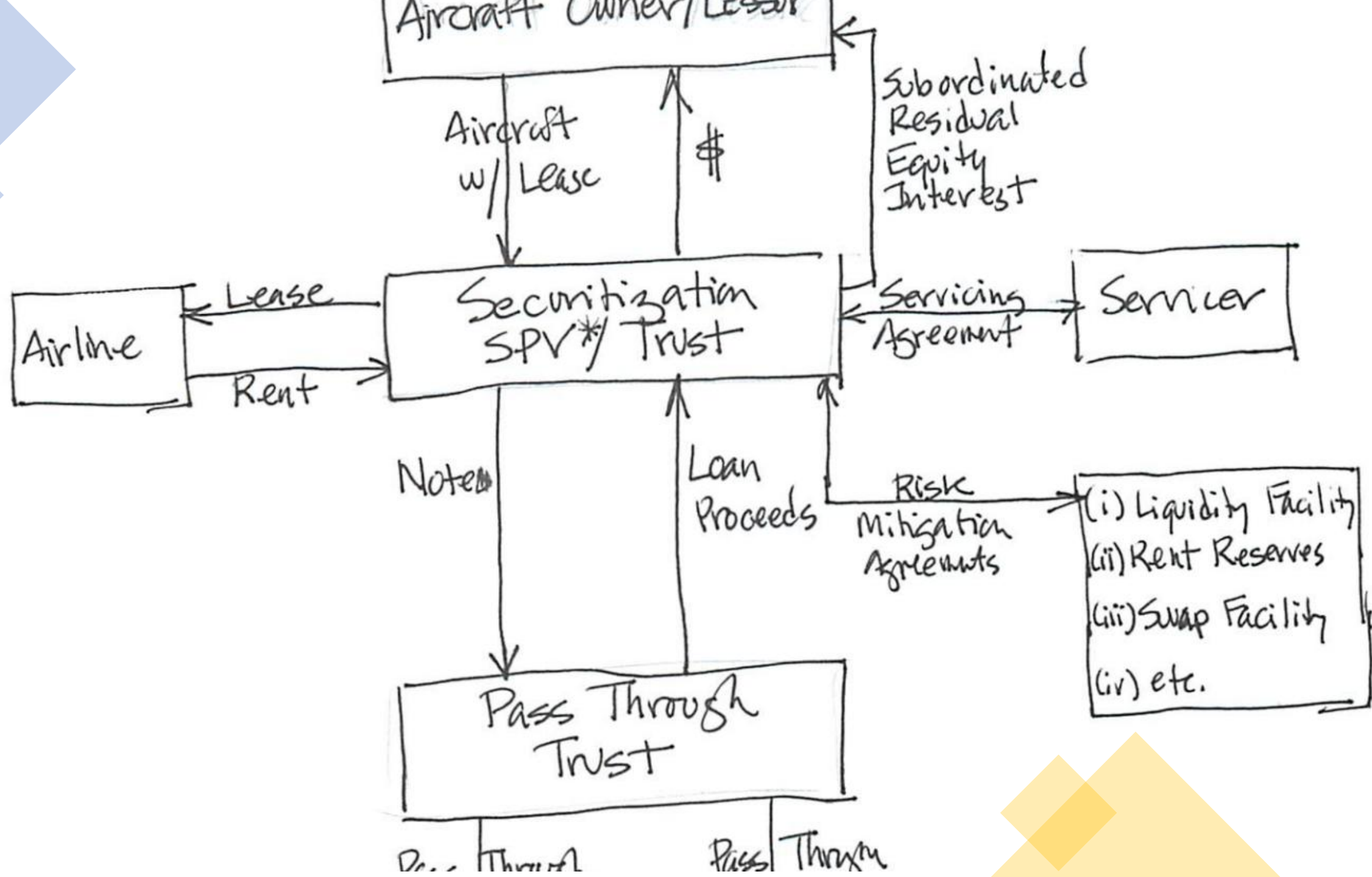
Conflict of Laws

Blue Sky One v. Mahan Air decides that, under English conflict of laws rules, the domestic law of the place where an aircraft was situated on execution of the mortgage determines whether a mortgage over that aircraft was validly created (the lex situs rule).

- *Blue Sky One* decides that, when an English court applies the lex situs rule to an aircraft mortgage's validity:
- the English court looks to the domestic law of the situs;
- it does not look to the conflicts rules of the situs;
- there is no return to sender.

Lease financing vs. debt financing

	Lease	Buy
Proceeds	\geq purchase cost of aircraft	$<$ purchase cost of aircraft
Residual value risk	Borne by leasing company	Borne by airline
P&L	Rent expense	<ul style="list-style-type: none">▪ Interest expense▪ Depreciation expense
Capital expenditures	Expense not capitalized	Purchase cost capitalized on balance sheet
Return conditions	Material part of deal economics	None
Security deposit	Lessor may require deposit up to three months of rent	None
Prepayable at par	No	Floating rate debt only
Tax shields	Rent expense	Interest expense and depreciation (100% in year 1)



Protections: Operation, Maintenance, Return Conditions



- **Operation and Possession**
 - Lawful use, all permits and insurance, restrictions on operations in some countries
 - Subleasing; Pooling and exchange: Customary arrangements with solvent carriers
- **Approved maintenance program compliant w/ FAA/EASA regulations**
 - Shop visits: FAA/EASA approved repair stations; workscope and timescale
 - “Back to birth” historical records in English on all parts
 - Monthly reports of hours and cycles
 - Airworthiness Directives and Mandatory Service Bulletins (Cost-Sharing)
- **Usage Fees/Maintenance Reserves/Other Security**
- **Return Conditions:**
 - Physical inspection, engine borescopes, records, test flight, deregistration etc.
 - Hard-time conditions: Hours or cycles on airframe, engines, LLPs...
 - Financial adjustments: Based on pre-delivery use or agreed threshold



Lease Documentation – Basic Principles

- ❑ Protect the pricing
 - ❑ Cash flows
 - ❑ Rents
 - ❑ Maintenance payments / contributions
 - ❑ Residual value
 - ❑ Ongoing maintenance, registration, compliance covenants
 - ❑ Condition of the aircraft at return
- ❑ Protect 'triple-net' nature of the lease
 - ❑ Tax representations and indemnities
 - ❑ Insurance covenants
 - ❑ Disclaimer / General indemnity
- ❑ Guard against the unknown (and prepare for the worst)
 - ❑ Representations and warranties
 - ❑ Unconditional Acceptance by Lessee [ACG Case – what does this really mean?]
 - ❑ Disclaimer / Waiver of all Warranties
 - ❑ Credit risk – deposits, credit support and financial reporting
 - ❑ Events of default / Remedies
 - ❑ Indemnities
 - ❑ Choice of Law / Choice of Jurisdiction

☐ Lease of Aircraft

☐ Delivery Procedures

☐ Conditions to closing

☐ Lessee's right to reject

☐ Lessee's / Lessor's right to walk

☐ ACG Form:

4.2 Delivery

(a) Delivery Condition: Lessor shall deliver the Leased Property "as is, where is" **and in the condition required in Schedule 2**, except for any items set forth on Annex 2 to the Certificate of Acceptance and any other items agreed in writing by Lessor and Lessee.

AYR Form (Ryan International):

2.1 Delivery Lessor hereby agrees to deliver the Aircraft to Lessee at the Delivery Location and to lease the Aircraft to Lessee, and Lessee hereby agrees to accept the Aircraft at the Delivery Location and to lease the Aircraft from Lessor, in each case, **on the Scheduled Delivery Date and in the Delivery Condition, subject to the satisfaction or waiver of the conditions precedent set out in Schedule 7 and Schedule 8 and otherwise subject to the terms and conditions of the Operative Documents**. Lessee shall execute and deliver the Acceptance Certificate to Lessor on the Delivery Date. The delivery requirements and delivery procedures are more fully set out in Schedule 3

See Also – Part II of Schedule 3 to the Ryan Lease

Conditions Precedent

Delivery Procedures – Ryan International

1.2 Discrepancies

Any discrepancy from the condition of the Aircraft as described in Part 1 of Schedule 3 which is identified in writing to Lessor by Lessee on or prior to the Scheduled Delivery Date (or during the flight test procedures pursuant to Section 1.1 of this Part II of Schedule 3) and which is not corrected by Lessor on or prior to the Delivery Date shall be corrected by Lessee or its designee and Lessor shall reimburse Lessee at 100% of Lessee's reasonable actual cost for such correction, payable on demand (together with detailed and substantiated labor and material invoices for all such amounts for which reimbursement is sought). **Lessee's right to make such a claim for reimbursement shall be Lessee's sole remedy for noncompliance, and Lessee shall not have the right to refuse acceptance of the Aircraft because of such discrepancies unless the existence of such discrepancies would prevent the issuance on the Delivery Date of an airworthiness certificate**, in which event Lessor and Lessee shall negotiate in good faith a fair and equitable procedure by which such discrepancies shall be corrected and the Delivery Date shall be delayed until such discrepancies are corrected, subject to Section 2 of this Part II.

Delivery Conditions

ACG: “**be airworthy**, conform to type design and be **in a condition for safe operation....**”

Ryan International: “...have and **be in compliance with** an **Airworthiness Certificate....**”

Drafting style: Your client's obligations, or the conditions precedent it must meet, should be narrowly drafted with objective criteria to judge compliance, and any exceptions should be broadly cast if possible

☐ Lease of Aircraft (Continued)

☐ Lease term / return of aircraft

☐ Detailed return conditions

☐ Critical to preserving the residual value of the aircraft

☐ Rent

☐ Security Deposit

☐ Cash vs. Letter of Credit

☐ Disclaimer

ACG Form

THE AIRCRAFT IS ACCEPTED BY LESSEE "AS IS, WHERE IS " AND LESSEE AGREES AND ACKNOWLEDGES THAT, **SAVE AS IS EXPRESSLY STATED IN THIS AGREEMENT**, LESSOR WILL HAVE NO LIABILITY IN RELATION TO, AND LESSOR HAS NOT AND WILL NOT BE DEEMED TO HAVE MADE OR GIVEN, ANY CONDITIONS, WARRANTIES OR REPRESENTATIONS, EXPRESS OR IMPLIED, WITH RESPECT TO THE AIRCRAFT, INCLUDING....

AYR Form (Ryan International)

EFFECTIVE UPON ACCEPTANCE OF THE AIRCRAFT BY LESSEE, WHICH SHALL BE EVIDENCED BY DELIVERY OF THE AIRCRAFT TO LESSEE, THE AIRCRAFT SHALL BE LEASED UNDER THE LEASE AGREEMENT "AS-IS, WHERE-IS, WITH ALL FAULTS" AND LESSEE AGREES, ACKNOWLEDGES AND ACCEPTS THAT NO INDEMNIFIED PARTY MAKES ANY WARRANTY OR REPRESENTATION WHATSOEVER CONCERNING THE AIRCRAFT.... LESSEE... HEREBY WAIVES, RELEASES AND RENOUNCES ALL WARRANTIES, REPRESENTATIONS AND OTHER INDEMNITIES, GUARANTIES, OBLIGATIONS AND LIABILITIES EXPRESS OR IMPLIED, ARISING BY LAW OR OTHERWISE.....WITH RESPECT TO THE AIRCRAFT....INCLUDING....

Short-Term Emergency Engine Lease – User Guide

“In relation to [the delivery procedures / delivery conditions], before accepting the Engine Package Lessee may satisfy itself that the Engine Package meets any specified delivery conditions, including the technical conditions in Clause 2.3.1. If the Engine Package fails to satisfy these specified conditions, Lessee may decide not to accept the Engine and the term will not commence. It is important to note that Lessor makes no representation or warranty regarding the condition of the Engine Package, and any specified delivery conditions will not constitute representations or warranties by Lessor that have relevance after acceptance by Lessee of the Engine Package.”

(Joint project between the Aviation Working Group and the International Air Transport Association)

- ❑ Representations and warranties

- ❑ Establishing very basic principles on which the transaction is based
 - ❑ Many of these will be backed up by legal opinions

- ❑ General Covenants

- ❑ From Lessor
 - ❑ Right of Quiet Enjoyment
 - ❑ From Lessee
 - ❑ Reporting, no liens, etc.

- ❑ Title/Registration/Filings

- ❑ Cape Town

- ❑ Possession

- ❑ Subleasing vs. Wet Leasing

- ❑ General Indemnity

- ❑ Scope - Lessor seeks broad scope / Lessee seeks narrow scope
 - ❑ Exclusions - Opposite holds true
 - ❑ Contest rights

- ❑ Tax Indemnity

- ❑ Risk of Loss

- ❑ Damage

- ❑ Repair/replace

- ❑ Loss of value?

- ❑ Total Loss

- ❑ Payment of agreed value

- ❑ Insurance

- ❑ Casualty – damage to or loss of leased aircraft

- ❑ Liability – damage to or loss of other property or injury/loss of life

- ❑ Basic structure of lessee insurance: ‘all risks’ vs. war risks / protective endorsements

- ❑ Lessor liability topics – recent Florida case (Vreeland v. Ferrer)

- ❑ Events of Default

- ❑ Lessee performance

- ❑ Lessee credit

- ❑ Remedies

- ❑ Repossession – termination, self-help and other topics

- ❑ Damages

- ❑ Section 1110 / Cape Town remedies

☐ Miscellaneous Provisions

- ☐ Lessor transfers – financings / sales
- ☐ Governing Law / Jurisdiction
 - ☐ Alternative Dispute Resolution?
 - ☐ Exclusive jurisdiction?

☐ Operational Matters

- ☐ Maintenance, operation and related topics
 - ☐ Operation in violation of law
- ☐ Maintenance Payments
- ☐ Return / Redelivery Procedures and Return Conditions
 - ☐ Inspections
 - ☐ Records
 - ☐ Technical condition



ACG Acquisition v. Olympic

ACG Acquisition v. Olympic

- Discussion Points

- Intent of the parties

- A remarkable bargain?

- Condition of the aircraft at delivery

- Important or not?

- Airworthy vs. Seaworthy?

- Lessor's obligation to deliver the aircraft in compliance with the delivery conditions

- A covenant? What was the remedy for breach?

- How did the Acceptance Certificate help the lessor?

- Why would a lessor be reluctant to take on full responsibility for delivery in the agreed condition?

- Appellate opinion

- Which lease provisions were most important and persuasive?

Discussion Question 1a

The Summary Judgment opinion rightly points out that this is an extreme case.

Why does the Summary Judgment opinion feel ACG's explanation of the position of the parties would be a "remarkable bargain"?

1.It's a "remarkable bargain" because ACG believes 4.2(a) and the other provisions in the lease regarding the certificates as a disclaimer to prevent any claim for breach of contract, which is unreasonable and uncommercial.

2.Issue of Allocation of Risk

Discussion Question 1a cont.

The Summary Judgment opinion rightly points out that this is an extreme case.

Why does the Summary Judgment opinion feel ACG's explanation of the position of the parties would be a "remarkable bargain"?

1.The judgement (2010) contended:

- The parties of contract can make a bargain, but it would be unfair and meaningless if: It unreasonably deprived a party's fundamental rights in transaction.

2.The judge's conclusion is:

- "The effect of the acceptance of the aircraft is limited to the right of rejection and does not extend to the right to claim damages, still less to claim total failure of consideration."

Discussion Question 1b

Does the appellate judge seem share this view? Why or why not?

“[C]omplexity of a modern passenger aircraft is such that . . . parties to leases such as this could face **years of uncertainty** as to the allocation of responsibility for defects of which neither of them were aware on delivery it is commonplace for parties in this market to contract . . . **appears to be intended to provide a structure whereby a lessee elects whether or not to accept an aircraft on lease and with it the risk of non-compliance** with required delivery condition becoming apparent later.”

¶42, 2013 Judgment

Discussion Question 1b cont.

Does the appellate judge seem share this view? Why or why not?

“[I]t is impossible to inspect an aircraft fully and therefore correspondingly impossible to eliminate the risk of undiscovered defects upon delivery. . . . **parties know that neither can be absolutely certain of an aircraft’s condition** at the point at which the lessee is called upon to accept delivery and the on-going risk. That commercial parties should in such a situation strive to achieve finality in relation to the allocation of risk and responsibility is a commonplace.” ¶43, 2013 Judgment

Discussion Question 2a

The trial judge focused a lot of attention on the specific defects in the aircraft, and on whether these might have existed at delivery to Olympic or might have arisen later. The trial judge also devoted a great deal of effort to considering the meaning of “airworthy” – one of the delivery conditions from Schedule 2

Why does the appellate judge appear fairly unconcerned about these issues?

1. The appellate judges mostly deferred factual determination to trial judge
2. The actual defect was so severe that regardless of applicable legal definition of “airworthiness”, the airplane was most likely not airworthy.
3. However, the actual defects are not relevant to the claim based on estoppel theory, the true dispositive issue the appellate judge found.

Discussion Question 2b

What do you make of the trial judge's analogy to "seaworthy"? How did the appellate judge feel about that?

1. It was a reasonable approach but not necessarily sound. Aviation is significantly different from naval navigation.
2. Aviation industry is distinguishable from others equipment leasing industries because of following factors
 - Expectations of the parties
 - Assignment of risk
 - Nature of non-operating owner-lessor in aviation

Discussion Question 3a

Both the trial judge and the Summary Judgment opinion put a great deal of emphasis on the lessor's breach of its covenant to deliver the aircraft in the condition specified in the lease.

Why was that considered important?

1. ACG fundamentally failed to perform its obligations in relation to the delivery condition of the aircraft. (clause 4 and schedule 2, Para. 10 and 11)
 - Olympic was able to carry out external inspections but the scope was limited. (Para. 20)

Discussion Question 3a

Both the trial judge and the Summary Judgment opinion put a great deal of emphasis on the lessor's breach of its covenant to deliver the aircraft in the condition specified in the lease.

Why was that considered important?

1. Regardless of their breach, Olympic are precluded by their acceptance of the aircraft from maintaining any claim. (Para. 33)
 - Court turned this down **conclusive proof** argument and said clause 7.9 does not waive any right the lessee may have. (highlighted in notes)
2. However, ACG ends up prevailing under the doctrine of equitable estoppel. (highlighted in notes).

Discussion Question 3b

Do you think the drafting of 4.2(a) contributes to the confusion, and if so, why? Did the Acceptance Certificate “fix” the problem (perhaps) from the perspective of the lessor?

4.2 Delivery Condition: Lessor shall deliver the Leased Property “as is, where is” and in the condition required in Schedule 2

- ▶ **ACG argued** “the aircraft and aircraft documents are satisfactory to the lessee”
 - ▶ Olympic stated in the Certificate of Acceptance that the aircraft “complied in all respects with the condition required at delivery under section 4.2 and Schedule 2.”
- ▶ **Olympic argued** against contractual estoppel
 - ▶ Estoppel only applied in so far as the lessee had been able to form a meaningful view based on its limited inspection and on the assumption that the aircraft and documents had been tendered in compliance with Schedule 2 of the lease.
 - ▶ The fact that Olympic accepted the aircraft does not in any way disable it from obtaining damages in respect of a breach of clause 4.2(a).

Discussion Question 3c

Why would a lessor be reluctant to agree to an unconditional obligation to deliver an aircraft in a particular condition? Did you see anything in the opinions that demonstrated how ACG approached the transition from Air Asia to Olympic?

1. ACG employed the services of Aircraft Engineering & Consulting Limited (AEC) to assist it with the redelivery of the aircraft from AirAsia and the delivery of the aircraft to Olympic in Singapore.
2. AEC produced an Inspection Discrepancy List following an inspection of the aircraft.

Discussion Question 3c cont.

Why would a lessor be reluctant to agree to an unconditional obligation to deliver an aircraft in a particular condition? Did you see anything in the opinions that demonstrated how ACG approached the transition from Air Asia to Olympic?

3. Photographs were taken to illustrate the discrepancies noted.
4. “ACG is typical of aircraft lessors in not being an operator of aircraft. A lessor’s role is essentially financial – to raise finance on the strength of which aircraft can be acquired and leased out. A lessor does not typically undertake maintenance of its aircraft.” ¶ 41, 2013 Judgment

Discussion Question 4

What lease provisions / other documents did the appellate judge find most important and persuasive? Why?

The interaction between § 4.2, § 7.9, Schedule 2 and the Certificate of acceptance is critical to the outcome of the case

- ▶ 4.2(b): lessee entitled to observe various specific technical inspections and tests.
- ▶ 4.2(f): lessee is entitled to note discrepancies on Annex 2 to the Certificate of Acceptance and to require their correction failing which the lease may be terminated
- ▶ Schedule 2: yardstick to measure the lessee's satisfaction with the aircraft
 - ▶ Lessee entitled to inspect the aircraft throughout the C check and to require the rectification of any defects.
- ▶ 7.9: delivery by lessee to lessor of a certificate will be conclusive proof that the aircraft and the aircraft documents are satisfactory to the lessee.

Discussion Question 4

What lease provisions / other documents did the appellate judge find most important and persuasive? Why?

“The combined effect of clause 7.9 and the Certificate of Acceptance is that the lessor is conclusively agreed to have satisfied both its **positive obligation to deliver the aircraft in a condition compliant with Schedule 2** and the condition precedent providing that **the lessee is not required to accept the aircraft unless it is in the condition required by clause 4.2(a) and Schedule 2**”

¶52, 2013 Judgment

Takeaways from the Olympic Case

1. There is a de facto duty to certify at delivery;
2. A potential legal claim (or a potential mechanism built in the contract) against the prior user for improper maintenance;
3. Fallacy of poor management or cash drought?

Q: What is the surest way to become a millionaire?

A: Become a billionaire and start an airline...

- *Richard Branson*

