Aircraft financing – how things have changed

Frank Porter

Partner
Buddle Findlay
Auckland

Overview

The September 11 2001 terrorist attacks have had a significant impact on the aviation industry. Shortly after these events, the airline industry experienced a very depressed market with fewer travellers, lower margins and higher insurance costs (where insurance was available). These all impacted negatively on the financial performance of airlines. Already, earlier in 2001 New Zealand had experienced the collapse of its second largest domestic carrier, Tasman Pacific which operated under the Qantas New Zealand brand. As a consequence of these circumstances lessors and financiers have had cause to critically review their finance and lease documents.

The coming into force of the Personal Property Securities Act 1999 in New Zealand has also required major changes to the registration of aircraft lease and security documentation. Although this is not examined in this paper in any particular detail, it is important to have a general understanding of its nature, and some areas in which it will have an impact on aircraft financing and leasing are highlighted.

On a global scale already prior to the events of September 11 there had been a strong movement towards an international regime for aircraft security with the Unidroit Convention on Interests in Mobile Equipment. This Convention addresses some important issues of concern and difficulty with recognition and enforcement of securities over assets that move between numerous jurisdictions.

The withdrawal of war risks and allied perils cover shortly after September 11 exposed the need for governments to become involved in maintaining aviation as part of an essential infrastructure. IACO has established a special working group to consider establishing an international mechanism to provide war risk cover for the aviation insurance industry where the insurance market is unable to provide sufficient cover. If this achieves multilateral government support it may bring some major changes to the aviation insurance industry in future years.

These and other developments have created a particularly interesting and challenging environment for aircraft financing lawyers.

1. NEW ZEALAND REGIME

Civil Aviation Act 1990

There is a New Zealand Register of Aircraft established under the Civil Aviation Act 1990. However, that register does not record title or security interests and is only an operational register. Every "owner" of an aircraft which flies to, from, within, or over New Zealand is required to register the aircraft and hold a valid certificate of registration for it, either in that Register or in an overseas register. However, the term "owner" includes any person lawfully entitled to possession of the aircraft for 28 days or longer. So the lessee of an aircraft for a term of 28 days or more would be an "owner" in terms of the definition and as such the only person entitled to be recorded on that Register in respect of the relevant Aircraft.

No Separate Register for Aircraft Security Interests

There is no provision under the Civil Aviation Rules (the subordinate legislation made pursuant to the Act) whereby a security interest can be noted on the New Zealand Register of Aircraft. From 1 May 2002, registration of security interests, which are deemed to include leases of more than one year over personal property (including aircraft), is governed by the Personal Property Securities Act ("PPSA").

Previously security and leasehold interests had been registrable under the Companies Act 1955 and the Chattels Transfer Act 1924. The PPSA provides for a transitional period of 6 months (to 31 October 2002) for these interests to be registered under the PPSA with their pre-existing priority.

Prior to July 2001 the New Zealand Civil Aviation Authority accepted notice by way of letter of a secured party's interest in an aircraft and would agree (without legal obligation) to advise of changes in registration. The CAA has as a matter of policy now abandoned this practice.

2. PERSONAL PROPERTY SECURITIES ACT 1993

Overview

The PPSA applies where personal property is used as collateral. Fundamental changes brought about by the Act include:

(a) the concept of what is or is not a security interest;
(b) a comprehensive priority regime; and
(c) changes to the enforcement regime for some security interests.

Only security interests will be recorded in the new computer-based personal property securities register ("PPS Register"). The Register will not identify the owner of any particular item of personal property and will not provide indefeasibility of title. As noted above, a "security interest" is deemed to include a lease for a term of more than 1 year

irrespective of whether the transaction secures payment or performance of an obligation.

Importantly for our purposes, the new regime will provide a limited scope for searching based on the serial number of a particular chattel (this will apply to aircraft). However, generally searching will be based on the debtor's identity.

2.1 Registration by Financing Statement

A security interest is registered by filing a "financing statement" containing the required information. If a financing statement relates to the registration of a security interest in serial-numbered goods (which are defined as a motor vehicle or an aircraft) that are consumer goods or equipment, it must contain further details including the year of manufacture of the goods, the make or name of the manufacturer and the model of the goods, the aircraft class, registration mark and a nationality mark, and serial number. A creditor is required to keep the financing statement up-to-date with all the information he has knowledge of. A financing change statement can be registered under s135 of the PPSA to change any details of a financing statement.

Choice of Law

The general rule under s26 of the PPSA is that the Act applies if, at the time the security attaches, the collateral is either in New Zealand, or the secured party knows that it is to be moved to New Zealand. New Zealand law also applies if the security agreement says that it does or if, for any other reason, New Zealand law applies.

However, sections 30 to 33 of the PPSA have special rules for particular types of collateral. Section 30 provides a choice of law rule applicable to intangibles and goods of a kind normally used in more than one jurisdiction (e.g. international aircraft). A security interest in such property is governed as to validity and perfection by the law of the jurisdiction where the debtor is located when the security interest attaches. A debtor that is a body corporate is located in the country of incorporation. A debtor that is not a body corporate is located at the debtor's place of business, or the debtor's principal place of business (if there is more than one), or the debtor's principal residence (if the debtor has no place of business).

For example, where a security interest is taken over aircraft of a debtor incorporated in Australia, Australian law will govern validity and perfection issues. This is so even if the aircraft is operated primarily in New Zealand. This means anyone dealing with goods of a kind normally used in more than one location, must, if searching for security interests, ascertain the location of the debtor. If the debtor is not located in New Zealand, searches and registration in the New Zealand PPS Register may be of little assistance.

Priority

The general rules of priority are that perfected interests ("attached" and either registered or where the security holder has possession of the collateral) have priority over unperfected interests (by order of attachment) over unsecured interests (which are not void for non-registration). For a security interest to "attach" the following must

occur: value must be given by the secured party, the debtor must have rights in the collateral, and the underlying security agreement must be enforceable against third parties within the meaning of section 36 of the PPSA. For an agreement to be enforceable against third parties either the collateral must be in the possession of the secured party or the debtor must have signed or assented to (in writing) a security agreement that identifies the collateral.

Priorities between two competing non-PPSA interests, such as between liens arising by operation of law, competing buyers, and interests created by the Courts, remain governed entirely by the common law. The Act does not govern a contest between a security interest and a non-PPSA interest (e.g. an equitable lien or constructive trust) other than in the case of s93 of the PPSA, which largely re-states the common law approach in respect of possessory liens. Common law principles will otherwise remain relevant in this context.

Under the PPSA a secured party continues to be able to regulate the priority of its security interest vis-à-vis that of another secured party through the use of a priority agreement.

One major exception to the priority of a secured interest is a "purchase money security interest" or "PMSI". This is equivalent to the previous "reservation of title" or "romalpa" interest. It is an interest in personal property taken by the seller of that property to the extent it secures an obligation to pay the property's purchase price, or by a person who gives value for the purpose of enabling a purchaser of that property to acquire rights in the property. The general rule is that a PMSI has super-priority over all other security interests. In order to attain this priority, the registration requirements under the PPSA in respect of a PMSI must be complied with.

There are further priority rules for accessions and processed or commingled goods (sections 78 to 86). There are also several technical priority rules for specific circumstances (Part 8).

Enforcement

Part 9 of the PPSA contains the rights and obligations of a creditor when enforcing security interests. However, Part 9 does not always apply. One exception is the enforcement of a security interest in "consumer goods" which will be governed by the Credit (Repossession) Act 1997. Another exception is that Part 9 does not apply to a receiver under the Receiverships Act 1993.

Importantly in the context of leases of aircraft, Part 9 does not necessarily apply to "deemed" security interests. Section 105(b)(ii) provides that Part 9 applies only to security interests that are not created or provided for "by a lease for a term of more than 1 year that does not secure payment or performance of an obligation". If a lease does not secure payment or performance of an obligation, then the enforcement of that lease would remain to be regulated by the terms of the lease itself and the common law. In practice, Part 9 would not apply to an operating lease where the lessee pays

merely for the use of the aircraft over time. In contrast, Part 9 may well apply to a "finance lease" (e.g. where ownership of the lease asset is transferred to the lessee at the end of the lease term, or the term of the lease runs for more than 75% of the asset's estimated useful life).

Mortgages over aircraft (and finance leases) will "in substance" constitute security interests and will therefore be subject to Part 9 unless the parties contract out of certain specific provisions. In Part 9, s109 states that a party with priority over all other secured parties may take possession of and sell the collateral. There is significant uncertainty as to the impact of this section on the rights of subsequent ranking secured creditors. There is a dispute as to whether this means that only the first in priority may exercise the right, thereby removing the contractual rights of enforcement that subsequent ranking secured creditors would otherwise have had.

The following are relevant rights and obligations of enforcement under Part 9:

(a) Before enforcement rights can be exercised, there must be a default or the collateral must be "at risk". Failure to pay monies due will always suffice, but the security agreement can (and should) specify other events of default.

(b) The primary enforcement remedy is that of seizure and sale under s109. This can be done by auction, public tender, private sale, or another method.

(c) A sale must be at the best price reasonably obtainable at the time of sale.

(d) Unless the collateral is at risk, the secured party must give the debtor and certain other interested parties a pre-sale notice at least 10 working days before selling.

(e) On sale under s109, all subordinate security interests are extinguished.

(f) The secured party must give the debtor and other interested parties a post-sale notice specifying the gross sale price, the costs of sale and the balance due to or from the debtor.

(g) If there is a surplus on sale, the secured party must pay the balance to the holders of subordinate security interests in order of priority before accounting to the debtor, or pay the surplus into court where there is any doubt.

(h) Another remedy is foreclosure by which the secured creditor can retain the collateral in satisfaction of the secured obligation. In that case a foreclosure notice must be given to the debtor and others with an interest in the collateral. If an objection is received to the proposal, the secured party must instead sell the collateral. If no objection is received within 10 working days, the secured party takes the collateral free of all subordinate interests.

(i) Under s132, the debtor has the right to redeem the collateral by payment of the "obligations secured" plus enforcement costs.

(i) Section 133 allows the debtor to reinstate the security agreement by tendering the sum in arrears (excluding the operation of any acceleration clause) plus enforcement costs and remedying any other defaults.

If a secured party does not follow the procedures required by Part 9 when enforcing its security interest, or acts contrary to the general standard required by s25 (to act in good faith and in accordance with reasonable standards of commercial practice), the secured creditor may be liable under s176 for any resulting reasonably foreseeable loss suffered by the debtor or any other party with an interest in the collateral.

The parties can contract out of certain provisions, thereby restricting the rights of enforcement or limiting the rights of the debtor. However, they cannot contract out of the rights that protect other parties. For example, they may contract out of the right to seize and sell under s109, but if this right is maintained they must comply with s110 (obtain the best price reasonably obtainable) and a notice of sale must be given to other affected parties under s114. A well advised lessor or mortgagee should seek to minimise its obligations to the debtor by contracting out of the following obligations:

- to provide a notice of sale to the debtor;
- to pay any surplus to the debtor;
- the debtor's right to reinstatement;
- the debtor's right to receive a statement of account;
- the debtor's right to receive notice of or object to a secured party's proposal to retain collateral;
- certain of the debtor's rights concerning accessions; and
- the debtor's right to redeem collateral.

3. WHEN an aircraft mortgagor/lessee ceases trading Documentation

The value of security documents and leases is put to the test when an aircraft mortgagor or lessee appears to be insolvent or is about to cease trading. The mortgage or lease document will almost always have defined events of default. Although non-payment of the secured obligations will inevitably qualify as an event of default, it may be more difficult to precisely identify when broader events of default are triggered such as the "material adverse effect" clause, or breaches of other security documents. Often, as was the case with Tasman Pacific Airlines (Qantas NZ), lease payments were up to date and prior to the appointment of receivers no clear breach of lease terms generally had occurred. It is important to consider these matters carefully, as an unjustified repossession based on a wrongly asserted event of default may lead to massive damages implications. The appointment of a receiver is usually a clearly identified event of default.

3.1 Monitoring

If it appears that the aircraft mortgagor or lessee is having financial difficulties, it is important to monitor matters closely so that prompt steps can be taken to protect the security interest as soon as appropriate. The remedies may ultimately include repossession, sale, or appointment of a receiver. These are addressed in sections 6

and 7 below. There are several difficulties that tend to arise when a lessor or mortgagee takes such steps to enforce rights. The longer matters are delayed, the more problematic these issues are likely to become.

Back up insurance

One of the first precautionary steps a lessor or mortgagee might take is to ensure that there is proper insurance cover in place in case the lessee or mortgagor has defaulted on payment of the insurance premium or otherwise caused a loss of insurance cover. Back-up insurance should therefore be arranged to protect this position.

3.2 Identify Ownership

It is not uncommon, particularly in the case of a larger aircraft, for the airframe to be owned by one person but at any one point of time for the engines attached to that airframe to be owned by somebody else . Lease and security documentation usually provides, as an exception to the requirements for the lessee/mortgagor to maintain possession of the aircraft, for engines and other parts to be substituted to allow necessary maintenance and as part of recognised airline pooling arrangements. Although in some cases this can under the relevant documentation lead to a transfer of ownership more usually title to the substituted engines or parts remains with the original owner. This underlines the necessity for a mortgagee to check who owns what. It is important that ownership, any encumbrances and any restrictions on the giving of security imposed on the owner be ascertained at an early stage. If insolvency seems a possibility, it would be prudent to confirm the location and ownership of the secured property and any other relevant property. For example, it may be critical to ascertain the ownership of the engine installed at the time, and the location of any spares or replacements (e.g. undergoing repair elsewhere).

3.3 Accession

Under New Zealand law, where an engine owned by a lessor is installed on an aircraft owned by another party, in the normal course title to the engine will not automatically vest in the titleholder of the aircraft to the prejudice of the lessor. Title will generally remain with the lessor of the engine. This is now governed by the PPSA.

Accessions are defined in the PPSA to mean goods that are installed in, or affixed to, other goods. Under the Act, a security interest in goods that become accessions continues in the accession (s78). Provided the security interest in the accession has attached at the time when the goods become an accession, that interest has priority over a claim to the accession made by the person with an interest in the whole. For example, under s79 a security interest in a replacement engine (where a financing statement has been registered) has priority over a secured claim to the aircraft.

There are some exceptions set out in sections 80 and 81. In addition, there are specific provisions in sections 82 to 85 dealing with commingled goods that have been manufactured, processed, assembled or commingled such that their identity is lost in the product or mass.

3.4 Replacements and Spare Parts

It is common and prudent in taking security over an aircraft to include specific reference to replacement engines and spare parts, even though these may not be owned by the grantor at the time the security is given. However, the future provider of the items may have an interest in the goods as lessor, owner through retention of title, or a super-priority under the new PPSA.

3.5 Accurate Records and Identification

Accurate records (with unique identifiers such as serial numbers, photos etc) should be kept of all parts including engines, propellers (if any), navigational and communications equipment, food trolleys, liquid containers and any other critical or valuable accessories. It may be possible to update these records and confirm their accuracy as soon as insolvency seems a possibility.

In *Tasman Pacific Airlines of New Zealand (In Rec) v PRI Flight Catering Limited* (High Court Auckland, CP 287-IM01, 13 June 2001, Nicholson J), Tasman Pacific had gone into receivership and PRI, a catering company, held numerous parts that belonged to Tasman Pacific or lessors of aircraft to Tasman Pacific. These included catering trolleys and liquid containers, some of which were quite valuable, but importantly they were designed specifically for the aircraft. Tasman applied for an urgent return of that equipment so that its aircraft could be sold as operational units, and so that the appropriate equipment could be returned with the leased aircraft. However, so far PRI has successfully resisted returning the equipment on the basis that, while not disputing that the property belongs to someone else, it cannot determine who owns what without being able to match the serial numbers. Therefore it has failed to return any of the property. This situation could have been avoided by a comprehensive inventory with specific identifiers for all important equipment.

Liens and Set-off

Statutory Liens

There is no statutory right as such to seize or detain an aircraft for non-payment of airport taxes, air navigation or landing charges. However, a similar effect might be achieved by certain statutory and regulatory powers. For example, under s41 of the Civil Aviation Act 1990, where any fee or charge payable under that Act has not been paid by the prescribed date, the Director of Civil Aviation may revoke the aviation document to which the fee or charge relates.

Under s99 of that Act, Airways Corporation of New Zealand Limited is the sole provider of air control services, approach control services, and flight information services. On 6 June 1995 the Civil Aviation Authority notified the International Civil Aviation Organisation that New Zealand reserves the right to withhold air traffic control clearances prior to the commencement of flight for non-payment of previous services. The Airways Corporation Manual of Air Traffic Services was amended to record that air traffic services can be withheld from a company or aircraft owner because of non-payment for services. In *Sutherland v Civil*

Aviation Authority (High Court Rotorua, AP 15/97, 4 June 1997, Fisher J) a pilot's appeal against a conviction for manoeuvering an aircraft without prior authority was dismissed. One of Mr Sutherland's arguments was that it was "unlawful" for the air traffic control unit to refuse services on the basis of non-payment of previous charges (because of Annex 11 of the Chicago Convention). This argument was rejected.

In *Airways Corporation of New Zealand Ltd v Geyserland Airways Ltd; Airways Corporation of New Zealand Ltd v White Island Airways Ltd* [1996] 1 NZLR 116 it was noted at p122 that s99(2) of the Civil Aviation Act 1990 makes it plain that Airways Corporation of New Zealand Ltd does not have a monopoly to supply air traffic control services. However, there is a certain "practical monopoly" over the provision of those services. Therefore, despite *Sutherland*, there may remain some scope for debate as to whether an effective monopoly provider can properly withdraw services (see *Vector Limited v Transpower NZ Limited* [1999] 3 NZLR 646 (CA) and *Gladwin & Brightv Metrowater* (CA11/00, 4 July 2000, Richardson P, Henry & Blanchard JJ)). Nevertheless, the practical effect is that the aircraft may be able to be detained until the issue is resolved.

(a) Possessory Liens

Possessory liens in respect of work carried out on the aircraft are well recognised (see for example *Nippon Credit Bank Ltd v Air New Zealand Ltd* [1998] 2 NZLR 1 (PC); *Air New Zealand Limited v Director of Civil Aviation and AG* (Auckland High Court, M2077-SW00, 27 March 2002, Baragwanath J). In the case of a possessory lienholder (such as in the case of a workman's or mechanic's lien) the lienholder would be entitled to retain possession of the aircraft until the lienholder's charges had been met. See s93 PPSA. A mortgagee seeking to enter into possession of the aircraft must first discharge the possessory lien. A possessory lienholder has a statutory right to sell the aircraft by auction under the New Zealand Wages Protection and Contractors' Liens Repeal Act 1987 so long as the procedures in that Act are followed. However, the procedures in that Act are not particularly suited to the sale of aircraft.

(b) Equitable Liens

An equitable lien might also arise in relation to aircraft until certain specific claims have been satisfied, typically to secure the return of purchase monies. The main remedy of an equitable lien holder is to apply to the court for an order for the sale of the property over which the lien operates. The holder of an equitable lien ranks as a secured creditor in the event of the debtor's bankruptcy or liquidation. However, the express contractual grant of a charge may be inconsistent with and may preclude any right to claim an equitable lien (see *Ashton Group Limited (In rec and liq) & Ors v Ambrosia Holdings Ltd and Coffey* (High Court Auckland, CP198/SW01, 26 June 2001, Morris J).

(c) Equitable Set-off

Equitable set-off was raised as an issue in *Kiwi International Airlines Ltd v Region Air (BVI) Ltd* (High Court, Hamilton, CP50/96, 11 September 1996, Penlington J). In that case the lessor had relied on a "hell or high water" clause to submit that the defendant lessee had no contractual right of set-off as a ground for refusing payment. Therefore failure to make payment could be relied upon as a default leading to a right to terminate, regardless of whether the lessee had a separate unliquidated claim. The plaintiff, referring to authorities, submitted that set-off is not allowed by a Court exercising its equitable jurisdiction in respect of a cross-claim for unliquidated damages for breach of contract against a sum payable under the contract for performance unconnected to that to which the cross-claim relates. However, as the hearing was interlocutory, the court did not express any view on the matter except to say that there was a serious issue to be tried. In *Grant v NZMC Ltd* [1989] 1 NZLR 8, 13 (CA) it was held that parties may contract out of the equitable right to deduct from payment, but this can only be done by clear and unequivocal words. In that case the obligation to pay rent free of any "deduction" was not clear enough to exclude set-off. The position as regards contracting out of statutory rights of set-off is still uncertain.

(d) Documentation

Documents used in aircraft finance usually contain provisions relating to liens and statutory rights of detention. Generally these require that the lessee/operator must not allow any lien to subsist. However, in practice the lessor knows that these will exist despite the clause, and the difficulty arises in dealing with any third party who holds a lien. If insolvency seems likely, it may be that pressure can be brought to bear on the debtor to ensure that any debts which could support a lien over the secured or leased property are discharged in full. Otherwise the lessor or mortgagee may be forced to deal with the lienholder directly and itself discharge the debts in whole or in part in order to obtain repossession.

(e) Precautionary Steps / Practical Issues

Another prudent step that an owner or lessor could take in advance is to notify any prospective or current repairers of the aircraft or equipment that there is a prohibition on the creation of liens. A lessee or bailee is entitled to create liens if that is within their actual or ostensible authority. Express notification to the repairers of a prohibition (before the repair contract is entered into) will give the repairer knowledge that the bailee has no such authority and will therefore preclude the lien from arising. The repairers are likely to insist on alternative arrangements, such as payment on account in advance.

If the lessee or mortgagor does not or cannot pay those debts (e.g. liquidation ensues), often the most practical way for the lessor or mortgagor to deal with the situation is to come to some settlement with the lienholder in order to obtain a

prompt release of the aircraft or aircraft equipment. Any sums paid can then be claimed against the lessee/debtor either under indemnities in the relevant documentation directly or in a liquidation of the company. However, there may be grounds to attack the lien, such as:

(a) whether the lien was properly asserted (e.g. for work on that specific engine or component rather than a different one);

(b) whether the debt was due and not simply accruing;

(c) whether possession has been lost at some point;

(d) whether the lien has been waived or abandoned;

(e) whether the correct amount owing had been correctly tendered and was wrongly rejected, or the lienholder had made it clear that it would not release the goods until a larger and improperly claimed amount was paid;

(f) whether terms with the other party are inconsistent with a right to claim a lien (e.g. the granting of credit).

Because of the high risk of being exposed to a claim for damages if the lien is wrongly asserted, there is often scope for negotiation. One important procedure is the option of making payment into court to obtain release of the aircraft or equipment, with the dispute then continuing to determine what becomes of the payment into court. This option is available where one party retains specific property (other than land) by virtue of a lien or otherwise as security for a sum of money but does not dispute the title of another to the property.

Access to Aircraft

Even if the security document provides a right to enter into the mortgagee's premises to repossess the aircraft, this may be blocked as a matter of fact. If physical obstruction is used, it may be necessary to use court intervention to enforce those rights. This is dealt with in more detail below.

Deregistration and Jurisdiction

Under the New Zealand Civil Aviation Rules the holder of the New Zealand Certificate of Registration for the aircraft must have lawful entitlement to possession. On termination of a lease upon default, the lessee will cease to have any lawful entitlement to possession. In this event, the Certificate of Registration of the aircraft will expire, and, if the person lawfully entitled to possession of the aircraft has not applied for registration of the aircraft and for the grant of a New Zealand Certificate of Registration within 14 days, the registration of the aircraft on the New Zealand Register of Aircraft will be cancelled.

In order to deregister the aircraft without the consent of the holder of the Certificate of Registration (the former operator) it is necessary to establish that the party into whose

name the aircraft is being transferred is lawfully entitled to possession of the aircraft for 28 days or longer. This can be done by way of statutory declaration. However, it is always available to an operator to voluntarily deregister the aircraft. A lessor can take advantage of this by obtaining an irrevocable deregistration power of attorney when the lease it entered into. Such a power of attorney would allow the holder to exercise this right on behalf of the operator if this becomes necessary upon termination of the lease. A power of attorney granted by a lessee survives the liquidation of the lessee in favour of a purchaser or person who deals in the property of the company provided that the power is for valuable consideration and is expressed to be irrevocable.

Particular difficulties may arise if the aircraft is registered in a different jurisdiction. This is illustrated by *Air New Zealand Limited v Director of Civil Aviation and AG* (Auckland High Court, M2077-SW00, 27 March 2002, Baragwanath J). Air New Zealand was entitled to a lien over the aircraft owned by Air Wisconsin (a subsidiary of United Airlines). The aircraft was entered on the Indian register in the name of NEPC-Micon Limited and issued with a certificate of airworthiness. In 1996 NEPC Airlines (a subsidiary using the aircraft) contracted with Air New Zealand for an overhaul of the aircraft by Safe Air Limited in Blenheim, New Zealand. NEPC was unable to pay for the work and Air New Zealand obtained judgment for $810,410.63 plus interest and a declaration that it was entitled to a lien over the aircraft. In 1997 judgment was entered in favour of Air Wisconsin declaring it to be the owner of the aircraft. Both Air Wisconsin and Air New Zealand sought removal of the aircraft from the Indian register and re-registration on the New Zealand register to enable its sale with clear title. However, Justice Baragwanath dismissed the application seeking on order requiring the New Zealand Director of Civil Aviation to register the aircraft. Section 6(2) of the Civil Aviation Act prohibits the registration of an aircraft in New Zealand if it is registered in another country. This reflects Article 18 of the Chicago Convention, which prohibits dual registration. The Convention contains no specific obligation to delete an aircraft from the register or record. Deregistration in India was a matter for the Indian authorities. As there was no evidence of gross breach of international law norms, there was no proper ground to override the "act of state" principle. Therefore the New Zealand Court was not permitted to make a declaration or orders that would be inconsistent with the position taken by the State of India.

This story highlights the potential difficulties with enforcing against aircraft registered in one jurisdiction but located in another.

Technical Records

Part 91.111 of the Civil Aviation Rules states that no person shall operate an aircraft unless the following documents are carried in the aircraft: current airworthiness certificate, the aircraft flight manual, a technical log for NZ aircraft, and the certificate of registration (for aircraft not in their country of registration). Without these documents the aircraft cannot be operated and used. Therefore it should be clear from the lease or security document that all such documentation and all other relevant documentation

to ensure the continued operation and marketability of the aircraft is covered, and these documents must be delivered when the aircraft is repossessed. If insolvency seems imminent, it is important to confirm the location of those records and that they are or will be accessible if the company goes into liquidation.

4. Remedies of Mortgagee

The above difficulties are likely to impact on any enforcement of remedies under a mortgage. These include repossession, sale, and the appointment of a receiver.

Repossession

A mortgagee can enforce a mortgage in New Zealand by taking physical possession of an aircraft in accordance with the terms of the mortgage and subject to Part 9 of the PPSA. Self help remedies are permitted and, unless a mortgagor refuses to deliver possession or otherwise disputes the mortgagee's right to repossess, there is no necessity to obtain a court order. No permission of any other party (including any official body) is required to enforce a mortgage by taking physical possession of an aircraft.

If the lessee/debtor obstructs the exercise of contractual rights of enforcement, Court intervention may be necessary to obtain possession and/or prevent the aircraft from leaving New Zealand. The plaintiff could be the mortgagee/lessor seeking to repossess the aircraft, or Court intervention could be used by the lessee/operator wishing to ensure that it retains control of the aircraft. In each case proceedings must be commenced showing the nature of claim and setting out the relief sought. There are generally three options open to a plaintiff:

(1) **Seek an injunction preventing the aircraft being removed from the jurisdiction**

If there is a possibility that the aircraft may be removed from the jurisdiction or otherwise dealt with in such a manner so as to defeat (or attempt to defeat) a legitimate claim prior to final judgment being given, then an interim injunction could be sought preventing the removal of the aircraft from New Zealand.

During 1996, the injunction remedy was used both here and in Australia in relation to Kiwi International Airlines Limited, but unusually it was sought by the lessee. *Kiwi International Airlines Ltd v Region Air (BVI) Ltd* (High Court Hamilton, CP50/96, 31 August 1996 and 11 September 1996, Penlington J) concerned an airbus owned by Orix Aviation Systems Ltd, a Japanese company registered in Ireland. On 21 April 1996 Orix entered into a dry lease agreement of the aircraft with Region Air (BVI) Ltd as lessee.

On the same date Region Air (BVI) Ltd in turn entered into a wet lease and operating agreement with Kiwi International as sub-lessee. Under that sublease agreement Region Air (BVI) Ltd leased the airbus to the plaintiff Kiwi International on an "aircraft crew maintenance and insurance" basis. Region Air Pte Ltd agreed to operate the aircraft on behalf of Region Air (BVI) Ltd.

During late 1996 Kiwi International began suffering financial difficulties and defaulted under the terms of the wet lease agreement. Ultimately Region Air (BVI) Ltd gave formal notice terminating the lease. The plaintiff made an urgent oral application on Saturday 5 September 1996 for an interim injunction seeking orders preventing Region Air Pte Ltd from repossessing the aircraft. The orders were granted by the court in the following terms:

> *"That an injunction to issue pending further order of the Court restraining Region Air (BVI) Ltd or its agents or employees or Region Air PTE Ltd, or its agents or employees from taking any steps (whether by way of repossession or otherwise) in consequence of the purported termination"*
>
> The judge relied upon submissions by the plaintiff that it had an equitable setoff in relation to the defaulted payments and in any case there was a serious question to be tried as to the amount which Kiwi International allegedly owed to Region Air. Another factor was that if the purported termination was acted upon and the aircraft was repossessed, then significant inconvenience would have been caused not only to the plaintiff but also to several hundred passengers.

Concurrent orders were also sought in Australia. As a result of those orders, the Airbus resumed flying until the Monday when Kiwi International resolved to go into voluntary liquidation. The Airbus flew to Brisbane that day where Air Services Australia claimed a statutory lien in respect of the aircraft. As a result, the aircraft could not be flown out of Australia without settlement of outstanding arrears to Air Services Australia. Region Air Pte Ltd then applied for rescission of the ex parte orders. The court ultimately rescinded the orders for many reasons including the fact that the company was in liquidation and no longer operating as an airline, the damages to Region Air Pte Ltd were significant and mounting, Kiwi International was unlikely to be able to pay any such damages, and Kiwi International was not itself in a position to make payment to the Australian authorities to secure release of the aircraft.

(2) **Apply for a preservation of property order**

The New Zealand High Court Rules allow the court to grant an interim preservation of property order. A preservation of property order may only be obtained in respect of an asset which is the subject matter of the litigation.

This procedure was used in the reported case of *Air Wisconsin Inc v NEPC Airlines* (1996) 10 PRNZ 125. This is the same aircraft as the one in the recent *Air New Zealand* case already referred to. The court granted a preservation order in 1996 to protect the seller's rights to repossession under the contract until final judgment on the disputed issues could be obtained.

(3) **Issue proceedings *in rem* against the aircraft pursuant to the Admiralty Act 1973**

The Admiralty Act 1973 to some extent codifies the common law and equitable rules that have developed to govern maritime ventures. Although the Admiralty Act mainly concerns shipping, section 5(1) of the Admiralty Act permits, *inter alia*, the admiralty jurisdiction to be invoked by an action in rem against a ship or aircraft where there is a maritime lien "or other charge" on that ship or aircraft (see *Transpac Express Limited v Malaysia Airlines* (High Court at Auckland in Admiralty, AD 36/99, 25 January 2001, Master Kennedy-Grant)).

Sale

An aircraft can be sold by a mortgagee if it has a power of sale in the mortgage document. Such a sale can be conducted privately or by public auction in accordance with the terms of the mortgage and Part 9 of the PPSA. There is no requirement for judicial supervision.

The procedure for enforcement of a mortgage in New Zealand is generally determined by its terms, but now will also be subject to the requirements of the PPSA. Once an event of default has occurred, notice has been given to the borrower requiring repayment and the borrower has failed to comply, then it would be available to the mortgagee to retake possession of the aircraft (if permitted by the mortgage document) and commence sale proceedings. The time periods would be determined by the mortgage documents and the requirement that the mortgagee obtain the best price for the aircraft reasonably obtainable at the time of sale (which may involve advertising and the like). The duty is owed to subsequent chargeholders and, in particular, the mortgagor (see s110 of the PPSA and s19 of the Receiverships Act 1993, in which the common law obligation has been given statutory force). The PPSA requires 10 working days' prior notice of sale to be given to the debtor and other parties.

In addition, a mortgagee cannot, under the New Zealand Credit Contracts Act 1991, enforce a mortgage in an "oppressive" manner. In this context "oppressive" means oppressive, harsh, unjustly burdensome, unconscionable, or in contravention of reasonable standards of commercial practice. In the normal course the sale by a mortgagee in accordance with the terms of a mortgage document on an arm's length basis would not contravene these provisions.

Appointment of Receiver

In light of the strict regulatory environment applicable to aircraft, the ability to appoint a receiver is particularly useful. Where the company has granted a security interest over its assets in favour of another party, that security agreement may entitle the other party (depending on its terms) to appoint a receiver over the assets subject to the relevant security interest. This is likely to become more common following the coming into force of the PPSA. As Part 9 of the PPSA does not apply to receivers subject to the

Receivership Act security holders may choose to appoint a receiver rather than follow the enforcement procedures under Part 9.

The receiver (usually as the company's agent) manages the relevant assets until such time as the security holder is paid in full or the receiver retires. During the receivership, the directors cease to have control over those assets. A receiver may continue to trade or may cease trading and realise the various assets of the company.

Action on the Debt

In situations of financial difficulty, this avenue of enforcement is probably the least attractive option. It may ultimately be necessary to file a claim in a liquidation (dealt with later).

5. REMEDIES OF LESSOR

The remedies of the lessor will also depend on the specific provisions contained in the lease agreement, and will be subject to the same difficulties mentioned in section 5 above.

Repossession

A lessor or a security trustee (acting as assignee) can enforce a lease by taking physical possession of an aircraft. This can be done without judicial proceedings. No permission of any other party (including any official body) in New Zealand is required. The various options for Court orders to support such rights are the same for a mortgagee seeking to repossess the aircraft.

Mitigation

At common law, a plaintiff is not allowed to recover damages to compensate it for loss that would not have been suffered if reasonable steps had been taken to mitigate that loss. This is a question of fact dependent on the particular circumstances of each case, with the burden of proving a failure to mitigate resting upon the defendant. However, a plaintiff has no duty to embark upon a hazardous course of action merely to protect the wrongdoer from the consequences of his own carelessness.

The normal steps in mitigation of a lease that has been terminated early would be to lease the aircraft to another party, or to attempt to sell the aircraft. Credit would have to be given to the defaulting lessor for any such mitigation in reduction of the loss suffered by early termination. In the present market, it may be difficult to find alternative lessees or buyers of aircraft. This will make it especially important to record all steps taken (e.g. evidence of advertising, expressions of interests, and information about other competing aircraft available in the market).

6. RECEIVERSHIP

Unless a contract provides otherwise, pre-receivership contracts do not come to an end merely because a receiver is appointed. Equally, the mere fact that the company is in receivership will not be a defence to the claim to enforce the contract or seek damages for a breach. The receiver merely decides in that role (usually as agent for the company) whether the company will breach a pre-existing contract by repudiation.

A receiver does not automatically become liable under contracts entered into by the company before the commencement of the receivership. At common law, a receiver will only incur personal liability under a contract entered into before the receivership if he or she makes it clear that the intention of the receiver is to incur personal liability for the contractual obligations. Under the Receiverships Act 1993 this generally remains the case. However, one important statutory exception is s32(5) of the Receiverships Act 1993 which provides that the receiver will be liable for the payment of rent and other payments due under a contract subsisting at the time of his or her appointment relating to the use, possession, or occupation of the property by the grantor.

The liability of the receiver under a lease or hiring agreement is limited to that portion of the rent or other payments which accrue in the period commencing 14 days after the date of the appointment of the receiver. However, the receiver may apply to the court to limit or completely excuse his or her liability for the payments, and the receiver is also entitled to an indemnity out of the charged assets.

In order to minimise potential liabilities under s32(5), receivers are often anxious to return leased property or resolve issues relating to leased property within this 14 day timeframe.

7. LIQUIDATION

Overview

With effect from the commencement of a liquidation of a company, the liquidator has custody and control of the company's assets and actions may not be commenced or, if already in existence, may not continue unless the liquidator agrees or the court orders otherwise. The rationale for this rule is that the assets of a company should not be dissipated in wasteful litigation, particularly if there is a more convenient method for determining the claim.

None of the effects of the commencement of a liquidation affects the rights of a secured creditor to take possession of, and realise or otherwise deal with, any of the company's property over which the creditor has a charge. Therefore the above comments about enforcement are still applicable to a liquidation situation. A secured creditor who realises property subject to a charge may claim as an unsecured creditor for any balance due after deducting the net amount realised.

Making a Claim

A claim can be made under s303 of the Companies Act 1993 for any debt or liability, including contingent, future and unascertained claims.

A claim must be in the prescribed form with full particulars with any documents that evidence or substantiate the claim. The liquidator must, as soon as practicable, either admit or reject a claim in whole or in part and give notice in writing of any rejection to the creditor.

The amount of a creditor's claim against a company in liquidation must be calculated (in a New Zealand currency amount converted if necessary) as at the date and time of the commencement of the liquidation. If a claim is contingent, or is for damages, or is in some other way uncertain as to amount, the liquidator may make an estimate of the amount of the claim or refer the matter to the Court for a decision on the amount.

Statutory Right of Set-off

Where mutual credits, debits, and other mutual dealings exist between a creditor and a company that has been put into liquidation, those mutual credits and debits and other mutual dealings must be set off against each other. However, the benefit of insolvency set-off is denied to a creditor in relation to a transaction made during the prescribed period (which is generally the 6-month period ending on the commencement of the liquidation) unless the creditor proves that at the relevant time the creditor did not have reason to suspect that the company was unable to pay its debts as they became due.

8. STATUTORY MANAGEMENT

Overview

The Corporations (Investigation and Management) Act 1989 was designed to enable the Registrar of Companies to determine whether corporations are at risk, and to enable action to be taken in relation to such corporations in appropriate cases. Statutory management, although rarely used, was mentioned as a possibility in September 2001 in connection with Air New Zealand. In contrast with a liquidation, statutory management has a severe consequence on the enforcement of security rights.

As the aftermath of September 11 revealed, airlines are an essential part of a nation's infrastructure. Where a carrier is or is about to become insolvent it is therefore more likely as a matter of public interest that such a carrier be placed in statutory management than companies operating in other industries.

The main consequences of statutory management are that management of the corporation vests in the statutory manager, and claims and the exercise or enforcement of rights against the corporation are suspended indefinitely. The statutory manager also has extensive powers to sell assets of the company despite securities over those assets.

Suspension of Obligations

Under s44, the statutory manager of a corporation may suspend the repayment of any deposit or debt, or the discharge of any obligation to any person, notwithstanding the terms of any contract, except where the obligation in question was incurred after the date on which the corporation was declared subject to statutory management. Any such suspension by the statutory manager does not constitute a breach or repudiation of any contract entered into by the corporation.

Moratorium

Section 42 contains an extensive moratorium provision which makes significant inroads into the normal rights of creditors and essentially stays creditors' hands during the period of statutory management. Among other things it prevents a lessor or mortgagor from:

(a) foreclosing, entering into possession, selling or appointing a receiver of the corporation's property or of property;

(b) exercising any powers or rights under any mortgage, charge, debenture, instrument or other security over the corporation's property;

(c) claiming or recovering, pursuant to any retention of title clause, hire purchase agreement, mortgage, lease or security, any property in the corporation's possession; or

(d) exercising any right of set-off against the corporation.

Power of Sale

Section 50(1) provides for a general power of sale of the whole or any part of the business undertaking. Section 50(3) is a critical section in relation to the negative covenants in security documents. Section 50(3) provides:

> *"The provisions of any agreement requiring any consent, licence, permission, or other authority shall not have any application in respect of any sale pursuant to this section, unless the Court, on application by any person who would be adversely affected, otherwise orders."*

Property or assets of a corporation which are subject to a security remain subject to that security where the statutory manager sells or disposes of them to a body corporate formed for the purposes of sale or disposal of the corporation's business undertaking (s51(3)). However, the position is different where the statutory manager sells or disposes of any shares, property or assets of such a body corporate. In that case, if any property or assets are subject to a fixed charge, the person entitled to the charge must be paid out of the proceeds of sale in priority to all other claims except the statutory manager's costs of arranging the sale (s51(4)).

Voidable Transactions

Statutory managers also have the powers of liquidators set out in ss 292-301 and 312 of the Companies Act 1993 (the voidable transaction sections). For these purposes the corporation is treated as a company in liquidation from the date on which statutory management commenced: s55(1).

Jurisdiction

The apparent extraterritorial reach of New Zealand's laws in relation to foreign assets of New Zealand companies will ultimately be tested by the operation of the rules of private international law applied by the Courts of the country in which the foreign assets are located.

Given the more extreme nature of these provisions compared with overseas laws, it is likely that courts in at least some jurisdictions would not recognise the moratorium because of its interference with express contractual rights. Lessors and secured creditors could take steps to exercise their rights over property located overseas, and a statutory manager, as a matter of practicality, would be faced with problems and delays in trying to assert rights overseas. Even if the foreign courts were to recognise the rights, there is likely to be a period of delay when, for example, an aircraft might be grounded by injunction pending a hearing to determine the statutory manager's rights.

This risk alone places a strong incentive on the statutory manager to negotiate with secured creditors, lessors and any other parties that could interfere with assets overseas. Alternatively, the statutory manager could effectively decide to abandon overseas flights and restrict the ongoing business in statutory management to domestic flights.

9. FURTHER DEVELOPMENTS:
Convention on International Interests in Mobile Equipment

9.1 Overview

The Convention on International Interests in Mobile Equipment ("the Convention") was designed to establish an international legal regime for the creation, enforcement, perfection and priority of security interests. Although New Zealand is not a signatory, it is worth noting its existence in terms of possible future direction.

The Convention is intended to be applied by separate Protocols, one of which is the Aircraft Equipment Protocol. The Aircraft Equipment Protocol adopts a practical approach to key issues in international asset-based civil aviation financing. Outright sales are outside the scope of the Convention, which is directed at credit and leasing transactions. The Protocol extends registration and priority rules to aircraft objects in a way that reflects civil aviation laws and practice in a number of states, and addresses the problems created by the international mobility of such objects.

The Protocol provides the creditor with two additional default remedies:

(a) To procure deregistration of the aircraft, thus permitting re-registration and another contracting State; and

(b) To procure the export and physical transfer of the aircraft to the territory of another State.

The default rules of the Convention are modified by the Protocol to meet the particular needs of the aviation industry.

(See www.unidroit.org/english/internationalinterests/conference2001/main.htm for the Convention, Protocol and a list of the signatory countries resulting from the diplomatic conference held in Cape Town between 29 October to 16 November 2001.)

LIABILITY AND INSURANCE

Types of insurance

There are various types of insurance available to cover the risks of aircraft ownership, operation and financing. These include hull all risk, war risks and allied perils and third party liability.

Requirements for Insurance

In addition to the usual extensive and detailed contractual provisions relating to insurance in lease and financing documents there are some statutory provisions. Under s29 of the Carriage by Air Act 1967, each domestic carrier is required to insure against liability for any damage consequent upon death or injury. Such insurance must be "adequate". If the aircraft is leased for more than 14 days, the lessee is the person who must insure the aircraft.

Section 87ZA of the Civil Aviation Act 1990 provides than any applicant for a grant or renewal of an international air services licence may be required to furnish proof of insurance cover against liability which may arise out of or in connection with the operation of the service in respect of death or bodily injury to any person and in respect of loss to any property to the extent that the Minister "deems reasonable" having regard to the nature and extent of the service.

Risk and Liability

The exposure of a passive lessor or mortgagee in New Zealand to third party liability while the aircraft is operated by another party is very limited. It would only arise if the lessor or mortgagee was in some way responsible for the aircraft or the harm caused.

The strict liability provisions under the Civil Aviation Act 1990 would generally not be applicable to an owner of an aircraft that entered into a dry lease with a lessee for a period greater than 28 days, so long as the owner took no part in operating or maintaining the aircraft.

Also, under the Civil Aviation Act 1990, and similarly under the Carriage by Air Act 1967, the Carriage of Goods Act 1979 and the Warsaw Convention (as supplemented by the Guadalajara Convention), an owner of an aircraft would not be considered a "carrier" unless it was a party to the contract with the passenger or the consignor, or if the lessor operated the lease (e.g. under a wet lease).

9.2 FINANCIER'S CONCERNS

Insurers of the aircraft operator's liabilities will generally include the owner/lessor/financier as an additional insured on the operator's insurance policies with a warranty that the owner/lessor/financier has no operational interest in the aircraft and will also waive rights of subrogation against such passive party. Lessors and mortgagees will also generally require to be named as loss payee and to have breach of warranty coverage and severability of interest clauses. Naturally if the owner does assume a greater interest (e.g. upon repossession), then comprehensive insurance will need to be put in place at that time.

War Risk and Allied Perils Cover

In response to the events of September 11, 2001 on 17 September 2001 war risks underwriters gave 7 days' notice of cancellation of air carriers' war risks and allied perils liability cover, but with the carriers' right to reinstate cover but only to USD50 million on payment of an additional premium by way of surcharge per passenger sector.

Because of the extremely low cover the USD50 million represented (which would have been grossly inadequate in the event of another similar disaster) the Governments in many jurisdictions (including New Zealand) agreed to provide indemnity or supplementary insurance cover to their national carriers in respect of liability beyond the cover available commercially.

Hull war risks cover was also cancelled but reinstated at greatly increased costs – in some case triple the previously applying premium.

Within a few weeks however, war risks liability cover up to USD1 billion became available in the market, and many carriers opted to purchase it. Nonetheless, this was subject to restricted availability depending on the air carrier concerned and the geographical areas of its operations.

Many Governments continue to provide indemnities or other insurance protection to their national carriers. In the U.S., the Department of Transportation has extended the provisions of FAA-issued war risk insurance policies for US carriers beyond their stated 19 May 2002 expirations.

The US Government has signalled that subsequent extensions will be on more expensive terms, including the threshold application level (up from USD50 million to USD100-150 million) plus a new premium structure to generate greater revenue. Debate continues in the US Government as to whether the FAA should continue to provide war risk cover to US airlines or whether they should rely on commercially available insurance.

One of the issues which arises from the indemnity structure is that interested parties that would otherwise be noted as additional assureds and loss payees (including mortgagees) under insurance policies (unless, as a matter of contract they have access to those indemnities) are reliant on the airline involved to apply the proceeds of an

indemnity claim to any loss suffered by the parties that were noted as additional assureds on the policy relating to that aircraft.

9.3 ICAO Response

Since the events of September 2001 and the giving of the seven day notice of cancellation of war risk insurance cover by insurance underwriters to airlines and insured parties around the world ICAO has established a special group on aviation war risk insurance. The group has been tasked to review the problem of aviation war risk insurance in light of the recent developments and to develop recommendations for a coordinated and appropriate assistance mechanism for airline operators and other affected parties if and when necessary to the extent the insurance markets are unable to provide sufficient coverage.

That study group has recommended the setting up of an international mechanism which would provide aviation war risk coverage for the aviation insurance industry with multilateral government backing for the initial years. As a long term solution the study group has recommended that an international convention be developed which would limit third party liability of the aviation industry from losses arising from war, hijacking and related perils. The ICAO Council is due to vote on these recommendations towards the end of May 2002.

10. Conclusion

The problems commonly experienced in the area of aircraft financing highlight the importance of the following:

(a) careful drafting before entering into the contracts, specifically addressing future problems and avoiding pitfalls, and registering the documents appropriately to ensure priority;
(b) keeping accurate and detailed records (updated regularly) identifying all goods of value and tracking their location;
(c) considering and complying with statutory and regulatory requirements at enforcement, and dealing effectively with debtor behaviour that could destroy or harm the security;
(d) acting promptly before it is too late.

The complexity of problems in these areas means that mortgagors and lessors should always seek legal advice from counsel experienced in these specific fields.