Aircraft financing – how things have changed

John Field

Partner
Blake Dawson Waldron
Melbourne

The airline industry has often been said to be volatile, but rarely, if ever, has that description been more apt than in the last 12 months.

In Australia, we have seen:

- Continuing vigorous competition among the established carriers, Qantas and Ansett, and the major new entrants, Impulse and Virgin Blue;
- The demise of Impulse as an independent carrier, and its ultimate purchase by Qantas;
- The terrorist attacks of 11 September 2001;
- The collapse of Ansett.

The economic consequences of the 11 September attacks for the aviation industry in Australia have parallelled those elsewhere in the world, where some renowned airline brands are no longer to be seen, such as Sabena and Swissair.

What has been different in Australia has been the accompanying opportunities for growth in the domestic market for the two remaining major carriers. Qantas, between 11 September last year and July this year, will have added some 15 new aircraft on domestic trunk routes and a further six new aircraft on regional routes, not including the aircraft that were operated by Impulse at the time of its acquisition. Virgin Blue, likewise, is operating at least eight additional aircraft on trunk routes.

All of this has made for a busy time for aircraft financing lawyers, and has thrown up a number of issues that have not been encountered in practice before.

LESSONS FROM THE ANSETT ADMINISTRATION

The Ansett administration is the first of a major airline in Australia. Although there have been previous aircraft repossessions by lessors/financiers in Australia, most notably in relation to Compass Mark I and Mark II, none has involved the voluntary administration regime under the *Corporations Act* or the predecessor *Corporations Law*.

The administration of Ansett has brought greater clarity to several areas of previous uncertainty.

Corporations Act implications

Under most of Ansett's aircraft leases, the appointment of an administrator would have been an "event of default" entitling the lessor, under the terms of the lease agreement, to terminate the lease, recover possession of the aircraft and recover the applicable termination amount. The same would typically have applied under mortgages of aircraft that Ansett owned.

For both owners/lessors of aircraft or other property that is leased to a company that goes into administration and for mortgagees of aircraft that are owned by the company, the voluntary administration provisions in the

Corporations Act will apply to regulate the rights and obligations of the owner/lessor and the mortgagee as against the administrator.

Special provisions apply in relation to leases. The first question for most lessors was whether they were entitled under the *Corporations Act* to terminate their leases to Ansett.

Under the *Corporations Act*, s.440C, an owner or lessor of property that is used or occupied by, or in the possession of, a company under administration cannot take possession of the property or otherwise recover it without the administrator's written consent or the leave of the Court. A similar provision restricts the enforcement of a mortgage or charge over property owned by a company under administration (*Corporations Act*, s.440B), except where the chargeholder holds a charge over the whole, or substantially the whole, of the property of the company (*Corporations Act*, s.441A).

In relation to leases, it is important to note a distinction between the wording of s.440C (the prohibited step being to "take possession of the property or otherwise recover it") and the wording of the equivalent provision in the United Kingdom, which stipulates that without the consent of the administrator or leave of the Court "no ... steps may be taken ... to repossess goods in the company's possession" (emphasis added).[1] In the UK it has been argued that giving a notice of termination of a lease would be a first step to repossessing the aircraft, and that to do so without the requisite consent or leave would be in contempt of court.[2] In the Australian context, however, it seems clear on the wording of s.440C that there is no constraint on giving a notice of termination of a lease, just on repossession itself.

Generally speaking, seven days after the administration begins, the administrator will become personally liable for the lease rentals and other amounts payable under the lease agreement that are attributable to the period from that date until the administration ends, if the company continues to use, occupy or possess the property (*Corporations Act*, s.443B(2)).

However, the administrator can, within that period of seven days after the administration begins, decide that the company does not propose to exercise rights in relation to the property. The administrator may give the owner/lessor a notice to that effect, in which case the administrator will not attract personal liability for the lease rentals (*Corporations Act*, s.443B(3) and (4)).

In the Ansett administration, Goldberg J, on the application of the administrators, extended the seven day period on several occasions, because he was satisfied that the complexity of analysing Ansett's needs and the different financial obligations applying to the various aircraft in its fleet made it impracticable for the administrators to reach a proper decision any sooner.

In many cases a lessor will be willing to leave an aircraft in the possession of the airline if the airline's administrator is personally liable for the ongoing lease rentals and maintenance and keeps the payments up to date.

On the other hand, where the administrator has given a notice under s.443B(3) that the airline does not propose to exercise rights in relation to the aircraft, thereby excluding personal liability of the administrator for payment of rent, the lessor will generally want to repossess the aircraft as soon as possible. You might think that the notice from the administrator would

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1 *Insolvency Act* 1986 (UK), s.11(3)(c).

2 See Western & Bissert, "Aircraft recovery: the options for lessors", International Financial Law Review, November 2001 at p.23.

amount to a sufficient consent for the purposes of s.440C to entitle the lessor to proceed with repossession forthwith. However, the prevailing view seems to be that a specific consent to repossession, or leave of the Court, is separately required. In the Ansett administration, the administrators obtained Court orders for the orderly return of aircraft over an extended period,[3] largely because of the logistical difficulties of arranging restoration of engines and APUs to their original airframes, assembly of maintenance records, etc. Some lessors who were fortunate to have an alternative use for their aircraft in the short term were able to negotiate (or obtain Court orders for) a speedy return of their aircraft, but they were a small minority.

Engine pooling issues

Pooling and interchange arrangements for engines, APUs and other aircraft parts are a common feature of the aviation industry, and virtually every lease or mortgage of aircraft will permit pooling and interchange arrangements in the ordinary course of business.

Engine pooling clauses will generally provide for "title tracking" (ie, where the engine lessor retains ownership of the original engine even where that engine is off-wing or affixed to another airframe), as opposed to "title switching" (ie, where the lessor of an airframe and engines takes title to whatever engines are affixed to the airframe from time to time).

The Ansett engine pooling clauses followed the "title tracking" format. As a result, lessors and other financiers whose engines were on other airframes when Ansett went into administration have had to locate their engines and negotiate with the owners of the other airframes involved to recover the engines. This has proved to be a far more complex and protracted exercise than most people expected.

Statutory and contractual liens

Aircraft lessors and mortgagees are always wary of statutory liens that can attach to an aircraft for unpaid navigation authority fees and landing charges. In Europe especially this is an issue, because (for example) Eurocontrol is entitled to a fleet-wide lien to secure unpaid charges referable to any aircraft in the airline's fleet.

In Australia, there is provision under s.59 of the *Air Services Act* 1995 (Cth) for Airservices Australia to have a statutory lien, but only on an aircraft by aircraft basis, for unpaid service charges referable to that aircraft. However, since the Constitutional challenge[4] to the validity of the statutory charging regime, Airservices Australia has chosen to collect its service charges by way of contract with the airlines[5] rather than under its statutory power, and in those circumstances no statutory lien applies.

Most airports in Australia are operated by airport lessee companies under long-term leases from the Commonwealth, under the regime enacted in the *Airports Act* 1996 (Cth). Unlike the position in Europe, there is no provision

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3 It is understood that some leased aircraft had still not been returned some eight months after the Ansett administration began.

4 The Federal Court found certain provisions invalid in *Airservices Australia* v. *Monarch Airlines Ltd* (1998) 152 ALR 656. Although this decision was reversed by the High Court on appeal (see *Airservices Australia* v. *Canadian Airlines International Ltd & Ors* (1999) 202 CLR 133), it is understood that Airservices Australia has nonetheless continued the practice it had adopted after the Federal Court decision.

5 S.8(4) of the *Air Services Act* 1995 allows Airservices Australia to provide its statutory services under a contract.

for an airport operator to have a statutory lien over an aircraft for unpaid airport fees.

In the course of the repossession of Ansett aircraft by lessors, at least one Australian airport operator sought to claim a contractual lien, on a fleet-wide basis over any Ansett aircraft located at the relevant airport, to secure unpaid airport fees owing by Ansett. The airport operator claimed that the lien was enforceable against the aircraft lessor as well as against Ansett: the argument went that the airport's terms of use stipulated such a lien, and that the lessor, by permitting Ansett to operate the aircraft to the airport in question, had impliedly consented to, and accepted, those terms of use, even though the lessor had never seen them, and even though the lease prohibited the incurring of such a lien. In my view the claim never had merit, and the airport operator was quick to withdraw the claim once legal proceedings were issued against it for recovery of the aircraft.

Deregistration powers of attorney

Under reg. 13L of the *Civil Aviation Regulations* 1988, the cancellation of the Australian registration of an aircraft can only be made on application by the holder of the certificate of registration (ie, the aircraft operator) to CASA, accompanied by the certificate of registration itself and the written consent of the holder of any property interest[6] in the aircraft.

A lessor or mortgagee of an aircraft will typically require the airline to provide a "deregistration power of attorney" in favour of the lessor/mortgagee, authorising the lessor/mortgagee (or its designated officers) to sign the required application form. Often the deregistration power of attorney will be expressed to come into effect, or to be exercisable, only while an event of default under the lease or mortgage has occurred and is continuing.

There has always been some doubt whether, as a matter of practice, CASA would recognise a consent form executed on behalf of an airline by a lessor/mortgagee acting under a deregistration power of attorney. Some lessors/mortgagees have attempted to obtain an acknowledgment from CASA in advance, at the time the deregistration power of attorney is granted. CASA has generally been willing to acknowledge receipt but nothing more.

Following the Ansett collapse, it seems that CASA was not willing to recognise a consent signed under a deregistration power of attorney in these circumstances. CASA required a signature by a requisite officer of Ansett as holder of the certificate of registration. In fact, the Ansett administrators were willing to co-operate and arranged for the requisite consent forms to be signed.

It was not necessary, therefore, to put the CASA stance to the test. In my view, if CASA's stance were challenged in court, CASA would be found to have no legal basis for refusing to recognise a properly executed deregistration power of attorney.

Interestingly, the relevant CASA form[7] was revised in December 2001, and now includes a note that, if a certificate holder is an organisation, an application to cancel or transfer an Australian aircraft registration must be signed by a director or secretary of the organisation or by someone

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[6] "Property interest" is defined in reg. 2 of the *Civil Aviation Regulations* 1988. It includes the interest of an owner, a hirer under a hire-purchase agreement and a hirer or charterer under a contract of hire or charter other than a hire-purchase agreement (ie, where the hirer/charterer has no purchase option).

[7] CASA Form 021.

authorised in writing signed by such a director or secretary. This suggests that CASA may now give greater weight to a deregistration power of attorney.

Although many financiers do still take comfort from holding a deregistration power of attorney, in practice they will in any event need the co-operation of the airline or its administrator or liquidator, because of the need to produce the original certificate of registration along with the deregistration application.

Copyright claims

A further interesting, and for most people unexpected, issue that has arisen in the course of repossession of Ansett aircraft is the assertion of a copyright claim in respect of the artwork reproduced, under licence, on the aircraft bulkhead. To date this has not proved a major impediment to the repossession, sale or releasing of the aircraft, as the claim has sought to restrain further reproduction or use of the artwork, but not use of the artwork as currently installed on the aircraft.

WAR RISK AND TERRORISM INSURANCE

Shortly after the 11 September attacks in the United States, aviation insurers worldwide gave a seven day notice of termination of all war risks cover. The termination took effect on 25 September 2001.

Airlines that agreed to meet a per-passenger premium surcharge were offered limited replacement cover, which restored the previous level of cover for death or injury to passengers on the aircraft, but which limited to US$50 million in aggregate the cover for death or injury to third parties and property damage on the ground.

Faced with that limitation, most airlines worldwide would have grounded their fleet once the previous cover terminated.

In the event, most governments have stepped in and provided a top-up indemnity to the previous levels of cover to the extent that commercial insurance is not available.

In Australia, the Commonwealth's indemnity has been provided by way of Deeds of Indemnity, and has been made available to airlines, airports, ground handlers, Airservices Australia and CASA. The indemnities were initially provided for only one month, and have been "rolled over" monthly since then.

Despite some initial uncertainty as to whether the Commonwealth's indemnities extended to financiers, the Commonwealth issued letters of "clarification" confirming that the indemnity deeds would cover claims made by financiers against the airlines under the contractual indemnities in their lease or finance documents.

On 10 May 2002, the Minister for Transport and Regional Services, John Anderson, announced that the Government had decided to extend the Commonwealth's indemnities by three months at a time. It is understood that a charge will also commence to be made for the indemnity.

At the same time, the Minister announced that Australia would support a global solution being developed by the International Civil Aviation Organisation to the ongoing aviation war risk insurance issue. The ICAO scheme would result in aviation war risk insurance coverage being provided by a non-profit company with multi-lateral government backing. Firms in the aviation sector of participating countries would be able to buy insurance under the scheme once their government signs the commercial agreement to join the scheme.

STRICT LIABILITY OF AIRCRAFT OWNERS

The restricted availability of war risk insurance has also focussed renewed attention on the strict liability imposed in Australia on aircraft owners and operators for damage caused to third parties and property on the ground by an aircraft in flight.

Strict and unlimited liability is imposed by the *Damage by Aircraft Act* 1999 (Cth), jointly and severally on operators and owners of an aircraft, for death or injury to persons, or material loss, damage or destruction of property, caused by an aircraft in flight or something falling from it.

The *Damage by Aircraft Act* came into effect in November 2000, following the denunciation by Australia of the 1952 *Convention on Damage caused by Foreign Aircraft to third Parties on the Surface* (known as the *Rome Convention*), and repealed the previous legislation[8] which had given effect to the *Rome Convention*. The *Rome Convention*, where it applied, had imposed strict but limited liability on the operator of an aircraft. The limits had remained unchanged since 1952.

The background to the introduction of the *Damage by Aircraft Act* was a discussion paper prepared by the Department of Transport in 1995. The discussion paper noted that, because many other countries, including the US, Canada and the UK, had denounced the *Rome Convention* (leaving only two *Rome Convention* countries[9] with scheduled air services to and from Australia) and because of the inconsistent liability position applying under different Australian State and Territory laws, it was essentially a lottery whether and how much someone could recover for injury, death or damage caused by an aircraft in flight, depending on where the incident occurred and where the aircraft was operating to or from. Under some State laws, liability was strict and unlimited; in other States and the Territories, common law negligence principles applied.

The discussion paper recommended that Australia should denounce the *Rome Convention* and impose a regime of strict and unlimited liability. The paper did not discuss the distinction between the aircraft operator and owner as the party liable.

The *Damage by Aircraft Act* applies, to the exclusion of inconsistent State or Territory laws, to every flight where there is a sufficient Constitutional nexus[10].

Following the events of 11 September 2001, various groups including the Australian Equipment Lessors' Association have lobbied for the *Damage by Aircraft Act* to be amended to exclude "passive financiers" (ie, owners, lessors and mortgagees, except where they are in possession and control of the aircraft) from liability. Both the US and the UK have forms of passive financier exemptions under their equivalent legislation.[11]

It is understood that Cabinet is due to be considering shortly a package of measures recommended by Treasury and the Department of Transport that includes a passive financier exemption.

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8 The *Civil Aviation (Damage by Aircraft) Act* 1958 (Cth)

9 Italy and Papua New Guinea.

10 This includes, in effect, flights by aircraft owned or operated by the Commonwealth (except the defence force) or by a foreign, trading or financial corporation, international and interstate flights, flights within the Territories, and flights to or from airports that are Commonwealth places: see *Damage by Aircraft Act* 1999, s.9(4).

11 In the US, see Title 49 of the *Code on Transportation*, §44112; in the UK, see *Civil Aviation Act* 1992, s.76(4).

TAX AND STAMP DUTY ROUND-UP

There have been a number of recent changes to the tax and stamp duty regime in Australia that affect aircraft financing. Although this summary does not in any way purport to be comprehensive, these are a few of the more notable changes:

Effective life for capital allowance deductions

The Commissioner has for some time been reviewing his determination of the effective life for aircraft, currently set at eight years, which forms the basis for determining the period over which the cost of an aircraft can be deducted under the capital allowance provisions[12].

In the Government's Federal Budget on 14 May 2002, it was announced that a statutory cap of ten years would be introduced from 1 July 2002 on the determined effective life of aircraft. This will prevent the Commissioner from effectively determining any longer period.

ATO rulings on cross-border leases

There was a period of some 18 months prior to the release of *Taxation Ruling* TR 98/21 in 1998 when it was impossible to obtain a ruling from the Australian Taxation Office in relation to cross-border leases of aircraft or other assets.

That published ruling set out the ATO's views on the difference between those cross-border leases to which royalty withholding tax would apply (in essence, where the use of the asset was the predominant element of the arrangement) and those to which it would not (essentially where the purchase of the asset was the predominant element) and to which interest withholding tax[13] would apply instead.

Following the release of IT 98/21, the market felt that the ground-rules for cross-border leasing were relatively settled. Private binding rulings have been obtainable for specific transactions, generally within the commercial timing constraints of the transaction such as aircraft delivery dates.

Since mid-2001, however, the ATO has been applying unprecedented scrutiny to cross-border lease transactions, and more than ten months elapsed without the issue of a ruling. Several transactions have been fully negotiated and even signed, but have not closed because of the inability to obtain a ruling. Delivery dates have come and gone, and the opportunity to finance aircraft by way of cross-border lease (including the ability to benefit from available export tax incentives in the US) has been lost. This has put Australian equipment users such as airlines at a competitive disadvantage with their international competitors.

The stated reason for the blockage within the ATO has been the need to consider the new capital allowance provisions[14] and their interaction with the new provisions regarding hire-purchase agreements,[15] both of which came into effect on 1 July 2001.

The information requests issued by the ATO as part of its consideration of ruling requests on cross-border leases during this period, however, have

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12 Division 40 of the *Income Tax Assessment Act* 1997 (Cth).

13 Usually, on any deemed interest component determined under s.128AC of the *Income Tax Assessment Act* 1936 (Cth), in the case of a cross-border hire-purchase agreement.

14 Division 40 of the *Income Tax Assessment Act* 1997(Cth).

15 Division 240 of the *Income Tax Assessment Act* 1997(Cth).

gone well beyond anything previously seen, and it has been difficult to see how much of the information sought has had any relevance to the tax issues involved.

The first cross-border lease ruling since July 2001 issued in mid-May 2002. It is to be hoped that the issue of that ruling heralds the end of the ATO's internal consideration of points of principle arising from the new legislative provisions, and allows the backlog of other rulings to be cleared without delay.

It is also to be hoped that the ATO adopts a sensible and timely approach to its consideration of future ruling requests in cross-border lease transactions, so that Australian equipment users do not suffer further competitive disadvantages as compared with their overseas counterparts by being effectively shut out of the cross-border lease market by the inability or unwillingness of the ATO to issue a ruling.

Proposed new Protocol to amend Australia/US Double Tax Convention

A Protocol to amend the Australia/US Double Tax Convention was signed on 27 September 2001. Subject to the passing of ratifying legislation in Australia and the US, the Protocol is expected to take effect on 1 July 2003.

Relevant to aircraft financing, the Protocol will abolish the royalty withholding tax that has applied to leases (other than hire-purchase agreements) of "industrial, commercial or scientific equipment".[16] Short-term operating leases of aircraft from US lessors to airlines in Australia will, therefore, cease to attract royalty withholding tax once the Protocol takes effect.

However, the Protocol makes no change to the provision[17] that deems an enterprise to have a permanent establishment in one of the states if the enterprise "maintains substantial equipment for rental or other purposes within that ... state (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months". This means that consideration will still need to be given to whether a US operating lessor leasing aircraft or other mobile but substantial equipment into Australia for more than 12 months will have a permanent establishment here as a result. Views differ as to whether the equipment needs to be leased at a fixed place in order to give rise to a permanent establishment on this basis, so excluding leases of aircraft. It is understood that the ATO has ruled in opposite ways on different facts in the past on this point.

Hire of goods stamp duty

The *Duties Act* 2001 (Qld) came into force on 1 March 2002. That brought to five[18] the number of Australian jurisdictions that have introduced legislation broadly giving effect to the Stamp Duties Rewrite project that was undertaken by the participating jurisdictions through the early and mid-1990s.

Each jurisdiction that has introduced Stamp Duties Rewrite legislation has included an exemption from duty under the "hire of goods" head for arrangements for the hire of an aircraft, ship or vessel, or an engine or other component part of an aircraft, ship or vessel.

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16 See art. 12 of the Australia/US Double Tax Convention, and art. 8 of the Protocol.

17 Art. 5(4)(b) of the Convention.

18 New South Wales, the Australian Capital Territory, Victoria, Tasmania and Queensland.

Although other States still retain rental business or hiring arrangement duty applicable to aircraft (but with different nexus tests from those applicable to hire of goods duty in the Rewrite jurisdictions), the aircraft exemption in the Rewrite jurisdictions has made it much easier for airlines operating in Australia not to be caught unintentionally by those imposts.

Mortgage stamp duty

Under the arrangements made between the Commonwealth and the States when the goods and services tax was introduced in 2000, stamp duty on mortgages is due to be abolished from 1 July 2005. Victoria has brought this forward by one year to 1 July 2004, and has already enacted the abolition.[19] Whether the other States follow through on this commitment remains to be seen.

In the meantime, the Rewrite jurisdictions of New South Wales, Victoria, Tasmania and Queensland[20] have introduced a broadly common nexus test for mortgage duty, namely, the presence of mortgaged property in their jurisdiction at the relevant time.

Apart from Queensland, the Rewrite jurisdictions that impose mortgage duty test the location of assets at the date on which the mortgage is executed, with some limited exceptions (eg, land to which the mortgage attaches within one year of its execution).

In Queensland, however, the new Duties Act also seeks to impose duty where the mortgage applies to Queensland property at the date of a further advance. Both NSW and Victoria had considered, but ultimately rejected, an amendment to their legislation to the same effect. In the case of movable assets such as aircraft, it is both impracticable and anomalous to recalculate the asset mix between different jurisdictions every time there is a further advance under the mortgage.

The absurdity of this approach is highlighted by the example of a secured fleet financing by any foreign airline, where mortgage duty could arguably be assessed on the entire financing amount if one of the mortgaged aircraft happened to be in Queensland airspace (en route from, say, London to Sydney) at the time a further advance is made. Try suggesting that to the treasurer of the foreign airline and see what reaction it elicits!

It is to be hoped that this element of the Queensland legislation will be amended to bring it into line with the NSW and Victorian provision, or better still, that all the Australian jurisdictions bring forward their committed abolition of mortgage duty altogether.

21 May 2002

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[19] See *Duties Act* 2000 (Vic), s.148A.

[20] There is no mortgage duty in the ACT.