THE LEGAL ASPECTS OF AVIATION FINANCE

IN DEVELOPING COUNTRIES

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To the memories of my

FATHER and, older brother IBRAHIM

Through their patience and love,
my education extended beyond the elementary school
of my village Santemai, Mitgamer, Egypt

ABSTRACT

The assessment of benefits and costs in determining national and international aviation policy by the developing countries differs markedly from that used for advanced countries. In view of the financial climate which prevails in the aviation industry today, it is important to examine the particular problems that surround aircraft financing in the Third World. Various policies and laws must be evaluated to assess what has been done and what can further be done to develop a more favourable climate for investment by financial institutions, and improve the capability of the less developed countries to participate more efficiently in the aviation industry.

The treatment of the subject matter begins in Chapter I with an overview of the aviation industry and it's financing Historical Review. Chapter II deals with the problem of recognition of title and security rights in aircraft under international law. Chapter III contains a detailed consideration of the types of commonly used security instruments in aircraft financing. Chapter IV sets out an overview of financing in developing countries, Chapter V contains a study of the various problems facing the asset financing of aircraft in the Third World and possible solutions.

In the last three chapters, emphasis will be placed on regional aviation issues. Chapter VI discusses security interests in aircraft in selected Arab and Muslim countries' national laws. Chapter VII sets out the security interests in aircraft in selected African countries' national laws, and Chapter VIII discusses security interests in aircraft in selected Latin American countries' national laws. Finally, a brief conclusion of the present study will be presented.

RÉSUMÉ

L'évaluation des coûts et profits dans un effort de synthèse de la politique nationale et internationale des pays en voie de développement dans le domaine de l'aéronautique diffère de celle utilisée dans les pays développés.

Compte tenu de la situation financière qui prévaut aujourd'hui dans le domaine de l'aviation, il est important d'examiner les problèmes spécifiques de financement de l'aéronautique dans les pays en voie de développement dans le but de définir et d'évaluer les diverses politiques suivies ainsi que ce qui doit être fait pour créer un climat propice aux investissements par les institutions financières et aussi pour améliorer la participation des pays en voie de développement au financement de l'aéronautique.

L'examen du sujet de cette étude débute au Chapitre I, qui passe en revue l'aéronautique ainsi le financement revision historique. Le Chapitre II traite du problème de la reconnaissance en droit international de titre et de droits en matière de sûreté. Le Chapitre III contient des notes détaillées quant aux types de sûreté habituellement utilisés pour garantir le financement dans l'aéronautique. Le Chapitre IV expose les modes de financements dans les pays en voie de développement, et le Chapitre V traite des différents obstacles qui s'opposent au financement capital d'une flotte aérienne par les pays en voie de développement et les solutions disponibles. Les trois derniers chapitres discutent de façon spécifique de l'aéronautique régionale. Le Chapitre VI explique le régime en matière de sûreté dans l'aviation au regard du droit interne de certains pays arabes et musulmans. Le Chapitre VII étudie le régime en matière de sûreté dans l'aviation au regard du droit interne de certains pays de l'Amérique latine, finalement nous présenterons une brève conclusion à cette étude.

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TABLE OF ABBREVIATIONS

AACO	Arab Air Carriers Organisation
AD	Aviation Daily
AEA	Association of European Airlines
AFFRAA	Association of African Airlines
AID	U.S. Agency for International Development
AITAL	Association of Latin american Airlines
AASL	Annals of Air and Space Law
ATA	Air Transport Association of America (US)
ATAC	Air Transport Association of Canada
AW&ST	Aviation Week & Space Technology
CCA	Commissioner of Civil Aviation (South Africa)
CFR	Code of Federal Regulation (US)
CICA	Canadian Institute of Chartered Accountants
CITEJA	Comité international technique d'exports juridiques aèriens
COFACE	Compagnie française d'Assurance pour le Commerce Exterieur (France)
CRS	Computer Reservations Systems
ECGD	Export Credits Guarantee Department (UK)
EEC	European Economic Community
ECOWAS	Economic Community of West African States
EDC	Export Development Corporation (Canada)

ESOPS	Employee Share Ownership Plans
Exim	Export Import Bank of Japan
Eximbank	Export Import Bank of the U.S.
FASB	Financial Accounting Standards Board (US)
J.Air L. & Com.	Journal of air Law and Commerce
JAR	Joint Airworthiness Requirements
IATA	International Air Transport Association
IAMTI	International Aviation Management Training Institute
ICAO	International Civil Aviation Organization
IDB	Islamic Development Bank
IDS	International Development Strategy
IET	International Equipment Trust
IMF	International Monetary Fund
ISO	International Organization for Standardization
ITA	International Transport Aviation Magazine
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
LASU	Large Aircraft Sector Understanding
LDC's	Less Developed Countries
MIGA	Multilateral Investment Guaranty Authority
OAA	Orient airline Association (Asia)
OECD	Organization for Economic Corporation and Development

OPEC	Organization of Petroleum Exporting Countries
PICAO	Provisional International Civil Aviation Organization
SDR	Special Drawing Rights
SELA	Latin american Economic System
SST	Supersonic Transport
UNCITRAL	United National Commission on International Trade Law
UNIDROIT	International Institute for the Unification of Private Law
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America

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INTRODUCTION

As we move into the decade of the 1990's and contemplate the 21st Century, an exciting future is ahead for all segments of aviation. A future that will reflect growth at an even more rapid rate considering that, at present, aviation and space technology stem basically from less than 89 years of development.

Aviation financing is an international business, and the results of a complex transaction can be the creation of various rights and obligations arising from a plethora of different regulations under a variety of different legal systems.

The obstacles affecting air transport growth in developing countries are, to a certain extent, due to the general global context, the inevitable priorities of the Third World countries, and problems specific to each country and region. The financing of large capital equipment has always raised important legal and financial considerations which take into account the high cost of capital equipment and the inherent risk that confronts such acquisition.

The investment required to raise transport capacity and to replace older aircraft is extremely high, which may cause further difficulties particularly at the present time when a large number of developing countries are facing balance of payment problems.

The airlines have had to devise means of financing acquisitions of new equipment through borrowing from foreign countries and foreign financial institutions and purchasing such equipment on credit terms from the manufacturers. The more aviation relies on credit as an element of its economic growth, the more ingenious will be the devices invented and adopted.

With respect to the problems of obtaining funds on loan, however, it can be said that the requirements of the airlines and its respective countries are so great in relation to their present capitalization that the debt-equity ratios have

consistently exceeded the limits acceptable to financial institutions.

From a financial view point the Third World airlines and their respective countries are in a precarious state, and efforts must be made to ascertain solutions to increase the airlines profitability. The machinery provided by the national laws must be simple, it must provide security for the investor, and it must not unduly restrict the airline in its operations or dealings. Furthermore, government policy as a whole must be changed for more participation with the international community for the benefit of their national airlines.

This essay does not by any means constitute a complete work upon the subject of the aviation financing in developing countries. The material gathered and examined in this essay constitutes an attempt to make the field of aviation financing in developing countries easier to understand. This task has not been a particularly easy one because of the lack of references, written documents of direct relevance and the difficulty in obtaining some of the existing materials.

CHAPTER I

THE AVIATION INDUSTRY AND ITS FINANCING HISTORICAL REVIEW

SECTION I: THE DEVELOPMENT OF AIRCRAFT TECHNOLOGY

Some two hundred years ago, poet-philosopher Dr. Samuel Johnson looked into the future with these words:

> "Instead of tardy conveyance of ships and chariots, man might use the swifter migration of wings. The fields of air are open to knowledge, and only ignorance and idleness need crawl upon the ground."[1]

Transportation has undergone profound technological changes within the last two centuries, from the steam engine in the 19th Century to container transport in the post-World War II era.[2] The aviation industry in particular has made a significant contribution to the global economy and transportation network. The invention of the airplane in 1903 by Wilbur and Orville Wright, which is generally regarded as one of the truly great technological achievements of all time, marked the beginning of the aviation industry. The impact that the airplane has had on civilization both as a mode of transportation and as a means of warfare has been phenomenal.[3] The international aviation industry has developed at a spectacular rate, especially since World War II, and it is now one of the fastest growing and most technologically advanced of all international industries.[4]

In a comparatively short time the airplane has evolved from a primitive flying instrument made of wood and cloth to one of the most sophisticated and complex machines. Human ingenuity from many different countries and backgrounds has contributed to its innovation and development.[5]

However, the airplane remains an expensive means of transport. The costs of carrying passengers in an airliner had fallen by three-quarters by the

end of the 1960's but was still not low enough to make the airplane compatible in cost to land transport. This drop in costs has been mainly concentrated in two periods: first, in the mid 1930's, when the shape of the airplane was revolutionized by the metal monoplane which culminated in the DC-3; then in the late 1950's, when the jet engine began to power airliners and the number of passengers that one airplane could carry jumped by over fifty per cent. Between these two points of technical innovation there was an era of gradual progress, in which the refinement of the basically unchanged airplane contributed little toward reducing operating costs but brought a greater improvement in speed and range.[6]

The interlude between the two World Wars witnessed major developments in the aircraft industry. It was within this period that air transport services began and organized airlines were first established. The first regular scheduled daily air service for passengers was initiated in Germany between the cities of Berlin, Leipzig and Hamburg on February 22, 1919. By 1929, however, the air transport service in the United States carried more passengers than that of any other country. One factor which contributed to this boom was the enthusiasm and interest generated by Lindbergh's successful flight across the Atlantic in 1927.[7] The aircraft used after World War II for passenger transportation was basically an adaptation of the military model. The American revolution in the design and construction of airplanes started with the introduction into service of the Boeing 247, the Electra and Douglas DC-1, DC-2, and DC-3.

The DC-3 was introduced into service in 1937 which was powered by a twin-wasps, and had a range of five hundred miles and a capacity of twenty-one passengers.[8] The establishment of transcontinental routes between the United States and Europe and the need for fast and non-stop air transport service stimulated the construction of bigger airplanes with longer range. The DC-3, which was the main airplane, required several stops to travel from one coast of the United States to the other. It was evident that the next innovation would

have to be the production of four- engine airplanes which would be capable of making a non-stop flight across the United States as well as the Atlantic. The three major aircraft manufacturing corporations Boeing, Douglas and Lockheed promptly responded to this need and introduced three airplanes into the market: The Boeing 307, the DC-4 and the Constellation. Differing slightly in size, capacity, speed and range, these airplanes nevertheless had the requisite characteristics to meet the need for air transportation during and after the Second World War.[9]

The major technological development that occurred in air transportation after the Second World War was the introduction of the jet airplane[10], started by introducing the Boeing 707 and the DC-8 which were the principal aircraft. Then Boeing, taking the lead, introduced into the market the gigantic Boeing 747, which was first flown on scheduled operations in January 1970. This was followed by the McDonnell-Douglas 380-passenger DC-10 trijet in August 1970 and finally Lockheed introduced its own slightly smaller wide-body trijet, the L-1011 in November 1970. Meanwhile, the European aircraft manufacturers developed their own joint venture. Through a European consortium they produced their own equivalent, the twin-engine Airbus A-300. However, the jet airliner did not prove to be the ultimate manifestation of advanced aircraft technology.[11] Before the airlines had been able to complete their jet re-equipment programmes, studies for a supersonic jet transport aircraft had already begun.

Is the Concorde with its tremendous cruise speed, which reduces the seven-hour London-New York flight to three and a half hours, to be the ultimate in aircraft innovation or merely the forerunner of a second generation of supersonic transport (SST)? This is the central question which studies, undertaken by all the major European and American airframe and engine manufacturers, have focused on. By late 1987, However, Aerospatiale and Snecma with French government backing turned their attention to what was

then referred to as "the supersonic transport for the 1990's". Since then, engineers have been busy formulating the methods and technology which are required for the design of this second-generation of SST.[12] At this point in time, it is reasonably safe to conclude that a technically and economically viable second- generation of SST is within reach in the medium term. However, there are still many barriers and considerable capital investment will be required, something which Europe alone will probably be unable to undertake.[13]

In conclusion, the real importance of Sputnik is not that it began the "Space Age", but that it marked the beginning of the information and high-technology revolution on the aerospace activities including the aviation industry which have become one of the major generators and simulators of scientific, technological, industrial and economic progress.[14] The airplane which was flown by the Wright brothers in 1903, and consisted of a simple and primitive structure has become during its 87 years of technological development a highly sophisticated, complex and expensive machine.

SECTION II: OVERVIEW OF THE AIRCRAFT FINANCE

A. Historical Background

The aircraft had been regarded in both the technical and business sectors as being suitable for potential use only in sporting or military activities. World War I naturally provided a great incentive for the development of military uses of the plane, so that by 1919 aircraft were efficient and reliable enough to permit the serious contemplation of air services for the public. The leading nations of western Europe, in particular France, Germany and England, provided the ideal setting for the growth of the infant aircraft industry. There was an abundance of surplus flying equipment, thousands of airmen were looking for civilian work, surface communications were generally poor and national prestige spurred on most countries to give their official blessing and financial support to airline projects.[15]

The airline companies were still young and their capital structures in most cases were simple. At their inception, some of the airlines were financed almost exclusively by private equity money, also, since most of them were government-owned, their equipment acquisitions were financed through government grants. The small size of the operation did not require large amounts of working capital and ground equipment. As the airlines grew, they required additional capital which few individuals were able to privately afford. It became necessary to look to the public for these new funds; something which was made easier by the fact that the tremendous growth possibilities of air transport has a certain romantic appeal in the eyes of potential investors. The public demonstrated a genuine willingness to participate in this growth without demanding immediate compensation in the form of dividends. Furthermore, the reputation of an individual airline was built almost entirely on its operating ability rather than on the quality of its business management. As a result, it was possible to reinvest an unusually large portion of current earnings in the business. Later, the process of equity financing was facilitated in several cases by the use of convertible preferred stocks[16] which, in effect, enable individual airlines to sell substantial amounts of common stock above the currently prevailing market prices.[17]

Since the end of World War II, the aircraft industry has entered a new phase in the evolution of its financial structures, being faced with new capital requirements far in excess of anything experienced in the past.[18] At that time, the unstable earnings record of airlines had caused airline stocks to be classified as highly speculative by conservative financial institutions.[19] Moreover, with the advent of the larger jets (DC-8's and 707's) in the 1960's, required an entirely different form of financing, and new sources had to be developed, as cash flow was not sufficient, investors did not have great faith in the airline industry and short term borrowing could not cover the longer amortization periods required. Consequently, aviation finance took on a more

disciplined attitude and the more serious participants approached financial planning on a more professional basis than the ad hoc methods of the past with the result that new financing structures and sources evolved.[20]

B. Stabilization and Future Growth Outlook

It is expected by most people who study aviation planning, that aviation travel will double throughout the world before the end of the century. Consequently, the industry shall experience a large and growing need for the resources to acquire not only the additional fleet requirements but the ground equipment and other assets essential to an expanding airline infrastructure.

There are several main reasons to believe that the foregoing predictions are realistic. In the third world there is a movement to using aviation as a means of transportation of populations that are becoming increasingly mobile, in the absence of adequate road or rail infrastructures. China for example has created nineteen airlines in the past few years in order to cope with the increasing element for transportation. In underdeveloped areas, airports may be built faster than road or rail systems and are less costly. In Europe and North America, with deregulation, many people have flown for the first time in recent years and wish to continue. In some places, a vacation by air once a year has become a necessity of life.

C. Current Problems of Airlines and Manufacturers

To further add pressure to the new world demands for aviation travel in North America and parts of Europe, older equipment shall become economically and technologically obsolete and noise and other environmental regulations shall further increase the rate of fleet obsolescence.

Manufacturers can no longer meet the demand for new aircraft, and there is a fear that quality control may be affected by the speed at which aircraft are

presently being built. Manufacturers are under close scrutiny by regulatory authorities and the public who have become alarmed by not only accidents involving older equipment, but brand new equipment as well (eg. British Midlands 737 crash in the U.K.).

The recent Aloha Airline 737 accident in Hawaii in April, 1988 triggered a reaction by the United States Federal Aviation Authority which may further exacerbate the situation as it proposes to limit the number of flights an aircraft can make in its lifetime. The tentative proposal centres on the number of flights that metal- fatigue tests show a given type can safely endure. Each aircraft type would be allowed to make half that number of flights. In similar tests the highest number of simulated flights made by a Boeing 737 fuselage has been 130,000. The number of flights made by the Aloha 737 was well over half that number (88,000) and would have been grounded if the proposed rule had been in effect.

D. Objectives of Financial Planning

While the situations involving the attention of aircraft because of noise legislation and the aging process pose a dilemma for the airlines and manufacturers, they inflict a double whammy on the financial institutions who have financed aircraft in the past through leveraged lease structures, for they will soon be awash with aircraft being returned at the end of their respective leases without any acceptable places to re-lease them in a market of great demand. Many of such aircraft will either not meet future noise or aging legislation restrictions or for one reason or another will not be competitive with the new state-of-the-art machines now coming on the market. So on the one hand, the banks shall be asked to finance new fleets of state-of-the-art aircraft while trying to recover their original investment from the residuals of the old aircraft.

However, the problems faced by the banks may create an opportunity for

airlines of nations where banks have hitherto been reluctant to become involved. The banks will undoubtedly be forced to place returned aircraft with whomever can offer the best prices and security for their risk, and those who are best prepared to deal, will most certainly secure the better transaction.[21]

In the case of many of the less developed countries, the financial condition of the airlines is usually weak and capital availability is very limited. This group of carriers while protected by bilateral agreements, often does not have sufficient traffic to operate profitably on international routes. Furthermore the lack of a developed economy often deprives these carriers of a profitable domestic system. Government-owned carriers have difficulty borrowing from the private sector even with government guarantees due to the weak credit quality of their government.

Furthermore, the present Gulf war will have its negative effect on the aviation finance world wide and on the less developed countries in particular. Traffic growth was already slowing and higher interest rates had added a whopping $500 million U.S. to the annual financing costs of the members of IATA.[22]

This is merely a historical review of airline financing, and considerable changes are likely to appear in the future. The prospects for the airlines of developed and the stronger developing countries are very encouraging as long as the global economy does not falter. If the airlines' profitability is linked to the global economic cycles, then the future years will bring more financially difficult times for the airlines industry. A number of carriers have substantial replacement plans, and favourable financing for this group of carriers, including those about to be privatized, is available. Although there is a substantial demand for aircraft in less-developed countries, financing will remain difficult unless a way can be found to insulate such transactions from domestic risk.[23]

In conclusion, governments initially took control of commercial aviation

for reasons related to national sovereignty and for the purpose of protecting their flag carriers. Unhappily sovereignty has little to do with today's restrictions- most of which are related to the protection of national carriers. This is an outdated notion, entirely inconsistent with today's financial and economic realities. Unfortunately, in most countries, there is little or no appreciation of the immense promise of international aviation.

In every country, government must find ways to balance environmental concerns with the necessity for economic growth.

In my view, that lack of commitment is rooted in ignorance of the huge benefits of aviation growth. Somehow, ways must be found to make policy makers understand that aviation is not a tool of commerce - it is commerce itself.

FOOTNOTES

Chapter I

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12. "A Supersonic Transport for Tomorrow", The Controller, September, 1987, at 25.

13. Ibid., at 26.

14. D.H. Bunker, The Legal Aspects of Aerospace Finance in Canada, D.C.L. dissertation, McGill University, Montreal, Canada, 1987, at 1; also Army General James Gavin called it "a technological pearl harbor"; for detailed see F.C. Durant (ed.), Between Sputnik and the Shuttle, AAS History series, Vol. 3, Univelt Inc., San Diego, California, U.S., 1981; also see, H.D. William and F. Emanual (eds.), "Space Flight", Merit Students Encyclopedia, Vol. 17, New York (1982), at 294.

15. Davies, supra, note 7, at 1.

16. The advantage of a "preferred stock" issue to management is that there is no obligation to pay a dividend, on the other hand, a disadvantage is that dividends must be paid out of profits after taxes. Preferred dividends cannot be considered as expenses, and the income tax related to the dividend is part of the burden of the issue. However, an issue of preference shares is sometimes the most suitable way for a company to raise finance in circumstances where it has already issued a substantial amount of debenture stock and its ordinary shares are not sufficiently attractive to support a further issue of equity capital. For a detailed definition see, K.D. Cole, Morley and Scott, "Corporation Financing in Great Britain", The Business Lawyer, Vol. 12, July 1957, at 321.

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CHAPTER II

RECOGNITION OF TITLE AND SECURITY RIGHTS IN AIRCRAFT UNDER INTERNATIONAL LAW

SECTION I: CREATION AND RECOGNITION OF TITLE AND SECURITY RIGHTS IN AIRCRAFT

The early laws, in most countries, seem to have focused on the purchase of aircraft from national manufacturers by national airlines. The matter was seen in much the same way as the purchase of a car. Today, however, what strikes one most is the business of selling aircraft across the borders. Only a few countries in the world have aircraft manufacturers engaged in building airliners for the civil air market. But aircraft finance does not only concern brand new aircraft. The second-hand market is also a very active one. Three major periods of boom can be identified. The first one is the period following the end of the Second World War roughly from 1946 to 1949. The second one is the entry into the jet age, the period between 1956 and 1960, when all major airlines tried to off-load the unprofitable propeller fleets on to the second-hand market. The third one is the period of stagnation in the 1970's, where it was once again imperative for operators to get rid of surplus aircraft.[1] However, the greatest boom of all was 1988-1989.

The legal framework for aircraft finance in Europe is more complex than that of the United States only because the operation of aircraft within Europe normally involves a much greater degree of international travel, particularly the Middle East, and North Africa, where legal concepts may differ radically from those of the industrialized West. Even within Europe itself, national laws regarding the treatment accorded property rights and security interests in aircraft vary significantly from country to country. The lender of monies on the security of aircraft is confronted with the problem of enforcing his security interest, validly created and publicly recorded under the laws of the country of the aircraft's flag, against adverse claims arising in another country when the aircraft is

temporarily in such other country and is subject to the jurisdiction of its courts. In the absence of any international rules, the lender's security interest is recognized at the discretion of the courts of the other country according to the law of the forum, which may well favour the claims of citizens and reject foreign claims as contrary to domestic law and public policy.[2] Moreover, the financial institutions have been extremely reluctant to lend money upon, or finance the purchase of aircraft intended for foreign flights, and funds for new equipment have been difficult to obtain. Furthermore, the foreign countries did not recognize or protect mortgage interests in aircraft or accorded inadequate recognition or protection of such interests. In conclusion, the matter of foreign recognition became of greater importance, especially when many American carriers were flying beyond the borders of the United States.[3]

There are too many theories of conflict of laws which have been applied by the courts of the world to permit complete certainty of solution. Essentially, one can point to two basic problems: (1) the creation of the mortgage; and (2) its recognition and enforcement.

Under the specific facts of each case, the right of any kind has been created, will depend not only on the terms of the agreement between the parties, but also on the provisions of law which must be applied to such right. This is primarily a matter of determining which law is to be applied and whether the transaction is valid under such law.

A. THE CREATION OF THE MORTGAGE

In determining which law applies to the creation of security interests in movables between local and foreign creditors, there are at least three possibilities:

(a) Some courts look to the law of the domicile of the owner, apparently on the theory of mobilia sequintut personam;[4]

(b) other courts view the law of the place where the contract is entered into and is to be performed as the law the situs of the chattel,[5] which is the place of its actual physical location at the time the security interest was created;[6] and

(c) other courts look to the law of the flag the aircraft.

Considering the various doctrines of conflicts of law applicable to transactions covering fleets of aircraft, one is impressed by the inappropriateness of each doctrine to meet current commercial needs in a logical manner. The domicile of the airline, i.e. its state of incorporation, may never see any of the aircraft its laws are supposed to affect. The same is true regarding the place where the contract was made. As for the lex rei situs, this doctrine, when applied to aircraft actually in flight, presents untold problems of fact finding. Fortunately, to be forewarned is to be forearmed, since it is probable that the transaction can be arranged so as to take account of the varying possibilities. In the case of mortgages covering after-acquired aircraft, it is necessary to provide in the indenture for the delivery of each aircraft in a state where after-acquired property clauses are legal and in accordance with the formalities of that State.[7]

It would also be desirable to have all of the aircraft in the fleet, or such of them as are to be subjected to the lien, brought into one jurisdiction when the transaction is closed, preferably the state where the contract is made and to be performed, which, if possible, should be the country of the airline's incorporation. Although it would not be difficult to close the usual transaction in the state of incorporation, the problem of herding all of the airline's airplanes into the jurisdiction at that time might well prove so costly as to be impracticable. However, there is no reason why the indenture should not be worded to provide that each aircraft should be bound under the mortgage separately only after it has returned from flight and has become immobilized in the chosen jurisdiction.[8] Furthermore, since 1948, it has become imperative

that the main consideration be sales tax. One must always choose a jurisdiction to minimize taxes at the time of title transfer.

B. ITS RECOGNITION AND ENFORCEMENT

Assuming that the problem presented by the foregoing discussions has been successfully resolved, and a lien created on an aircraft which will be recognized as valid under each of the doctrines of conflicts of laws discussed, there remains the much more serious problem of the extent to which such a lien will be recognized and enforced in other countries.

This is almost impossible to predict, although the rule most usually applied appears to be that a foreign right in a foreign chattel will be recognized and enforced only to the extent that such a right is not contrary to the public policy of the forum. It is almost universally true that a prior lien may be placed on a chattel in a foreign state which could have the effect of making the mortgage valueless.[9] Restrictions which diminish the effectiveness of rights created in different jurisdictions may be either judge-made or statute-made. In any event the secured creditor may find the value of the security diminished by reason of the removal of the chattel from the country where the lien was made.

In conclusion, with the possibility of many different and unpredictable kinds of treatment of secured interests in aircraft by various countries, it was obvious that an international convention which would bring certainty to international air transportation was necessary. In 1948 the Convention on International Recognition of Rights in Aircraft (Geneva Convention) was adopted to this end.[10] As advocated by Frederick Hines, there are still numerous problems of conflict of laws with respect to real rights in aircraft because of numerous substantial differences among the major legal systems of the world.[11]

Moreover, any international convention, to be of any practical use, must accord recognition and substantial protection to validly created rights in foreign aircraft. It must include an undertaking on the part of each country to limit the

amount of local prior liens which it will permit to be placed ahead of a pre-existing mortgage on a foreign aircraft. Because such recognition and protection must be uniform throughout all contracting states, the differing national philosophies as to the relative status of the secured creditor with respect to the general creditors must be carefully weighed and a solution found which is satisfactory to all.

SECTION II: THE 1948 GENEVA CONVENTION

A. INTRODUCTION

After the Second World War, the world faced a new situation in aviation. The United States stepped forward as the leading manufacturing and financing nation in the field, followed at a distance by Great Britain. The Americans wanted to expand the export trade in aircraft and were willing to participate in the financing of such exports.[12] The need for an international treaty to protect a creditor's security interest in aircraft was discussed even before the emergence of the commercial aviation industry. There was a general consensus among manufacturers and airlines that large sums of money would have to be borrowed in order for the industry to develop and expand. Before the end of World II, they agreed to work for an international agreement on recognition of rights in aircraft.[13] In 1931 The Comité international technique d'experts juridiques aériens (CITEJA) produced two draft conventions, one relating to an aeronautical property record and the other to mortgages and other secured interests. During the Chicago Conference in 1944, at the suggestion of the American delegation, a resolution was adopted[14] recommending that the various governments represented at the Conference give consideration to the early calling of an international conference on private international air law for the purpose of adopting a convention dealing with the transfer of title to aircraft, and that such private air law conference include in the bases for discussion the existing draft conventions relating to mortgages, other real securities and aerial privileges.

The matter was considered by the CITEJA in Paris in January of 1946. It was again considered by the Interim Assembly of the Provisional International Civil Aviation Organization (PICAO), held in Montreal in May 1946. The results of the discussion at this latter meeting produced a unified draft combining the principles of both the early CITEJA drafts. Real progress toward achieving unanimity was reached in meeting of an Ad hoc Committee held in Paris in February of 1947 to consider the replies from the various countries to the PICAO questionnaire and to work on a new draft Convention.[15] This draft was circulated by the International Civil Aviation Organization (ICAO) to all member states and formed the basis for consideration by the fourth commission of the first Assembly of ICAO in May 1947,[16] which met in Montreal, considered the Paris draft and elaborated a new draft which was discussed by the ICAO legal Committee in Brussels in September of 1947. This final draft was submitted for the approval of the ICAO during the 2nd Assembly held in Geneva in June of 1948, and the Assembly adopted what has since been called the Convention on the International Recognition of Rights in Aircraft.[17]

B. BRIEF OVERVIEW OF THE CONVENTION

The guiding principle of the Geneva Convention is that rights of property in aircraft which are validly constituted and recorded in conformity with the law of the state in which the aircraft was registered take priority over all other rights (Article X).

In other words, the Convention adopted the rule of the law of the flag rather than that of the lex rei sitae,[18] except in salvage situations (Article IV) where the admiralty priority rule is approximated. There is also a provision which envisages security interests encompassing spare parts (Article X). The Convention provides that courts sitting in a country other than that of the aircraft's nationality cannot apply their own conflict of law rules, but must look to the country where the aircraft was registered as to nationality at the time the

right was created.[19] The main features of the Convention include: a general recognition of rights in aircraft (Article I); central registries established in each State (Articles II and III); an overriding international preference or priority order with respect to certain claims (Articles IV, VII, para. 5-6); and establishment of internationally accepted conditions with respect to the execution of judgements and the sale of aircraft (Article VII).

The Convention also contains a clause, which has become almost ubiquitous in the majority of international conventions, stating that it does not apply to aircraft used in military, customs or police services (Article XIII).

The advantage of the Convention is that it allows the development of a new source of law, which will draw upon a number of regional legal systems preserving the best elements of each. However, economic pressures have forced States to ratify the Convention in order to allow certain transactions to be accomplished.[20] Generally, the Convention has been evaluated as a solid legal achievement in the field of international aviation law, with the possible drawback that it may have been "before its time" when it was introduced in 1948.[21]

The present revival of interest in the private financing and leasing of aircraft and consequently in the Convention seems to be proving commentators correct on both points. In the absence of the Geneva Convention, a creditor holding a security interest in an aircraft is exposed to the wide divergence in law, procedure, and practice of foreign courts. A creditor could bring an action in a foreign court, but he would be basing has action largely on the hope that the foreign court, as a matter of comity, would recognize his duly created security in the aircraft. In the final analysis, the law of the lex situs would probably be employed by the Court to determine the recognition of a foreign security interest in a movable chattel.

C. THE FUTURE OF THE CONVENTION

Because of the nature of international commercial aircraft financing which involves millions of dollars, the highly mobile character of aircraft, and the operational hazards to which they are subject, it is desirable to afford maximum protection to those who finance such purchases.[22] From the standpoint of such financial institutions it is important that their rights, and the priority of those rights in point of time, be recognized in those countries through which the aircraft will travel. It is also considered advisable to have each aircraft of the fleet being financed made jointly liable for the entire loan on the fleet. From the standpoint of the aircraft purchaser or operator, it is advisable to make provision for the recognition of mortgages on spare parts, otherwise he would have to have sufficient funds to purchase them outright or forego the purchase of any new equipment given that a fleet of aircraft is of little value without spare parts with which to maintain it in operation. However, both this and the fleet mortgage principle have presented difficulties as indicated below.

Before considering the substance of Article I, it should be pointed out that the applicability of the entire Convention is somewhat limited by Article IX. Under this Article, with the exceptions there noted, the Contracting States will not be obliged to apply the Convention within their own territory to aircraft there registered.[23]

The Convention is also not concerned with the creation of rights in aircraft, but only with the recognition of rights in aircraft created on the national level and recorded in a national register of the State of registration of the aircraft (Article I, para. 1). The Convention does not purport to protect international credit as such in all aircraft, but is limited to protecting credit in aircraft while abroad. Furthermore, it does not purport to protect certain interests created through operation of law as opposed to by agreement of the parties. Moreover, the extremely important phase of international judicial relations which the Convention does not cover relates to execution proceedings and the necessity

for filing notice of such proceedings in the record of the Contracting State whose nationality the aircraft bears. Preceding drafts included a provision for the registering of foreign executions on aircraft and made provisions that a purchaser from the owner, buying the aircraft after the registering of the attachment or execution, would not prevail as against the executing creditor or the vendee at the judicial sale. The point was made at Brussels that a foreign judicial sale could be defeated by the fraudulent transfer of the aircraft by the owner to some innocent third party, who registers. The purchaser not having actual or constructive notice of the attachment would be entitled to prevail as against the attaching creditor by the municipal law of most countries. Therefore, so the argument goes, the foreign Court would have to recognize the paramount title of the new owner and dismiss the attachment against the aircraft by reason of the undertaking in Article I of the Convention. Consequently, when the court looks to the State of registration to determine whether the fraudulent transfer is valid by the law of the flag, it will consider that country's law on conflicts of law, which, in most cases, would apply the law of the place where the chattel was at the time of purported transfer. Thus, by a somewhat roundabout way the court of the forum would end up by applying its own law.

Has the Geneva Convention been a success? In view of the limited number of ratifications,[24] the Convention does not supply the safe and sure international legal framework of aircraft finance that was initially hoped for. Moreover, chattel security generally has been rendered less important by the presence of other forms of security, such as government credit insurance and general guarantees of borrower obligations allowing lenders to look into general profits, commercial organization, moral standards and capability in general.[25]

It has been suggested that the lack of ratifications may be due solely to the hesitation of many governments regarding a multilateral agreement. However, a commentator stated his belief that it is still the general consensus that the Convention has provided a useful ad practical solution to the problem

of aircraft financing, and that the financing of aircraft during the 1950's and 1960's was not the acute problem the drafters of the Convention had expected.[26] In the face of all these developments, it will doubtless be necessary to modify the Geneva Convention if it is to hope to obtain further recognition by ICAO member States. However, it seems doubtful whether even in its modified form, it will be able to attract the adherence of States in large numbers.[27]

In conclusion, the Geneva Convention appears to have been intended to unify under a single international agreement certain sacred principles of air law which have remained under control of national laws. The Convention has tried to recognize rights in aircraft, and when in need, to rely on national laws and their conflict of laws to solve more complex problems.

It is important to bear in mind that the Geneva Convention was first signed in 1948 when the rules of international finance and trade were not as sophisticated as they are today. A major codification of secured rights on aircraft through a multilateral agreement may well be proposed next by States in enormous need of capital to finance the purchase of the next generation of aircraft.[28]

Required future action appears to be clear. On one hand there is need for a thorough revision of the Geneva Convention based on sound comparative legal documentation, on experience already had thereunder and on suggestions from writers and learned societies in the field. On the other hand, there is strong suggestion that there is no need for revision of the Geneva Convention since there has never been a Geneva Convention Case. The author believes that there is great need for the introduction of provisions for recognizing security interests in aircraft into bilateral treaties of friendship and commerce or into treaties of aviation, a method equally or even more promising because the participating countries will be cognizant of and responsive to the real need of the industry including those of both transporters and financiers, in legal as well as economic terms.

SECTION III: NEW CONVENTION PROPOSAL

The international community certainly needs increasing amounts of money to deal with major international problems. In the aerospace industries, Boeing and other transport builders were seeking a standard agreement among commercial aircraft exporting nations, one that would be fair to all the manufacturing countries and leave the door open to other builders to enter the field and cope with the staggering financial needs of developed and developing nations alike in maintaining efficient air transport fleets.[29] The U.S.A. and four nations involved in the European Airbus project agreed on an agenda for further detailed negotiations which they anticipate will lead to a new international agreement on the financing of civil aircraft developments.[30] Under these circumstances Japanese, American and European leasing companies were searching for a new direction for development in the form of leasing as asset-based financing.[31] Since lenders may not safely rely on the mechanisms of the Geneva Convention, and the use of forms of security such as conditional sale can mean finding one's way through a tangle of complex and unfamiliar laws with no assurance of certainty at the end. As possible means of overcoming these problems, and with the demand for new forms of aircraft finance which will always be the case, transactions must be individually tailored to meet these different national laws.

A. THE INTERNATIONAL CONVENTION OF FINANCIAL LEASING

The International Institute for the Unification of Private Law (UNIDROIT), and the U.N. Commission on International Trade (UNCITRAL), have sought to resolve the international sales disputes, and on 26 May 1988, the UNIDROIT adopted the Convention on international finance leasing. Representatives of fifty-five States participated in the conference. Five States signed the Convention on the day it was opened for signature. The Convention requires

three ratifications to bring it into force.

The financing of equipment throughout the world relies more on the traditional advantages of leasing than on tax considerations, since the U.S. and U.K. followed other countries into tax neutrality in 1986.

Modern leasing began in the U.S. in the early 1950's, spread to Europe and Japan in the early 1960's and to the rest of the world during the 1970's. The development of manufacturing and service industries in industrial and developing countries alike owes much to lease financing techniques, and it is the development of flexible leasing techniques which will be the key to future growth. The 1980's proved to be the decade of the internationalisation of leasing.

Given that leasing is understood in different ways in different countries, the International Convention on Finance Leasing, as its preamble states, has it as an objective to promote the international leasing business by establishing uniform rules suited to regulating the triangular relationship peculiar to the international finance lease. If this common understanding of the private law aspects of the international finance lease can be obtained among as many countries as possible, it should be of immense significance in promoting international transaction.[32]

1. Overview of the Convention

The Convention addresses that type of leasing commonly known as "financial leasing"; operating leasing is therefore excluded from its scope.

The distinct, sui generis nature of financial leasing is further delimited in the preamble to the Convention, by reference to the triangular relationships it encompasses, involving supplier, lessor and lessee, and in Article 1 (1), to its pluricontractual basis, made up as it is of two contracts, a supply agreement and a leasing agreement. These two agreements are no longer treated under

the International Convention on Financial Leasing as separate contracts but rather as a single complex transaction involving the interpenetration of two interdependent agreements and of the rights and duties of the parties under each of these agreements. The factual connection between the two constituent agreements of this transaction is brought out in Article 1(1)(a) where it is specified that the supply agreement is concluded on terms approved by the lessee. As well, the Convention has four key objectives:

1) to remove responsibility from the lessor to the supplier. The underlying conception is that since it is the lessee who selects the supplier and the equipment, and the lessor's role is essentially financial, responsibility for non-delivery, late delivery or delivery of non-conforming equipment should rest primarily on the supplier, not on the lessor. To that end Article 10 provides that the duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee, whilst Article 12(5) largely excludes claims by the lessee against the lessor except to the extent to which the failure in performance results from the act or omission of the lessor. This is reinforced by Article 8, which provides that except as otherwise provided by the Convention or stated in the leasing agreements, the lessor shall not incur any liability to the lessee in respect of the equipment save to the extent that the lessee has suffered loss as the result of its reliance on the lessor's skill and judgement and of the lessor's intervention in the selection of the supplier or the specifications of the equipment. However, for the protection of supplier and lessee certain qualifications are made to the general principle shifting liability from the lessor to the supplier.

   First, the supplier cannot be made liable both to the lessor and to

the lessee in respect of the same damage.[33] Secondly, the lessor will incur liability for loss resulting from a combination of reliance on the lessor's skill and judgement and the lessor's intervention in the selection of the supplier or the specifications of the equipment. Thirdly, the lessee cannot be compelled to pay for equipment which he does not have. Accordingly, if the equipment is not delivered or if the lessee exercises a right of rejection and the lessor fails to cure the non-conforming tender, the lessee may, on terminating the leasing agreement, recover rentals and other sums paid in advance.[34] Prior to such termination the lessee may without payment of rentals so long as he has not lost the right to reject.[35] The lessee's right to reject equipment and terminate the leasing agreement, and the lessor's right to cure a failure in performance, are now expressed to be exercisable on the same conditions and in the same manner as if the lessee had agreed to buy the equipment from the lessor under the terms of the supply agreement.[36] This provision, which results from a proposal made by the United Kingdom delegation, is new and is designed to ensure conformity with the Vienna Sales Conventions, whilst obviating the need to set out the detailed rules contained in that Convention. Once the lessee has lost the right to reject the equipment he must pay for it, and his remedies are restricted to claims against the supplier, unless the lessor was at fault. Finally, the lessor warrants that the lessee's quiet possession will not be disturbed by a person who has a superior title or right, or who claims a superior title or right and acts under the authority of a court, where such title, right or claim is not derived from an act or omission of the lessee.[37]

2) To restrict the lessor's liability to third parties. For similar reasons

the Convention seeks to restrict the lessor's liability to third parties by providing that the lessor shall not, in its capacity as lessor, be liable to third parties for death, personal injury or damage to property caused by the equipment.[38] This is an important provision designed to ensure that the spread of product liability does not catch a financial lessor qua lessor. In other words, the mere fact that the lessor is a national supplier of the lessee under the leasing agreement is not to attract liability to third parties if death, injury or damage is caused by the equipment. But the lessor's liability in any other capacity, e.g. as owner, remains unaffected.[39] So where legislation or a convention imposes liabilities on owners as such, e.g. for ground damage by aircraft or for oil pollution by ships, the leasing convention confers no immunity. This point is reinforced by Article 15, which provides that the Convention does not prevail over any treaty which has already been or may be entered into.

3) To safeguard the lessor's title on the lessee's insolvency. Another important benefit to the lessor under an international financial lease is conferred by Article 7(1), under which the lessor's real rights in the equipment are to be valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution. This follows the previous draft but has been strengthened by adding a definition of "trustee in bankruptcy" to include a liquidator, administrator or other person appointed to administer the lessee's estate for the benefit of the general body of creditors. Where however, under the applicable law the lessor's real rights in the equipment are valid against such a person only on compliance with rules as to public notice, those rules must be complied with.[40] Formulating the rules as to the

applicable law caused some difficulty, particularly in relation to ships.

The Working Group of Technical Experts set up by UNIDROIT decided at its meeting in Rome that the original proposal to refer to the State of registration was difficult to implement owing to the emergence of facilities for separate registration by barefoot characters under the 1986 Convention. They therefore recommended the State of the flag as the relevant state. This was rejected by the Conference as being too liable to capricious selection, and the State of ownership registration was adopted. Article 7 preserves the efficacy of other Conventions such as the Geneva Convention 1948 on Recognition of Rights in aircraft, and also preserves the priority of a range of admiralty and aircraft rights in rem, including arrest and detention.

4) To ensure the effectiveness of provisions for liquidated damages. One of the major problems confronting a financial lessor in common law jurisdictions is to make a provision for liquidated damages on default by the lessee which will withstand attack under the rule against penalties. Article 13, which contains a useful catalogue of remedies for the lessor, enjoins the court to uphold such provisions unless they would result in damages substantially in excess of the amount that would place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms.[41]

Two other points merit attention. First, Article 2 contains a neat provision extending the provisions of the Convention on financial sub-leasing transactions. The purpose of Article 2 is to ensure that a financial lessor is not treated as a supplier in relation to a sub-lessee. This is achieved by providing that the Convention applies to each sub-leasing transaction which is a financial leasing

transaction as if the person from whom the first financial lessor acquired the equipment were the supplier and as if the agreement under which the equipment was so acquired were the supply agreement. Hence no matter how many sub-leasing transactions in the chain, there is one unique supplier in relation to any sub-lessee, namely the person who supplied the first financial lessor

If the first financial lessor acquired under a sub-lease from an operating lessor, the operating lessor is the supplier as regards sub-lessees. Secondly, the Convention can be excluded by agreement of all three parties and where not excluded in toto may in general be derogated from or varied by the parties in their relations with each other.[42] However, the parties may not derogate from or vary the lessor's warranty of quiet possession in so far as the superior title, right or claim is derived from his intentional or grossly negligent act or omission,[43] nor may they derogate from or vary the effects of Article 13(3)(6) and (4). The first of these preserves the court's power to strike down a liquidated damage clause which provides for damages substantially in excess of those required to compensate the lessor for the loss of his bargain; and Article 13(4) prevents a lessor who has terminated the leasing agreement from claiming accelerated rentals as such, though he is entitled to have the value of these (i.e. the amount of the future rentals duly discounted) taken into account in computing liquidated or unliquidated damages. This reflects existing English law.[44]

In conclusion, the States party to this Convention recognizing the importance of removing certain legal impediments to the international financial leasing of equipment, while maintaining a fair balance of interests between the different parties to the transaction, are aware of the need to make international financial leasing more available to developing countries. As a matter of regret, however, it should be pointed out that the Convention contains several provisions that are a far cry from the realities of actual international finance

leasing business being conducted in U.S. and other industrial countries. The financial aspect of finance leasing is not taken into due consideration in the Convention.

Practically, the financial institutions are refusing to rely on it, in due recognition of this shortcoming.

FOOTNOTES

Chapter 2

1. J.W.F. Sundberg, "Rights in Aircraft: A Nordic Lawyer Looks at Security in Aircraft", Annals of Air and Space Law, Vol. VIII, 1983, at 233 (hereinafter cited as A.A.S.L.).

2. G.G. Kaplan, "Legal Aspects of Aircraft Finance in Europe", Journal of World Trade Law, Vol. 9 (1975), at 136.

3. F.E. Hines, "Legal Difficulties in Secured Airline Equipment Financing", J. Air L. & Com., Vol. 15, 1948, 11 at 21.

4. Rhode Island C. Bank V. Danforth, 14 Gray 133 (Mass. 1859); Runyon V. Groshon, 12 N.J. Eq. 86 (1852).

5. Kusser V. Siouxcity H. & M. Co., 199 Iowa 200; 200 N.W. 404 (1924); Thomas G. Jewett, Jr. Inc. v. Keystone Driller Co. 1282 Mass. 469, 185 N.E. 369 (1933).

6. Restatement, "Conflict of Laws", s. 257, 265, 272 (1934) by the American Law Institute.

7. Ibid., s. 265(b).

8. G.N. Calkins, Jr., "Creation and International Recognition of Title and Security Rights in Aircraft", J. Air L. & Com., Vol. 15 (1948), at 156.

9. Restatement, supra, note 6, s. 268(d).

10. Geneva Convention (1948).

11. Hines, supra, note 3.

12. Wilberforce, "The International Recognition of Rights in Aircraft", 2 International Law Quarterly, 1948, at 421.

13. T. Conlon, "The Aircraft Mortgages Convention: The United Kingdom Moves Toward Ratification", J. Air L. & Com., Vol. 43 (1977), at 731.

14. Final Act International Civil Aviation Conference Chicago, 1944, Part V.

15. Present at this meeting were delegates of the U.S.A, UK, France and Belgium.

16. A total of forty-seven nations and seven international organizations participated in the Assembly, J. Air L. & Com., Vol. 14, 1947, at 378.

17. The Convention comprises XXIII articles and was signed in Geneva by twenty states, and as of the 1st of July 1986, sixty countries had signed, and fifty had ratified. For the historical background of the Geneva Convention refer to CITEJA Documents Nos. 22, 73 and 162, and ICAO Documents Nos. 4534, 4545, 4546, 4548, 4549, 4551, 4552, 4556, 4569, 4635, and 5722.

18. J.P. Honig, The Legal Status of Aircraft, The Hague, Martinus Nijhoff, Netherlands, 1956, at 8.

19. "Annotated text of the Convention on International Recognition of Rights in Aircraft", J. Air L. & Com., Vol. 16, 1949, p. 70 by the Legal Sub-Committee of the Air Coordinating Committee.

20. N.M. Matte, Treatise on Air-Aeronautical Law, The Carswell Co. Ltd., Toronto, 1981, at 578.

21. ICAO Working Paper, A. 12-WP/36, LE/5.12/3/59.

22. "Ownership in World Airline Equipment", Vol. 18, 1947, Boston Bar Bulletin, at 265.

23. Thus if an aircraft registered in country A is being financed by a bank in country B by means of a hypothec which has been duly recorded in country A and local creditor in country A brings execution proceedings, country A will be not bound to apply any but Articles III and VIII of Geneva Convention assuming both countries A and B are signatory states.

24. Supra, note 17.

25. Sundberg, supra, note 1.

26. D.I. Johnston, "Legal Aspects of Aircraft Finance Part II", J. Air L. & Com., Vol. 29 (1963), at 299; also see Doskow, "Transitory chattels and Stationary Law: A Proposal to Facilitate Secured Financing of Aircraft Employed in International Flight", J. Air L. & Com., Vol. 26, 1959, 36 at 52, calling for the adoption of bilateral agreements as superior approach

to international secured aircraft financing.

27. Matte, supra, note 20.

28. C. Jacquemin, "Règles relatives aux droits d'hypothèque et de saisie conservatoire, en droit aérien", Revue générale de l'air, Vol. 36 (1973), at 182.

29. "Boeing Seeks New International Aircraft Finance Agreement", Aviation Daily (hereinafter A.D.), 25 May, 1982, at 134.

30. D.A. Borwn, "U.S.A., Europe Agree on Agenda for Aircraft Financing Talks", Aviation Week & Space Technology, Nov. 2, 1987, at 36 (hereinafter AW & ST).

31. "The Draft UNIDROIT Convention on International Financial Leasing" which has been adopted by the International Institute for the Unification of Private Law", Quarterly News Bulletin, No. 75-76, July/October, 1988, (hereinafter UNIDROIT).

32. O. Nagano, "Cross-border Leasing - Its Current Status and Tasks Ahead", World Leasing Yearbook (1988), at 20.

33. Art. 10.

34. Art. 12(4).

35. Art. 12(3).

36. Art. 12(1), (2).

37. Art. 8(2).

38. Art. 8(1)(b).

39. Art. 8(1) (c).

40. Art. 7(2).

41. Art. 13(3), (2) (b).

42. Art. 5.

43. Art. 8(3). A Contracting State may substitute its domestic law for this provision if its domestic law does not permit the lessor to exclude its liability for its default or negligence (Art. 20).

44. R.M. Goode, "Conclusion of the Leasing and Factoring Conventions-1", The Journal of Business Law, July, 1988, at 347.

CHAPTER III

TYPES OF COMMONLY USED SECURITY INSTRUMENTS IN AIRCRAFT FINANCING

INTRODUCTION

It is remarkable how the legal concept of security in both the common and civil law systems has developed from Roman law origins. Usually, legal systems presented with the difficult task of regulating new technical, social or economic devices will strive to preserve continuity and to attempt to supply the appropriate solutions through reliance on established patterns. They will adjust rather than innovate, with greater or lesser success depending on their flexibility, and only strong pressures can produce new legal ideas; though such solutions be driven along well-trodden paths, they will still be crossed by long shadows from the distant past. Such developments are exemplified by the law of aviation. Within one generation, aviation went from a mere fancy to an effective, economical and accepted means of transportation. It flourished and took on solidity in an economy where credit financing is a basic characteristic.

The more aviation relies on credit as an element of its economic growth, the more ingenious will be the devices invented and adopted. Thus it becomes possible to use as security any of the assets, corporeal and incorporeal, owned or controlled by the industry. Methods range from the classic personal suretyship and real pledge, to the delicately balanced arrangements of conditional sales, equipment trusts, trust receipts, assignment of accounts receivable, and of course, various mortgage types of security.[1]

The law in force today in regard to security interests in aircraft in many respects still adheres to the basic principles of Roman law which developed three forms of security in chattels: the early fiducia cum credditore, and the

later pignus and hypotheca.[2] In the civil law, the institutions of pignus and hypotheca were adopted as pledge and hypothec applying respectively, with certain exceptions, to moveables and immoveables. On the other hand, the common law developed the security devices of pledge and chattel mortgage from the Roman law institutions of pignus and fiducia cum creditore [these being used as means of securing the creditor's interest in moveable property].[3]

In this chapter I will discuss the various types of security instruments generally available in aircraft financing.

SECTION I: INDEPENDENT SECURITY DEVICES

A. CHATTEL MORTGAGE AND HYPOTHEC

1. Chattel Mortgage

Historically, this institution developed differently in the common and civil law systems.[4] The chattel mortgage is one of the most commonly used security instruments in aircraft finance. In the common law, a chattel mortgage is considered to be an agreement vesting in the creditor the title to the chattel, defeasable by performance on the part of the debtor of the obligation for which title to the chattel is conveyed as security.[5] One of the major disadvantages of the chattel mortgage is that in being a security instrument created by common law, it is unknown to several major legal systems of the world and particularly the civil law systems. Therefore, the rights of creditors holding a valid mortgage of that form outside the state of registration of an aircraft may be compromised in the absence of similar provisions in foreign law.

The outstanding characteristic of the chattel mortgage is its flexibility. It may be used with regard to both property presently owned by the debtor, and after-acquired property, particularly spare and replacement parts. A chattel mortgage can cover any property described and identified at its source or

location which may become attached to or incorporated in a mortgaged aircraft. Chattel mortgages may also be used to create a subordinated lien on property already owned in connection with accumulated or pre-existing debt as compared to a conditional sale transaction which can only exist in connection with a purchase.[6]

In common law jurisdictions, the law of property usually makes it mandatory to register the chattel mortgage, subject to certain exceptions in which the chattel is delivered to the mortgagee and continues to remain in his actual possession. In general, registration systems, created by statute in common law jurisdictions, serve to put persons on notice of the existence of the instrument, which effect can also be achieved by factual knowledge.

In civil law jurisdictions prenda means a dispossessory security interest in chattels except where changed to a nondispossessory interest by statute. Hypothec, on the other hand, means a nondispossessory security interest, primarily applicable to real property, in the nature of a lien, extended by some statutes to personality as well. This leaves the title-shifting common law chattel mortgage in a special category. Nevertheless, the general term "mortgage" will be used where the specific type of security is not at stake.[7]

In conclusion, it is not surprising to find differences in the law protecting security interests in chattels, where for thousands of years the underlying rules developed purely as a matter of local concern. Yet it is comforting to see that these differences are far more the result of forces of tradition and inertia than a response to any real-life demand. Distinctions between title and lien, and between dispossessory and nondispossessory interests are far less important than appearance would indicate. Pressures of those supplying financing (especially those acting in international trade), have forced even those jurisdictions most encrusted with tradition, into making their laws of security arrangements amenable to everyday needs.

2. Hypothec

This is a simple lien on real and personal property, the security remaining with the debtor, and possessory rights vesting in the creditor. However, there may be an agreement that possession will not be taken until the debt is due.[8] Fiducia on the contrary, brought into play the title which was transferred for security. At a later stage fiducia was replaced by the less stringent nondispossessory pignus and hypotheca. In the corpus juris civilis,[9] paignus and hypotheca appear merged into one legal institution. Faced with this variety of possible solutions, medieval Romanists disregarded the title shattering fiducia and gave preference to the dualism of dispossessory pignus for chattels and the nondispossessory hypotheca for real property. The French Civil Code adopted this solution.[10] Directly therefrom, or in some cases, indirectly from the Spanish Civil Code,[11] the dual system of dispossessory prenda on the one hand and the hypothec on the other, was retained in the more recent Latin American Civil Codes.[12]

The solution in aircraft financing was to reclassify an aircraft as a immoveable instead of an moveable. In this manner, the statute subjected the aircraft, including security interests in it, to the law of real property and thus made the aircraft amenable to a nondispossessory type of security.[13]

The concept of hypothecation in English law is embodied in the word "charge" which involves the notion of the burdening of some subject property with an obligation in the sense that failure to perform that obligation involves a resort to that property to secure satisfaction of the obligation.[14]

In the case of the hypothecation, there is neither a full transfer nor a division of ownership rights. The right of a holder of a charge who obtains an order for a judicial sale is not equivalent to that of a proprietor who is selling his own property, even though the court has given him the power of sale. Moreover, the holder of a charge is under certain duties towards the person

who is for this purpose still regarded as owner. This right is also not in the nature of immediately realisable and exercisable Jura in re aliena, such as, for instance easement rights. It is potential only and not available for exercise until there has been default, which means only that the debtor is no longer limited to a claim in contract to recover his property.[15] It is not only a fact that the rights conferred by the hypothecation are only potentially exercisable; even when they become exercisable in fact they are not dominium rights, though they do belong to the wider class of proprietary rights. They are exercisable over res aliena not res propria. Again they do not comprise actual enjoyment rights over property. The analogy which arises when the charge has become enforceable is with the power rather than with the easement.

Roman law, particularly as it had developed by the time of Justinian, had established a system of priorities and privileges taking as its point of departure the well known adage "prior tempore potior uire". In the legal systems of the common law and the civil law, the rank of security liens constituted by contract is generally determined by this principle. The time of creation may be when the agreement was reached, when it was reduced to writing, and executed, when the moveable was handed over, or when the instrument was filed for registration or actually registered.[16]

The opposite rule of rank, i.e. inverse time sequence, has been adopted in maritime law and applies in aviation law only where expressly incorporated as in the Geneva Convention.[17] It must also be made clear that the recognition of the existence of an interest is not identical to enforcement of such interest. In this respect local law will determine the ways and means available except as modified by the Convention.[18]

In conclusion, the chattel mortgage and its counterpart in civil law, the "hypothèque et gage sans dépossession" are probably the most familiar of the security devices which may be used for aircraft finance in the major western European countries. The American legal influence has also been generally

received in Western Europe and the rest of the world through the development of the concept of lease and conditional sale financing for aircraft.

B. CONDITIONAL SALES AGREEMENTS

The conditional sales contract has been a traditional technique used by sellers and lenders to secure obligations incurred by American domestic air carriers for the purchase of aircraft.[19] Thus, a number of countries have adopted the conditional sale, although some States have laws which prevent foreigners from owning aircraft registered in them.[20] The conditional sales contract allows the vendor to remain the owner of the thing sold until the purchaser has paid the price in full. The transfer of ownership is not dependent upon the paying of the price but upon the agreement of the parties. The contract may contain a clause according to which the purchaser shall only become the owner when he has paid the price. In other words, the sale itself is not conditional but only the transfer of ownership, which occurs when the price is paid.

It is essential that at the time of default, all components and parts physically attached to a particular aircraft be subject to the same lien as the aircraft. Thus it may be provided that the lien of the particular mortgage on any particular spare part which become attached to an aircraft subject to another mortgage will be subordinate to the lien of the other mortgage so long as the spare part remains so attached. It can be seen that such a provision may not be operative under a conditional sales agreement but would probably be held valid under a chattel mortgage.

The problem under the conditional sales agreement arises out of the fact that the vendor of the aircraft is not likely to be the vendor of all the spare parts attached to the aircraft. The problem of tort liability of the aircraft owner can arise in certain jurisdictions in instances where a conditional sales agreement

has been employed, under which the lender is the title owner of an aircraft although the aircraft is registered in the name of the operator.[21] The conditional sales contract has often been preferred by lenders because of the preferential rights of repossession accorded a conditional vendor in the title. It permits persons who have neither the resources nor the credit necessary to buy goods for cash to acquire goods and possessions and pay for them out of future income. It permits contractors and manufacturers to acquire equipment with which to carry on their operations.[22]

C. EQUIPMENT TRUST FINANCING

The equipment trust is used primarily in railway and airline financing. Commercial aircraft financing has borrowed, to a considerable extent from precedents established in the field of railroad equipment financing. The greater part of railroad equipment financing in the United States is handled under the Philadelphia Plan which first evolved about 1870. The essence of this plan is that the equipment is leased to the railroad, and the railroad pays for it through rental payments to the trustee. The rentals are then applied to the corresponding maturities of principal and dividends of certificates issued under the plan and held by the investors.

The second form of equipment trust used by railroads is known as the conditional sales plan. Under this arrangement, an investment banking house, acting on behalf of the railroad, finds an institutional investor or a group of such investors who are willing to advance the funds to purchase equipment. Under the conditional sale, the purchase price of the equipment is usually paid in equal instalments of principal and interest, with title to the equipment vesting in the railroad. Upon payment of the last instalment upon delivery of the equipment, title is transferred by manufacturer to the investor who is usually represented by agent. It is interesting to note that the investor normally has no direct right of action against the railroad under the conditional sales plan, but must rely upon

the agent to enforce the debtor's obligations.

Under the Philadelphia Plan, the equipment trust certificates represent on their face an obligation of the trustee with the guarantee of the railroad company a lessee for payment of principal and dividends. The specific purpose of the endorsed guarantee was to provide the certificate holder with a direct right of action against the railroad and a guarantee is customary under the conditional sales plan as well. The Philadelphia Plan equipment trust is still in the historical form involving the use of vendors and two documents called the "agreement" and the "lease". The vendors no longer serve any useful function, since the equipment is transferred directly to the trustee and the two separate documents also have outlived their usefulness. In the mid-1950s a modified form of the Philadelphia Plan was prepared which eliminates the vendors and combines in one Equipment Trust Agreement the important provisions of both the agreement and the lease. The result was a substantially simplified document without change in substantive right which was gaining general acceptance in Canada and the United States. This is an ancient practice, hardly ever used now.

The equipment trust used in aircraft finance is more commonly in the conditional sale plan, also known as the New York Plan. The trust is usually referred to in the conditional contract between the aircraft manufacturer and the carrier, and is executed prior to the equipment being delivered to the carrier and after is executed prior to the start of production of the aircraft. Depending upon whether the trust comes into effect before or after delivery, the agreement may provide for the appointment of inspectors to inspect the equipment on delivery and, if satisfactory, to accept it on behalf of the carrier and so certify to the trustee.[23]

In the early 1970s, when it became increasingly difficult to obtain long-term loans from institutional participants, many carriers were able to meet their needs by obtaining the debt component of leveraged leases through public

issues of equipment trust certificates. Under an equipment trust, a trustee purchases an aircraft with the proceeds of a public issue or private placement of equipment trust certificates, representing up to eighty per cent of the aircraft cost, with the airline advancing the balance of the price. The trustee leases the aircraft to the carrier at a rental sufficient to amortize principal, interest and expenses, and at the end of the lease, title to the aircraft passes to the carrier.

The principal advantage of the use of equipment trusts is the facility of financing where participation is divisible into as many parts as there are holders of trust certificates. These certificates are also transferable and may be pledged by the holders as security in other transactions, although the normal situation is where large blocks of certificates are placed with a small number of financial institutions who hold them to maturity. It was proposed by Boeing[24] that an "international equipment trust" be developed to facilitate the placing of the guarantees of export agencies such as Compagnie française d'assurance pour le commerce extérieur (COFACE) (France), Hermes (Germany), Export Credits Guarantee Department (ECGD) (Great Britain) and Export Development Corporation (EDC) (Canada) with the trustee of an equipment trust, so that all of the participants of an international production consortium could have a uniform approach to capital markets worldwide.[25]

D. FLOATING AND FIXED CHARGE

The legal systems of different countries have approached the problem of using the complete enterprise of an airline as security in different ways. The legal problems relate to the nature of the enterprise, which includes moveable and immoveables, both corporeal and incorporeal.

Both the fixed and the floating charges originated from the law of England.[26] The instrument used to create a fixed and floating charge is an instrument known as a deed of trust. Usually, the conditions of the trust deed will include covenants in favour of a trustee, who usually represents the security

holders, to continue to carry on business in a proper manner and to repay the securities issued under the trust deed as and when due.

In common law jurisdictions there are no specific statutory provisions which regulate mortgages on aviation enterprises. In the United States, the security device used to mortgage an enterprise is a fixed charge known as the corporate mortgage.[27] In Canada and in the United Kingdom, fixed and floating charges may be used to mortgage corporate assets in favour of a creditor in the same trust deed.[28]

1. The Floating Charge

The essence of a floating charge is that it remains dormant until either (1) the company has defaulted and the debenture holder has taken some step to realize his security; or (2) the company ceases to be a going concern. Up to that moment it does not attach to any particular asset, but when that moment arrives it "crystallises" and attaches as a specific security upon the then existing assets, carrying priority over the unsecured creditors as of such date.

It is characteristic of the floating charge that when adequately created, it covers property later acquired by the company without any words implying futurity of assets. Once the asset is acquired, it falls under the charge, although it does not become a fixed charge until default. In the case of the floating charge, the company remains free to deal with the assets in the ordinary course of business and pass good title.

A floating charge need not cover all the assets of a company; it may be that the company has given fixed securities over certain defined assets and a floating charge over the remainder. Or it may be that only part of the assets is charged initially. This gives a floating charge over such assets provided that it sufficiently appears that it was the intention of the parties that the company should continue carrying on its business.[29]

The advantages of a floating charge to an airline operator are evident. This security device furnishes an airline enterprise, as mortgagor, with a wide latitude and flexibility in its everyday dealings. The creditor has a valid and binding instrument which can be enforced while on the other hand, the airline operator is able to pool, lease, loan, transfer and sell any aircraft, engines and spare parts in the normal course of business. The floating charge therefore allows the airline the equivalent flexibility that a "basket-lien" clause under a chattel mortgage would provide.

2. The Fixed Charge

The fixed charge differs from the floating charge in the sense that the assets subject to the fixed charge cannot be disposed of without the charge continuing to bind the mortgagor in possession. The fixed charge is a specific charge or mortgage on certain definite assets. It can also affect aircraft specifically. The corporate mortgage employed in the United States is in the nature of a fixed charge and consequently, does not provide the mortgagor with the same freedom of disposition in his business dealings as the floating charge.[30]

E. LEASE AND FINANCING

Leasing was used in commerce as a financing tool before the Roman Empire.[31] It was developed in England from the mid-1880's onward [32] and in the United States, in the form of equipment trusts, during the early twentieth century.[33]

Modern leasing is understood in different ways in different countries. In the financing sense it comes under the general heading of instalment credit for a wide range of equipment from office machinery to oil refineries and aircraft. Leasing in many countries is similar to, or the same as, hire purchase. In other countries, the two concepts are very different indeed and should not be

confused. In leasing, the first rule to observe is that the ownership of the item being financed is vested in the lender, and the right to use is vested in the borrower.[34] Lease financing is no longer restricted to aircraft, railcars and ships, and has come to be widely used for virtually all industry purposes as well as for professional and consumer purposes, and it remains a growing industry world-wide.[35]

(a) Nature of Leasing

> The lease agreement has been defined in general terms as a contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains ownership of the asset, and the lessee has possession and use of the asset on payment of specified rentals over a period.

Equipment leasing has been defined by various laws and regulations throughout the world.[36]

Where the lessee is given an option to purchase at the expiry of the lease, rental payments under the lease are approximately equal to the lessor's initial cost of the equipment plus interest, profits and the expenses of leasing. Under such conditions, leasing is a substitute for purchasing. The lessee enjoys almost all the rights of a conditional vendee, and the lessor's right to payments and security are approximately those of the conditional vendor. The major difference, of course, is that (absent an option to purchase) the lessee never acquires title to the leased equipment and thus loses the residual value thereof unless an eventual purchase is negotiated.[37] Juridically, such contracts in common law provide for the bailment of the equipment leased. Accordingly, in addition to those rights and obligations arising out of the contractual relationship between them, the rights and obligations of bailors and bailees are also conferred and imposed upon the parties. In particular, the lessee as bailee may have recourse to remedies such as trespass or conversion for the

protection of the possession conferred by the contract. It is inherent in a contract of lease that the lessee receives both possession of the equipment and the right to use it,[38] in return for a consideration to be paid to the lessor.[39]

In a contract of lease, the lessor must supply the equipment which corresponds with the description contained in the contract.[40] Normally, the lessor must also take reasonable care to ensure that the equipment is in a reasonably fit condition for the purpose for which the lessee is to use it.[41] Such liability may be specifically excluded by a provision in the contract but will not apply in the event of a fundamental breach of the lessor's undertaking.[42]

(b) Types of Leases

The type of lease to be used in any transaction depends upon the desire of both the lessee and lessor and upon their respective factual circumstances. The simple concept of leasing has acquired a wide range of descriptions and definitions resulting from the legal interpretations and treatments arising from the classification of leases for purposes of taxation, accounting, securities legislation, bank regulations, usury statutes and contractual relationships. These classifications have also derived various perceived meanings in different political jurisdictions as well as from industry to industry. For example, similar types of leases are often called by different names in different jurisdictions. In the United States and Canada, for example, there are "true leases", "lease backs", "dry leases", "wet leases", "cross-border leases", "leveraged leases", "finance leases", "tax leases", "double-dip leases".

Within the broad definition of a lease there are two basic lease categories from which all other types of lease derive: "finance lease" sometimes known as full payment leases, and "operating leases".

A finance lease is a contract involving payment over an obligatory period of specified sums, sufficient in total to amortise the capital outlay of the lessor and give some profit. The obligatory period is less than, or at the most equal

to, the estimated useful life of the asset. The lessee normally acquires the asset either because of an option to purchase granted as a term of the lease or as a result of a "put" exercised by the lessor, and is always responsible for maintenance of the asset.

The reasons to finance lease, primarily are because it facilitates asset - based financings which may be the only way to go for an airline facing reschedulings, improved cash flow, with constant principal and interest payments; potential access to tax benefits; and possibility of getting the deal qualified as off-balance sheet.

An operating lease is any other types of lease, where the asset is not wholly amortised during the non-cancellable period of the lease and where the lessor does not rely for his profit on the rentals in the non-cancellable period. In some operating leases the lessor is responsible for maintenance. The lessee in an operating lease seldom acquires title to the leased equipment at the end of or during the term.

However, operating leasing is clearly off corporate and country "balance sheets", it affords operational flexibility by avoiding a long-term commitment to any aircraft type; it eliminates the pre-delivery cash outflow typical of an outright purchase, and in the extreme case of a very poor credit where raising long-term capital in any form, is virtually impossible, it may be the only possible route.

Sharp distinctions between the finance and operating lease call for separate and different economic treatment. The importance of distinguishing between the operating lease and the finance lease frequently extends beyond the convenience of the lessee of using the equipment for a short period. The principal influences on the classification of equipment leases are taxation and accounting.

(b-i) Tax Consequences of Leasing

Tax leasing is a financing where tax ownership of the equipment is held by a party other than the user. During the early 1980's, the increasing awareness of capital equipment users around the world of the availability and the utility of the Cross-Border lease expanded the device of leasing across national borders. The emphasis in the past has been on the tax benefits available in countries like the United States and Great Britain.[43]

The form of a leasing transaction is dependent upon the taxation laws of the country of residence of the lessor and accordingly the arrangements and techniques of leasing may vary considerably between countries. Where tax concerns are of major importance, it is usual for a leasing company to have access to taxable income, and to shelter it by purchasing assets for use by lessees, part of that shelter being reflected in a lower rate to the benefit of the lessee. The major argument in favour of leasing companies being eligible for industrial investment incentives is that they are able to spread the incentives to all industrial companies, whether those companies are in a tax-paying position or not.[44]

The 1980's have seen major tax changes in the mature economies of the United States, Europe and most recently Japan.

In the late 1970's and early 1980's tax benefits accounted for between 10% and 12% of the total financial requirements of airlines placing private financing. The United States and the United Kingdom legislated early in preventing cross-border leasing, particularly of aircraft. Further, tax reform has led to a reduction of tax rates in most developed economies. This has reduced significantly, even in an airline's domestic market, the present value benefits of leasing. These changes reduced significantly the contribution of tax payers to finance aircraft procurement.

Other markets opened up, especially in Hong Kong and Japan. The

Japanese market particularly has been used in the late 1980's to use tax benefits to make an upfront net contribution to the purchase price of aircraft. The new regulations of 1987 saw the end of the generous present value benefits in excess of 20%.

These changes also produced a more structured form of lease. Japanese leases, where structurally available, will continue to offer effective sub-**LIBOR** for debt. The Hong-Kong market is still available for compatible jurisdictions. Sweden has seen, prior to tax changes late in 1989, a significant level of leasing activity in 1988 and 1989. It must be the case, however, that cross-border tax subsidies will not constitute a major source of procurement finance for the 1990's.

Uncertainty in the tax markets leads to major change which stimulates the market for airfinance. That change is uncertainty itself.[45]

However, throughout the world, governments have been reviewing both their policies with respect to leasing and the perceived abusive effects on the collection of taxes in their respective countries, and have been tightening the screws accordingly. The actions should have been a signal to everyone in the industry that the drain on government treasuries would not be tolerated forever.[46]

(b-ii) Accounting Considerations

The comparative youth of the leasing industry means that in some countries there is no formal way of accounting for leases, and no legislation specifically aimed at leasing. However, there is now an international accounting standard for leasing. The most formal and rigid tax and accounting guidelines are found in the United States and Canada. In accounting by lessees and lessors, the main issue has been whether the lessee should confine his disclosures to a note in the accounts. Most opponents of capitalization are

happy to make a comprehensive note containing the same information. However, in some countries lease obligations are entirely ignored in the accounts. Lessors have widely different methods of accounting for leases in different countries, although the most common question is when to recognize the taking of profits during a lease term. In the U.K., for instance, early accounting methods recognized profits towards the end of the term, using the sum-of-the-digits method, but in recent years an investment period method of accounting recognizing profits earlier in the term has found more favour among lessors.

A change from one accounting method to another during the lease term is not uncommon. The North American system requires that if an asset is in essence the subject of a purchase sale transaction, and if the lessee debtor acquires an "equity" in the asset, then the asset must be capitalized on the books of the lessee and amortized accordingly with the attendant financing charges being written off in each accounting period notwithstanding how the parties decide to entitle the documentation.[47]

How accountants determine whether or not a particular lease is of one category or the other is an ongoing problem. A substantial number of jet aircraft presently in use are not reported as assets on financial statements of any company airline. Lessees view them as operating leases, while lessors treat the leases as substantive sales.[48] Both the Financial Accounting Standards Board (FASB) in the United States and the Canadian Institute of Chartered Accountants (CICA) are still having difficulty in creating consistent guidelines.[49]

(c) International Leasing

International leasing transactions have grown tremendously. By definition, cross-border leasing involves more than one nation and, therefore, more than one body of law. Each transaction must contemplate the relationship of the laws of the jurisdictions of the parties as well as of the proper law of the

contract. Any attempt to standardize contract forms and internationalize contractual relationships may be very difficult and confusing since the laws of the various interests are bound to be different, particularly between civil law and common law jurisdictions.[50] Moreover, cross-border leases involve other problems such as withholding taxes, foreign exchange risks, political risk, and while these problems are not insurmountable, they do create an expensive form of financing.

The world-wide environment of cross-border leasing is presently in a state of reorientation and is moving toward asset-based financing transactions for several reasons. In the first place, many state-owned airlines and aerospace companies have been, or are in the process of being privatized.[51] This will undoubtedly result in less sovereign-guaranteed loans to these companies and more activity in the use of cross-border leases as a means of security to replace the sovereign guarantee. Thus, the risk in aircraft financing is gradually shifting from airline balance-sheet risk to aircraft or asset risk.

Secondly, with the deregulation of the airline industry in the U.S., the relaxing of regulations in Canada and the movement towards deregulation in Europe,[52] there has been and continues to be an accelerated shakeout in the industry through mergers and acquisitions, as well as diversification of fleet-mix because of increased competition. Leasing as asset-based financing and the function of the operating lease facilitate the perceived requirement of financing the modern, efficient fleets of the future.

Thirdly, the competition among commercial aircraft manufacturers will enhance the use of operating leases as the manufacturers are entitled to participate in the residual risks. Fourthly, airlines in developing countries are seeking new techniques for financing new fleet acquisitions while, at the same time, avoiding debt restrictions imposed by the International Monetary Fund (IMF) or the importing countries' own Ministry of Finance regulations. One technique is "off-country balance sheet" financing through the facility of cross-

border leasing.

The following are conditions which will need to be satisfied to lay a satisfactory basis for the diversification and sophistication of the leasing business by the world leasing industry in cross-border leasing.

First, it is necessary to restore the tax system and environment which have so far helped tax-oriented leasing to grow. It is to be hoped, however, that the favourable tax system and environment will be restored. Second, it is also necessary to improve the environment of government financing. The "samurai lease" was an example of direct government support to cross-border leasing through the Export-Import Bank of Japan. Third, it is hoped that a model tax treaty which clearly sets out the treatment of cross-border finance leasing will soon be prepared and ratified. High rates of withholding tax which may be as high as 30%, depending on the case, can be a substantial deterrent of cross-border leasing. The Organization for Economic Corporation and Development (OECD) recommended in its report in 1984 that withholding tax on cross-border leasing transactions be removed, since it is not appropriate to include income from leasing in the definition of royalties. Withholding tax is merely one of the tax problems that hamper the growth of the cross-border leasing business. The report of the OECD is nothing but a recommendation, but when bilateral treaties are renegotiated, reference will certainly be made to it.

However, the leasing transactions have the same characteristics as export-credit structures, as derived from the Large Aircraft Sector Understanding (LASU) agreement:

1. Maximum 85% financing;
2. Term limited to 10 or 12 years;
3. Constant amortization of principal and interest;
4. Possible spares financing;
5. Multicurrency option; and
6. Complex interest-rate structure.

The export-credit agencies have agreed to account for asset values and have accepted to book the uncovered amounts only, a fact which has resulted in a much needed increase in cover volume for leasing transactions.

The support of the export-credit agencies can also take the form of what is known as pure lease cover which is the same as normal full cover, but without the interest rate support and without the currency restrictions.

On the positive side, the export-lease scheme carries no cost and has no obligations to the lessee until the aircraft is physically delivered. On the negative side, its maximum allowed term is too short and bears no relation to the economic life of the aircraft and the practice in the industry.[53]

(d) Effect of International Agreements

The country of registry of an aircraft assumes certain responsibilities under international law that are reflected in a series of multinational agreements dealing with aviation. These agreements range from bilateral arrangements concerning operating rights between two governments to multinational agreements directed primarily at safety in international civil aviation,[54] agreements dealing with crimes in aviation such as aircraft hijacking,[55] sabotage[56] and crimes aboard aircraft,[57] multilateral liability conventions and multinational agreements affecting security interests in aircraft.[58]

The obligations and prerogatives under many of the provisions of these agreements relate not to the nature of the private agreement under which the use of aircraft is acquired but the state of registry of the aircraft. The cornerstone of safety in international civil air navigation is the International Civil Aviation Convention, usually referred to as the Chicago Convention.[59] This Convention places responsibility on the state of registry for the operation of the aircraft. In aircraft lease situations the state of registry may not be the state of the operator and consequently may not be the state of primary interest in the

aircraft's use while, nevertheless, retaining the international responsibility for its safety. This problem has been one which has troubled the international community for some time and was resolved just recently by an amendment to the Chicago Convention permitting the transfer of responsibility under that Convention from the state of registry to the state of the operator.[60]

In the area of recognition of security interests in aircraft the issue of leased aircraft has also long been of concern. Article 1 (1) of the Geneva Convention specifically requires contracting states to recognize right to possession of aircraft under leases of six months or more, if such rights have been constituted in accordance with the law of a contracting state in which the aircraft was registered as to nationality at the time of their constitution and are regularly recorded in a public record of a contracting state in which the aircraft is registered as to nationality.

The legal sub-committee of the U.S. Air Coordinating Committee of 1949 explained this provision in the following manner:

> "It will be noted here that... the right to possession is recognized. Hence where there is a sub-lease, the sub-lessor will be protected as against the original lessor. The primary purpose of this clause is to safeguard the right of a purchaser of an aircraft under an equipment trust or hire purchase agreement to the continued possession of the aircraft pursuant to his contract, as against an attaching creditor of the security title holder. This six month period was chosen as one which would cover all bona fide financing transactions, and at the same time not require courts to consider as rights against the aircraft many small claims for short-term leases, where the objective was not to finance the purchase of the aircraft. Although primarily intended to promote the financing of aircraft, this clause is certainly broad enough to cover long-term leases as such".[61]

The Convention for the Unification of Certain Rules Relating to International Carriage by Air performed by Persons Other than the Contracting

Carrier, referred to as the Guadalagara Convention addresses the relation of the liability provisions of the Warsaw Convention as they relate to the charter and hire of aircraft. The Convention on Damages Caused by Foreign Aircraft to Third Parties on the Surface, signed in Rome on 7 October 1952[62] referred to as the Rome Convention relates to liability caused by foreign aircraft to persons or property on the ground and is reflected in the proposed Article 23(1) which recognizes the distinction between the state of the operator and the state of registry.

While lessors and lessees may not be directly concerned with those conventions that deal with crimes aboard aircraft, they should be aware of their existence. The role of the state of the operator is particularly noted in the Hague "Anti-Hijacking" and the Montreal "Anti-Sabotage" Conventions.

SECTION II: REGISTRATION OF AIRCRAFT

A. INTRODUCTION

As the world's airline industry has matured and developed a certain amount of stability, lenders have developed more and more confidence in the residual value that can be attributed to aircraft. As a result, we have seen an increase in reliance upon the collateral value of the aircraft itself to secure the financing of the acquisition of aircraft by airlines, either through purchase or lease, and a decline in reliance solely upon government bank or other such guarantees. The financiers of aircraft for international use should carefully analyse the effect that the country of registration of the aircraft could have on their rights. The registration establishes a national identity of the aircraft and with it the responsibilities and undertakings of the state of registry.[63]

Registration in the most general sense of the term including inscription as well as recording, is required to perfect the security. The effects of such registration vary considerably from country to country. In the common aircraft

purchase or lease transaction, there are contracts between the seller and purchaser or owner-lessor and the lessee-airline user. In addition, there is almost certainly another party, usually a bank or leasing company, and in the case of a leasing company, also a lender lending to the leasing company. Title registration provides a method for recording the existence of perfection as against third parties and placing the world on notice as to the various rights flowing from the transaction, such as the right to receive rents in the leasing situation.[64]

B. THE CHICAGO CONVENTION

Towards the end of the Second World War, the concept of absolute sovereignty espoused by the Paris Convention of 1919 (Convention Relating to the Regulation of Air Navigation) had become incompatible with the need for international cooperation. The aftermath of the war had resulted in a new humanistic international spirit and accompanying political tendencies. The United States had never ratified the Paris Convention, as it was in their interest to continue to promote freedom of air traffic. Consequently, this new spirit of freedom of movement caused the United States to enquire among other states as to the possibility of convening an international civil aviation conference. Subsequently on November 1, 1944 (although the war was to continue for another six months) delegations from fifty two states of the fifty five invited, met in Chicago with a view to the regulation of international civil aviation,[65] which resulted in the signing of a final act on December 7, 1944.

By the time the Chicago Convention was drafted, customary international air law had so completely accepted the concept of nationality of aircraft that no question could possibly have existed as to the fact of nationality of any aircraft lawfully carrying the national insignia of a particular state. However, registration does not create nationality but is simply evidence of nationality.

The Chicago Convention directly recognizes the state as the guarantor

of the conduct of aircraft possessing its nationality, as well as the protector of such aircraft.[66] The most important and direct recognition of aircraft as being legal entities is found in Article 5 of the Convention which provides for a direct obligation of each State to accord to "all aircraft of the other contracting States" certain transit and non-scheduled traffic privileges. The Chicago Convention provides that aircraft have the nationality for the state in which they are registered[67] that an aircraft cannot be validly registered in more than one state,[68] and that the registration or transfer of registration of aircraft in any contracting State must be made in accordance with its laws and regulations.[69] Each State can decide for itself what requirements must be laid down with regard to the registration of an aircraft. One state may therefore register aircraft belonging to aliens, whereas in others, such registration may be prohibited, all depending on the national legislation. The Chicago Convention thus follows along the lines of the revised Article 7 of the Paris Convention and Article 8 of the Havana Convention.

The attention that IATA had devoted to the registration of aircraft problems[70] resulted in an IATA resolution, which proposed an international register to replace the national register. In view of the historical development of the aircraft nationality principle, the international register seems to be an impossibility. The main purpose of an international register would be to facilitate the use of any aircraft registered therein by the airlines of the contracting states without any further formalities. One advantage of this would be that if an aircraft was temporarily used by an airline of another State, transfer of registration would be unnecessary. A simple notification to both the international and national registers would suffice. By the notification, the aircraft would come under the supervision of the authorities of the state of the user, and throughout the period of use, it would not enjoy the protection of the state of origin even though it was still entered on the national register. Theoretically, this method may seem advantageous, but there are too many practical

drawbacks. For example, it would be possible to avoid taxes and customs duties, and many obstacles would be encountered in the transfer of an aircraft from one register to another.[71]

Consequently, IATA has suggested that an alternative way to facilitate the exchange of aircraft would be the removal from the various national legislations of the provisions which prevent the registration of aircraft belonging to aliens on the national register. It would then be necessary to permit the registration for aircraft belonging to a foreign airline in the national register when they are in use by a national airline and the problem becomes one of national rather than international concern.

In recent years, there has been a marked increase in arrangements for the lease, charter and interchange of aircraft, particularly without crew, operated in international commercial services. Undoubtedly, these arrangements will increase in the future, since they promote high utilization of expensive aircraft. But the Chicago Convention did not adequately specify the rights and obligations of the state of a lessee-operator of such an aircraft since the Convention is oriented towards the state of registry of an aircraft rather than the state of the lessee.

There are many practical solutions which could have been adopted for difficulties which can arise in the case of a lease, charter and interchange arrangements without crew: First, leaving the operation of the aircraft to be governed by the state of registry, exempting the aircraft from the law of the state of registry, "validation by the state of registry of a foreign crew's licences", the negotiation of ad hoc solutions; second, the delegation of functions of the state of registry to the state of the operator; third, the transfer of registration of the aircraft from one state to another. It was pointed out that the weakness of this last solution was that the whole system of the regulation of international air navigation was founded on the concept that the registration of aircraft has a certain stability. Moreover, it would be impracticable to change registration on

very short notice and nationality and registration marks would have to be changed, perhaps in a period of a few days in the case of interchange; fourth, the use of the annex machinery envisaged an ICAO standard which would provide for delegation by the state of registry of its functions under the Convention to the state of the lessee of an aircraft without crew. It was recognized, however, that there could be deviations from such standard, and that the standard would not relieve the state of registry of its responsibility under Article 12 of the Chicago Convention. Finally, an amendment to the Chicago Convention was proposed. The practical solution of delegation of functions of the state of registry to the state of the operator would be accompanied by agreements (either a general multilateral agreement, or a limited multilateral agreement) whereby third states would accept the substitution of the state of the operator in place of the state of registry for discharge of the latter's responsibility with respect to the aircraft concerned. This would pose fundamental legal problems which arise under various articles of the Chicago Convention,[72] which could not be overcome merely by a process of delegation, since third party states would not be bound to recognize a delegation and could always insist upon compliance with provisions of the Convention by the state of registry itself.[73]

In 1978 the Legal Committee of ICAO considered the matter of lease, charter and interchange at its 23rd session and discussed the merits of an amendment to the Chicago Convention versus a separate multilateral convention to solve the problem. The Committee finally recommended that an amendment to the Chicago Convention would provide the best and most effective solution to outstanding problems[74] and a draft amendment to be included in the Chicago Convention as Article 83 bis was submitted to the ICAO Council which in turn proposed the amendment to the 23rd Session of the ICAO Assembly where it was finally adopted.[75] The amendment will come into force when the protocol has been ratified by ninety-six states, i.e. two-thirds of the

ICAO membership at the time of adoption.[76] As aircraft become ever larger and more expensive to purchase and operate, they may in the future often be operated by international operating agencies composed of states or by virtue of co-operative arrangements between airlines of different nationalities. The operation by international operating agencies of large and expensive aircraft registered on other than a national basis could become a reality in the future, which could lead to the use of Article 77 of the Chicago Convention and of the related ICAO Council general determination made thereunder in 1967. Article 77 empowers the Council to determine in what manner the provisions of the Convention relating to nationality of aircraft shall apply to aircraft operated by international operating agencies; and the Council determination, as drafted in 1967, contemplates joint registration of aircraft on other than a national basis as well as international registration.[77] However, such registration would undoubtedly only apply to the joint operating organization of a limited regional character as it is difficult to imagine that the Council would have the power to authorize international registrations, thereby waiving the requirements of registration in a particular state.[78]

In summary, in connection with aircraft title registration and perfection of lien rights of aircraft, one must first determine which nation's laws apply to the transaction, in order to permit the utilization of the aircraft by the airline lessee user without limiting or removing the protection of the rights of the owner lessor and its lender. Then one must determine what the various rights of the owner-lessor and its lender would be under the laws of the nation selected. In the case of the rights of the parties, careful consideration must be given to the details of the transaction such as maintenance requirements and agreements in light of the selected nation's laws pertaining to mechanics' lien priorities, complications arising from pooling arrangements and rights of others in parts, rather than in the whole aircraft. Finally one must determine whether or not it is likely that another nation, either by contract under the Geneva Convention or

by an exercise of comity, would enforce these rights if the aircraft were located in that other nation at the time these rights were to be exercised.

FOOTNOTES

Chapter 3

1. S.A. Bayitch, "A Study in Comparative Aviation Law of the Western Hemisphere", University of Miami Law Review, 1958, Vol. 13, at 152.

2. N.M. Matte, "La Convention de Genéve relative à la reconnaissance internationale des droits sur l'aéronef, trente ans après", Annuaire de droit martime et aérien, t. IV, 1979, at 372.

3. Brown & Ashby, supra, Ch. 1, note 17.

4. J.H. Wigmore, "The Pledge-Idea: A Study in Comparative Legal Ideas", 10 Harvard Law Review, at 321, 1896; H.W. Chaplin, "The Story of Mortgage Law", 4 Harvard L.R., at 1 (1890).

5. Bayitch, supra, note 1.

6. J.D. Lambert, "Survey of Domestic and International Aspects of Aircraft Equipment Financing", The Business Lawyer, April 1963, at 651.

7. Bayitch, supra, note 1, at 159.

8. C. Salkowski, Institutes and History of Roman Private Law with Catena of Texts, E.E. Whitfield (ed.), London: Stevens and Haynes Law Publishers, 1886, at 500.

9. "Inter Pignus Autem et Hypothecam Tantum Nominis Sanus Differet", DIGEST, 20.1.5.1.

10. Code Civil, art. 2076 (Fr. 53rd Dalloz, 1954).

11. Codigo Civil, art. 1863 (1889).

12. Codigo Civil, art. 768 (Brazil 1916); Codigo Civil, arts. 2403, 2405 (Ecuador 1950); Codigo Civil, arts. 1837, 1891 (Venezuela 1942).

13. H. Garapon, Code de l'air, Paris, 1971, p. IX; Codigo Civil, art. 812 (peru 1936).

14. E.I. Sykes, The Law of Securities, The Law Book Co. Ltd., Australia, 3rd ed., (1978), at 16.

15. Ibid., at 15.

16. Bayitch, supra, note 1, at 180.

17. Geneva Convention, art. IV(2).

18. For example, art. 1122 of the Egyptian Civil Code provides that: "where there are special rules governing the pledge of certain movable things, they will be applied instead of the general rules". Ismail, The Law of Aviation in Egypt, LL.M. thesis, McGill University, Montreal, Canada (1953). The Geneva Convention was ratified by Egypt on September 10, 1969.

19. W.W. Eyer, "The Sale, Leasing and Financing of Aircraft", J. Air L. & Com., Vol. 45 (1979), at 228.

20. Belgium, France, Federal Republic of Germany, Italy, Netherlands, Spain, United Kingdom, United States. Matte, supra, Ch. II, note 20, at 547.

21. D.I. Johnston, Legal Aspects of Aircraft Finance, LL.M. thesis, McGill University, Montreal, Canada (1961).

22. K.C. MacKay, "Conditional Sale Contracts", (1967) Meredith Memorial Lectures, McGill University, at 8.

23. D.I. Johnston, "Lease and Equipment Trust Agreements", (1967) Meredith Memorial Lectures, McGill University, at 1.

24. J.B.L. Pierce, "The View from Seattle", Euromoney Trade Finance Report, Special Supplement, Feb. 1987, at 20; see also, Aerospace Industries of America, Inc., "Aircraft Financing: The International Equipment Trust", Washington, D.C., October (1981).

25. D.H. Bunker, The Law of Aerospace Finance in Canada, Institute and Centre of Air and Space Law, McGill University, Montreal, Canada, 1988, at 143.

26. "The Availability of the Floating Charge as a Security Device in the United States", Col. L.R., Vol. 28, 1928, at 360.

27. A.S. Dewing, The Financial Policy of Corporations, New York, The Ronald Press Company (1953), 5th ed., at 195.

28. L.C.B. Gower, "Some contrasts Between British and American Corporation Law", Harvard L.R., Vol. 69, No. 8, 1956, 1369 at 1397; Fraser, "Reorganization of Companies in Canada", Col. L.R., Vol. 27, 1927, 932 at 934.

29. Sykes, supra, note 14, at 785.

30. Johnston, supra, note 21, at 104.

31. The earliest record of equipment leasing occurred in the ancient Sumerian City of UR about 2,010 B.C. which involved leases of agricultural tools to farmers by the priests who were, in effect, government officials. These transactions were recorded on clay tablets which were discovered in 1984. See: Encyclopaedia Britannica, 15th ed., Vol. 1, p. 326; "The Age of God-Kings", Time-Life Books, Alexandria, Virginia (1987), at 9.

32. For centuries, personal property leasing was not recognized under English Common Law although real property was leased extensively. Under the Common Law possession of personal property imputed ownership. Eventually, the law of bailments based on European law was developed as a result of commercial pressure.

33. Bunker, supra, Ch. I, note 14, at I-20.

34. T.M. Clark, "The Basic Leasing Concept", World Leasing Yearbook (1988), at 17.

35. R.S. Sowter, "Lease Finance for Airlines", Air Law, Vol. IV, No. 1, 1979, at 15.

36. The two most commonly used methods of lease financing in Islamic laws, with few exceptions are the operating and finance leases as we know them today: "The operating leases are called (Ijara) and the finance leases (Ijara wa Iktina) under either form, the title to the asset is retained by the lessor until the expiry of the lease contract. Terms and conditions for all leases, once agreed, are binding upon the parties to the leases, as long as such terms do not contravene Islamic laws, rules, jurisprudence, etc." "Leasing in Islam", M. Afzaal Ellahi, World Leasing Year Book, 1988, p. 42; see "Islamic Banking and Finance", by Tariq Hassan, in Current Issue of International Financial Law, D.G. Pierce, H.H. MCHan, F.E. Lacroix and Ph. N. Pillai (eds.), Singapore (1985), Singapore National Printers (pte.) Ltd., at 98; "A lease is a conveyance, by a lessor to a lessee, of the right to use a tangible asset usually for a

specified period of time in return for rent." Canadian Institute of Chartered Accountants Handbook, section 3065.03(n).

37. Comment, 66 Yale L.J., at 751 (1957). Short-term leasing is not deemed to be the equivalent of a purchase of the leased equipment but may be employed for other business such as accommodating seasonal fluctuation in passenger traffic; see Johnston, "Aircraft Leasing", 9 McGill L.J. 32 (1963).

38. Beecham Foods Ltd. v. North Supplies (Edmonton) Ltd., (1959) W.L.R. 643.

39. McCarthy v. British Oak Insurance Co. Ltd., (1938) All E.R.1.

40. Astley Indust. Trust Ltd. v. Grimsley, (1963) 1 W.W.R. 584; Charterhouse Credit Co. v. Tolly, (1963) 2. Q.B. 683.

41. Yeaman Credit Ltd. v. Apps, (1962) 2 Q.B. 508.

42. Suisse Atlantique Société d'Armement Maritime S.A. v. N.V. Rotterdamsche Kolen Centrale (1967) 1 A.C. 361.

43. Bunker, supra, ch. 1, note 14, at I-57.

44. Clark, supra, note 34, at 18.

45. John Sharman, a speech presented at "Aircraft Financing Today", An IATA Conference, Marriott Marquis Hotel, New York, April - June 1990.

46. D.H. Bunker "Aviation Lease Financing", Air Transport Management, January/February 1990, Vol. 2, Nu. 6, at 4.

47. The European Leasing Federation (Leaseurope) has published its own accounting standards in four languages known as "The Declaration of Seville", which has apparently been accepted by several countries see: Leasing Digest, April, 1984, at 20. Leaseurope takes the position that the capitalization of leased assets in the accounts of the lessee as required by the International Leasing Standard IAS-17, is not legally correct as "it is based on a definition of ownership which is economic and not judicial".

48. P.F. Coogan, "Leasing and the Uniform Commercial Code", in B.E. Fritch and A.F. Reisman ed., Equipment Leasing-Leveraged Leasing, 2nd ed., Practicing Law Institute, New York (1980), at 777.

49. Bunker, supra, note 25, at 31.

50. Bunker, supra, note 25, at 61.

51. In Canada, De Havilland Aircraft Company of Canada, Canadair was purchased from the Canadian Government December 1986, see Bercuson, David, Granatstein, J.L. and Young, W.R., Sacred Trust?, Toronto, Doubleday, 1986; "Teleglobe Canada was sold in April 1987", see The Financial Post, April 13, 1987; In the United Kingdom, Rolls Royce and British Airways were privatized by way of sale shares to the public in May 1986, see The Economist, July 18, 1987, at 62; "Shares in Singapore Airlines", see Airline Business, August, 1987, p. 12; "The Royal Jordanian Airline has plans", see Airline Business, July, 1987, at 5.

52. D.J. Bederman, "Prospects for European Air Deregulation", 21 International Lawyer, 1987, at 561.

53. "Debt and Lease Aircraft Financing in the Arab World: An Asset - Based Financing Perspective", paper submitted to the IBA Seminar, on "Islamic Finance", Paris, France, June 1990.

54. Convention on International Civil Aviation, 7 December (1944), 61 stat. 1180, T.I.A.S., No. 1591.

55. Convention for Suppression of Unlawful Seizure of Aircraft, 22 UST 1641.

56. Convention for Suppression of Unlawful Acts Against the Safety of Civil Aviation, ICAO Doc. 8966 (1971).

57. Convention on Offenses and Certain Other Acts Committed on Board Aircraft 20 UST 2941.

58. Convention on the International Recognition of Rights in Aircraft, 17 September, 1953, 4 UST 1830, T.I.A.S. No. 2847.

59. Supra, note 54.

60. For more details see "Registration of Aircraft", at 57, infra.

61. Legal Sub-Committee of U.S. Air Coordinating Committee (3 Jan. 1949), Doc. Acc.88.11, at 4.

62. ICAO Doc. 7364 (Consolidated amended version attached to LM 1/8.4-80/4).

63. Stewart, "Multinational Aircraft: Present and Future Problems", 17 Aerospace International 30 (1981), No. 5.

64. R.J. Goldstein, "Aircraft title Registration and Perfection of Lien Rights in Aircraft", Air Law, Vol. IV, No. 1, (1979), at 2.

65. For delegates to the Chicago Convention, see Document 2187, published by the Provisional International Civil Aviation Organization (International Civil Aviation Conference), at 5.

66. Article 12: This article included a new principle in international air law to the effect that over the high seas the rules to be in force are those established under the Convention.

67. Article 17.

68. Article 18.

69. Article 19.

70. Fifth Annual General Meeting of IATA, the Hague, September, 1949.

71. The problems involved in the registration of ownership, liens and mortgage alone would render the idea impossible.

72. Provisions respecting registration (Articles 17 and following) and respecting the adoption of International Standards and Recommended Practices (Articles 37 and following).

73. G.F. FitzGerald, "Air Law 1972-2022", 51 Can. Bar Rev. 264, at 266.

74. G.F. FitzGerald, "The Lease, Charter and Interchange of Aircraft in International Operations - Article 83bis of the Chicago Convention International Civil Aviation", A.A.S.L. Vol. VI, (1981) at 49.

75. Doc. 9311 A23-Min. P/1-13, Assembly, 23rd Session, Montreal, September 16-October 7, 1980, Plenary Meetings, Minutes, 12th Meeting, 146. Resolutions A23-2 (Amendment of the Chicago Convention Regarding Transfer of Certain Functions and Duties and Ratification of Protocol Incorporating Article 83bis into the Chicago Convention).

76. The Chicago Convention was amended on October 6, 1980 by the 23rd Assembly of ICAO. The Amendment will come into force on the date on which the ninety-eighth instrument of ratification is deposited with ICAO. As of April 1, 1987 there have been 39 ratifications.

77. Bunker, supra, note 25, at 170.

78. See M. Milde, "Nationality and Registration of Aircraft Operated by Joint Air Transport Operating Organizations or International Operating Agencies", A.A.S.L., Vol. X, 1985, at 133; R. Mankiewicz, "Aircraft Operated by International Operating Agencies", J. Air L. & Com., Vol. 31, 1965, at 304.

CHAPTER IV

OVERVIEW OF FINANCING IN DEVELOPING COUNTRIES

INTRODUCTION

The types of financing used have changed considerably, in particular, over the past 40 years, and some developing countries' financial requirements have been met with injections of capital from abroad. The rapid increase in loans contracted on the international market began in the early 70's, and has reduced the relative importance of traditional forms of financing (direct investment and official aid) and since the beginning of the 80's new problems has been generated as well, which must be solved if developing countries are to re-establish both regular growth and their position in international economic relations.[1] Moreover, developing countries will have to rely less on external debt and more on direct private investment both foreign and domestic.

In fact, overreliance on external financing, even if readily available, could lead to delays in making the necessary adjustments and could compound long term problems, which usually arose because of faulty domestic management or unsuitable economic policies (relating to the exchange rate, interest rates, the budget and so on). If non-oil developing countries are forced to constrain their financing demands severely, the impact on their economies could be extremely difficult in social as well as economic terms, particularly for many of the poorer countries. The lack of development could also constitute a drag on the world economy. It is essential that this be recognized and that every effort be made not only to increase unilateral transfers but to avoid putting barriers in the way of non-oil developing countries increasing their export earnings to pay for imports. A number of developing countries have been remarkably successful in recent years in achieving higher rates of growth, in part based on the export

of manufactured goods. This has added to the problem of adjustment in some of the older industrialized countries and given rise to pressures for increased protection of domestic industries. Continued strong growth of these developing countries also provides market opportunities, particularly in high technology areas. Protection can only inhibit long-run changes to domestic and international trade patterns that are required to maintain a strong world economy and more efficient and dynamic national economies.[2]

Any deterioration, however moderate, in the international environment and especially any slow-down in the rate of development of world trade would be bound to hamper banks. This is for two reasons:

1) it will be very difficult to adjust the developing countries' external situation to this slow-down any further. This means that, in the case of the (anticipated) slow down in the growth rate of the world economy, two things would happen; (a) competition between the developing countries would be much greater and could only be supported by successive devaluations which would have very damaging structural effects; and (b) the terms of the developing countries and the bank's choice between respecting external commitments and sustaining minimum growth at home would be very different from what they were in 1982.

2) Given the anticipated increase in the developing countries' financial requirements, the banks will be unable to avoid substantially increasing their lending. Historically speaking, the banks have always played a supporting role in developing countries' financing.[3]

This chapter will look at the historical and future prospects of the debt crisis situation. And then, criteria for solutions to aircraft financing in view of the debt situation will be proposed.

SECTION I: AN HISTORICAL OVERVIEW OF THE DEBT SITUATION AND ITS FUTURE

A. OVERVIEW OF THE DEBT CRISIS

Typically, developing countries have relatively small incomes and large financial requirements. As a result, many reasons for injecting financing from abroad were found in the 1950's: the developing world did not have enough domestic savings or foreign exchange; its financial requirements were huge; the returns on capital were greater there than in the industrialized world and so on. By 1950, after liquidation in the period of 1930-45, the developing countries had very little debt. But loans from the industrialized countries increased rapidly in the period 1955-60, more rapidly in fact that the developing countries' exports that went to service them. By the end of 1971 direct investments were an estimated $80-100 billion and the debt $110 billion. Asia had the biggest bills to pay 42% of the total, Latin America owed 38% and the recently independent African countries owed only 20%. At the end of 1983, the external debt of the poorest countries - the non-oil producing LDCs alone amounted to 900 billion dollars.[4]

A country's external debt must be seen within the context of its economic capacity and the specific causes of its difficulties, since this might simply consist of short-term liquidity problems owing to a temporary balance of payments disequilibrium or the unfavourable maturity profile of its external debt.

In 1979, the renegotiation of Turkey's external debt received international attention, as did those of Poland in 1981 and in 1982 and Romania in 1982.[5] At the turn of the year, in 1982-83, a number of debtor countries - Brazil, Romania, Cuba and Mexico - declared their inability to repay their loans as scheduled, requested negotiations and, in the meantime, took unilateral measures with respect to the handling of repayments.[6] In addition, by the end

of 1982, Argentina had reached agreement with its foreign creditors both on the principles governing the rescheduling of its debt service payments falling due in 1983 and on new loan agreements with private creditor banks.

The main cause of the crisis was that the first oil-price shock in 1973 not only brought about a tremendous transfer of resources, but also, as a consequence, a retransfer of resources through credits, in particular to non-oil producing developing countries. The second price shock in 1979 and the beginning of the U.S. anti-inflation policy put some countries in a difficult situation. They were not only confronted with higher oil bills but found it increasingly difficult to service their debts, since high interest rates in international financial markets boosted the floating interest rates attached to their credits whilst the economic effects of disinflation were left. Finally, some oil exporting countries were hit by the drop in the price of oil in the early 1980's because they had based their economic policy too much on the presumption of steadily rising revenues from oil exports. During the decade of 70's, many other factors had contributed to the development of the crisis. Imprudent borrowing, political instability, governmental incompetence, corruption, and the heavy stream of flight capital[7] caused by these factors helped to turn some credit-worthy countries into risk countries.[8] Serious repayment problems characterize most of the developing countries, which in net terms are also the major borrowers. According to recent figures, the external debt of the 133 countries included by the IMF as developing countries amounted to about $1095 billion and was projected to reach $1223 billion by the end of 1988. This figure includes loans from all sources - banks, governments, and other lenders, as well as government guaranteed loans; it also includes short-term credits-those with a maturity of less than one year.[9]

For most countries in Africa and Latin America, however, the 1980's were a lost decade for development. The immediate growth prospects for the developing countries taken as a group are not encouraging, and no change is

expected for the time being. The present trend of dual tracks will continue with Asia leading what causes deep concern is that in the short - and even medium - term all the major economic reports from the World Bank the IMF, UNCTAD, DIESA's World Economic Survey, etc., predict little if any recovery in per capita output in Latin America and sub-Saharan Africa.[10]

B. NATURE AND SIZE OF THE DEBT AND FUTURE PROSPECTS

In analyzing the nature and size of the developing countries' debts, it is useful to make both terms plural. There are, in current use, a good dozen different universes of developing countries, mostly undefined. The universes vary from the 1956 universe of almost every country outside of Western Europe, North America, and Japan, to the very much smaller universes like the most seriously affected countries or the least developed countries.

The very poor countries, are more or less self identifying and may be described as countries where the current account deficit is determined by the availability of capital. The balance of payments analysis for these countries is rather different from what it is in other countries. These countries, except in specific operations and for very limited purposes are going to borrow much from the commercial banking system of the industrialized world. The countries in this situation include India, Pakistan, Bangladesh, the countries in French speaking Africa whose debts were simply expunged by an act of the French Government in 1971 and so on. There is a concomitant view that aid to these countries should be in the form of grants.[11]

It is less and less likely that any very considerable sums of grants or grant-like external sources of finance will be available to other, less poor countries on the conventional list of the developing countries. Furthermore, there will be some rather serious external financial problems in some of the petroleum-producing countries. Nevertheless, some of these countries have a

fair sized industrial base which is now growing rather rapidly, or has been growing over the past decade or two. There are relatively modern manufacturing agricultural sectors, and most of these countries are deeply involved in international trade. Moreover, they import capital, and can be expected to continue to do so over a considerable period in the future. Fifteen or twenty years ago, however, these countries were borrowing from official sources on relatively easy terms. One remembers the Agency for International Development, (AID) programs of the U.S. in the early and mid 1960's. That is no longer the case and is rather unlikely to be the case in much of South and Central America, Eastern Asia, Southern Europe and in parts of the Middle East.

In any event debts of the developing countries seem to have increased considerably during a period when there was a sharp adverse movement in their terms of trade, in large part, but not entirely on account of the price of petroleum.[12] This has now been overtaken by yet other events which have been diverse from country to country.

Klaus M. Leisinger[13] argued that cancelling the debts of one government by its successor would undermine lender confidence and not address the needed policy changes that would prevent the continuing misuse of credit. However, the commentator stated his belief that for a long-term solution to the debt problems is the continuing social and economic development on a broad basis and for many countries, it is, therefore, important to establish confidence in the domestic economy and in the political leadership. Only in this way is it possible to stop the immense flow of capital out of the Third World.

On the other hand, it has been argued that the lending process is often irresponsible and illegitimate and continues to allow bad debts to pile up.[14] However, several attempts were made by groups of developing countries to establish a united front on the debt problem, given the magnitude the apparent intractability of this problem, and because of the lack of major progress in

providing debt relief to developing countries, it is likely that it would continue to rank high among the problems confronting developing countries in the years to come.

Obviously, the International Development Strategy (IDS) for the 1990's that is under preparation in the United Nations will have to provide an agreed frame-work for multilateral cooperation and address the ways and means of correcting these unhealthy trends and to revitalize growth.

The new strategy will have to take into consideration the persistence of large imbalances in the world economy, between the developed economies themselves as well as between developed and developing economies. It will also have to suggest ways to improve macroeconomic policy coordination among major industrial countries so as to reduce monetary instability.

Moreover, there should be continuous review and appraisal of progress towards the development objectives, which is more true for the 1990's, where the technologies, communications and the integration of international financial markets will continue to grow more rapidly than the ability of governments to manage them.[15]

Recently the US AID has signed agreements absolving ten African Countries of about $305 million in debt[16], and to be eligible for debt relief a nation must be engaged in economic reform programmes approved by the IMF or the World Bank. In some cases, debt will be relieved in stages as the debtor reaches those economic targets.[17]

In conclusion, the Third World debt raises a potential threat not only to U.S. commercial banks but also to those of Japan and Western Europe. The possibility of extensive default has serious implications for the international financial system as well as world trade and investment. Accordingly, the IMF, IBRD, and BIS have participated, along with national governments, to alleviate the repayment burden and, in some instances, to augment the flow of capital

to debtor countries.

Debt restructuring has been the major approach accepted, especially since 1982, both by governments and commercial banks. Some progress has been made through the Baker Plan, although success has not been as great as expected. To a major extent, of course, the resolution of the debt problem depends upon market conditions for various primary commodities, which at least during the first part of the 1980s were not particularly favourable to the exporting countries.

The Third World debt problem is far from resolved, particularly if a resolution implies the general absence of payments arrears and debt restructuring; yet recognition of the potential seriousness of the situation, coupled with changes being introduced by banks, governments and international organizations, is an indication that the least some progress is being made.

SECTION II: CRITERIA FOR SOLUTIONS TO AIRCRAFT FINANCING PROBLEMS IN VIEW OF THE DEBT CRISIS

A. INTRODUCTION

Airlines around the world have performed rather poorly in financial terms following the period of negative cash flow: few have the retained earnings or the borrowing power to finance re-equipment. This problem is most acute in the non-oil producing developing world where the equipment is oldest and the need for replacement most pressing. There is no solution - no form of creative financing - which provides a simple answer to all re-equipment needs. Airlines are expected to return a profit with their current equipment, a result they are unlikely to achieve until there is a sustained period of traffic growth and a better match between capacity and demand. This view is, of course, somewhat naive

in that many of the airlines in the developing world never make a profit - it simply is not part of their corporate objectives. In these cases the financing of a sale does not depend on the potential profitability of the operator but on the credit-worthiness of the government underwriting the loan. It will often be this government which is the final arbiter in deciding which aircraft is to be purchased. Unfortunately, many third world governments are not much more credit-worthy than their state airlines.[18]

That there is only one passenger market has not prevented regulatory bodies from creating an artificial split between scheduled and charter markets, which has resulted from decisions made by the regulatory bodies. In different parts of the world different regulatory systems apply; however, there seems to be a general consensus that airlines should operate profitably as follows:

1) They must have a fully professional understanding of the true costs of operating, whether it be of the whole network, or each route, or each flight, or even of each seat. Those airlines which measure themselves in terms of average cost per hour or per mile, or study average stage lengths and average yields per passenger mile, usually end up by buying the wrong aircraft, flying the wrong routes and making bigger-than-average losses.

2) The airline must have a creative marketing force to search out and exploit new opportunities, and which aims to maximize revenue on each service. This involves thinking seriously about various forms of pricing policy and proposing fares that are related to true costs and not too strongly self-dilutionary.

3) The airline must have strict control over its costs and be prepared to either invest heavily or cut heavily on costs in order to improve profitability.

These three internal attributes are of little value, however, unless there

is also the ability on the part of the airline to know the regulatory and financial framework of the industry in which it must continue to make a profit.[19]

Preliminary ICAO estimates for 1989 indicate that the world's scheduled airlines as a whole achieved an operating profit of 4.7 per cent of total operating revenues compared with a profit of 6.12 per cent in 1988[20]. On the other hand almost from the moment Iraqi tanks crossed the Kuwaiti border on August 2, the world's major airlines knew they were in trouble. Economically, the sharp rise in fuel prices as a result of the crisis has impacted severely on the airlines industry, and is being felt in higher fares and charges; as well as through greatly increased insurance premiums for airlines operating through the Gulf region.

Apart from some exceptions (freight in Africa, passengers in Latin America), it is to be noted that the domestic traffic growth of these countries has not kept pace with their progress in international traffic if there is any. The domestic networks have suffered from adverse conditions and have been affected by all sorts of obstacles: aviation policies based on a monopoly or very limited competition, financial policies that are incoherent or cannot be applied due to their unwieldiness or to the commercial context (currency, repayments, authorizations to purchase parts, difficulties in re-equipping the fleet, lack of enterprise or discouragement of initiative, etc.).

Apart from a reform of structures and methods, an entire way of thinking must be changed. In this regard, the World Bank has suggested the following three guidelines for commercial aviation:[21]

1) the creation of well organized and economic domestic networks;

2) the utilization of the aircraft for any kind of development in areas where surface transport is inadequate; and

3) operation of air freight.

The World Bank still adheres to the three conditions, which were defined

in 1972, required of the projects submitted to it for approval: economic planning; efficient organization; and administration. Management and profitability will act as guidelines for the future.

The World Bank optimistically predicts that with adequate development of these three points and of tourism, aviation can look to the future with confidence. It is important to get beyond the initial assistance formula, which was too closely geared to the aircraft/airport complex, and use all the new possibilities for the benefit of the economy in general.[22]

I will discuss below some of the most general solutions proposed to date for financing the purchase of aircraft in view of the debt crisis.

B. GENERAL SOLUTIONS

1. Privatization[23]

Privatization of state-owned airlines, whether total or partial, is an aspect of air transport deregulation or liberalization found only outside the United States. While privatization may be a manifestation of a deregulation policy, it is not solely a function of deregulation. Privatization may also serve as an aid to national administration by reducing the national debt through the sale of valuable assets, and may be used as a means of raising capital from sources other than government in order to finance expensive fleet re-equipment. Apart from fleet re-equipment, it seems that the advantages of privatization are that an airline may be run on sound management principles rather than as a quasi-bureaucracy and that airlines may be made more competitive in an international environment.[24]

For some years, a definite trend on the part of some governments has been to insist that their carriers, even though government-owned, stand on their own feet with a minimum of operating and financing support. This trend is now heading towards privatization of a number of major carriers, with quite a few

governments seriously considering such an option. Some governments are beginning to feel that privatization leads to greater operating efficiencies, while at the same time freeing up limited government resources for more pressing needs.

From the financing viewpoint, lenders look at a privatized carrier more as an airlines credit than as a government credit, and lend on a secured or unsecured basis depending on their analysis of the airline's earnings, cash flow, balance sheet, and management strategy. However, private sector banks, institutional lenders and to some extent the public market in the U.S., Europe, and the Far East, are willing to lend or lease to newly privatized carriers on reasonable terms without government guarantees. I would assume that if such carriers wanted to avail themselves of export financing, they would be able to secure the necessary guarantees.[25] Moreover, privatization would give carriers more flexibility to respond to market demand and try other means of financing aircraft, such as equity issues or "asset value guarantees", in which lenders assume more risk by sharing in the cash flow generated by operation of the aircraft. As well, privatization, especially on a partial scale, would be easier to achieve than mergers or acquisitions that would run into legal, political and financial obstacles, and conservative government philosophies in some cases that believe in state ownership of flag carriers.[26] On the other hand, privatization does not result directly from deregulation or liberalization, nor does it reflect changes in political philosophy from government control to profit-oriented commercial operations.

Furthermore, policy makers must resist the temptation to see privatization as a panacea for economic reform in the developing world Politically, economically, and administratively, it is an extremely difficult undertaking. Privatization will not resolve all of the problems surrounding public enterprises. At the same time, experience reveals that privatization is both desirable and feasible. Creative and innovative thinking as well as systematic and strategic

planning are required to realize its full potential. Policy makers should continue to seek out opportunities for privatization, and must learn to tailor the privatization solution to the unique political, economic, and social conditions that exist in each different national setting. A healthy state is one that can recognize its own limits, can tap the creative and productive talent of its private citizens, and can accept its full responsibility to ensure that the fruits of the labour of its public and private enterprises are justly shared.

2. The Operating Lease Method of Financing

An operating lease is a transaction in which a carrier acquires the use of an aircraft without the obligation to pay back the full cost of the asset, either directly or indirectly, over the term of the lease. This definition embraces the conventional operating lease with a term of,say, five years; it also includes transactions which, while structured to continue to full pay-out, contain "walkaway" provisions whereby the lessee can return the aircraft to the lessor or to the manufacturer before the time stipulated in the lease. While these latter transactions are, to a certain extent operating leases, they are quite different from conventional manufacturers' deficiency guarantees or other arrangements under which the manufacturer agrees to buy back the aircraft only on the default of the user. What are the reasons to rent on an operating-lease basis? In the extreme case of a very poor credit where raising long-term capital in any form, debt or lease, is virtually impossible, it may be the only possible route.

On the more positive side however and for the better credits, operating leasing is clearly off corporate and country "balance sheets"; it eliminates the pre-delivery cash outflow typical of an outright purchase, other than those that have to be made for purposes of reserving a slot with an operating lessor. In most operating lease situations a funds provider is involved as a third party to the lease. Typically, the operating lease involves a specialist lessor company which has borrowed funds to provide the major part of the finance required.

These borrowed funds will be secured by an assignment of the lease transaction and a mortgage over the assets, but the lender will also have full recourse against the lessor. The principal reason airlines preferred leasing in the past was because they provided 100 per cent financing, did not tie up capital, and had lower monthly payments than if the aircraft was purchased But today the short-term operating lease is becoming increasingly viable due to deregulation and the need for airlines to have a lot of flexibility.[27]

(a) Financial Flexibility

Many airlines turn out to be under-capitalized and insufficiently credit-worthy to make the long-term financial commitments required by a purchase or full pay-out lease. Many others are not able to use all of the tax advantages of ownership and see the operating lease as a method of optimizing their aircraft ownership structure. Other carriers, particularly in Third World countries which have weak economies or have had to reschedule their international debt, may be prevented by their authorises from entering into long-term arrangements which would be counted as an additional national debt. Thus, the operating lease becomes a flexible response to their financing needs.

(b) Marketing Flexibility

There is greater ease of entry and the quasi-permanent franchise that some airlines held over some markets is no longer guaranteed indefinitely. In these circumstances many airlines find it difficult to make the long-term commitment to a particular marketing strategy that outright purchase involves, whether it be a direct purchase or through a full pay-out lease. Again the operating lease provides a neat answer.

(c) Technological Flexibility

The new generation of aircraft[28] on the market, offers very considerable

advantages over the technology of the 1960's and 1970's. However, these aircraft and the engines that power them, may be superseded during the 1990's by a new generation. Many airlines wish to retain the flexibility to move to the latest technology when it becomes available and they see the operating lease as a useful tool to achieve this objective.

In conclusion, the operating lease business has come a long way from its original position at the margins of the industry, where essentially it was a way for airlines to put their surplus aircraft out to work with third parties. Operating lease financing has now become a major factor in the financing of aircraft. Because of the value it adds to the industry and the advantages it provides both for the capital markets and the airline users, it is likely to become an even greater force in the future development of aviation financing in developing countries.[29]

On the other hand, in the future some airlines may well become just operating companies with no significant assets, and therefore they could become extremely vulnerable. So this evolution in financing is quite understandable if airlines have no other choice than forfeiting residual value; it is more questionable when it is for the sake of sophisticated transactions. The strong airlines will continue to own a significant portion of their fleet. They will rent a limited number of aircraft, and the best names will even find banks prepared to finance with the flexibility of the operating lease. There is no doubt these airlines will become stronger, and that they will have the ability to manage their assets as effectively as possible. The other airlines will continue to weaken their balance sheets. Their profitability will come from the day-to-day operations which itself will not be so easy as it is now, and their future in the view of their financial problems will be in the hands of their banks, but bankers usually seek guarantees, especially when the credit is poor. Extreme difficulties can be foreseen for airlines which will need loans, and they will not have any assets to provide as collateral.

However, it must be said that airlines have to own a significant portion of the fleet they operate. It is clear that fewer airlines can afford this ownership. The aircraft financing community has tools to enable these airlines to operate a new aircraft they cannot buy. If these new aircraft strengthen their profitability and their balance sheets and enable them to buy aircraft in the future, there will be a happy end to the situation. If not, the aircraft financing community will only have pushed forward an unfortunate and irreversible situation.

3. The Pooling Agreements

Pooling is a common form of cooperative agreement in all parts of the world. While pooling may involve different types of arrangements, it is basically an agreed split of a particular market between carriers who are pool partners, with a penalty assessed on any partner taking in excess of its share, or at least not reaping the profit from the excess. A pool partner has no incentive to take traffic from its pool partners, because all partners share according to their agreement, regardless of the actual quantity of traffic carried. However, pool partners cooperate to the exclusion of non-pool operators. It is to the advantage of the pool to increase its market share at the expense of non-pool members. The result of such an agreement is a grouping of pool partners against all non-pool carriers.[30] Protection of the home market is provided in many instances on a direct or indirect basis by the local government, the local airline or both.

Apart from the usual methods of cooperation - pools, interline agreements, station service, joint use and interchange agreements - new approaches emerged, with varying degrees of success, as seen in the creation of the Scandinavian Airlines system, the European Air Union project, and vast pooling agreements in the commonwealth countries. Moreover, we see a regional multilateral agreement in Eastern Europe, and the creation of Air Afrique, to quote only the main innovations in the field of interairline

cooperation. At the same time, mergers and associations mostly dictated by the new economic conditions governing operation took place in national contexts.[31] On one hand, there is lack of qualified personnel in all areas and at all levels, which is considered a major handicap and a crucial problem, particularly by the African contributors. Personal strength must be consolidated and training provided from top to bottom of the scale. As well there is a lack of supervisory staff which affects middle-grade personnel such as workshop mechanics and after sales and handling staff. There is also political influence which may vary in its directness or frequency, in airline activities, which can make the pooling agreements problematic to the Third World carriers, in addition to the financial difficulties which they are facing.

On the other hand, cost reduction is one of the primary motivations behind pooling and related types of carrier agreements, which involve airline cooperation on the technological side and generally are concerned with eliminating the duplication of certain overhead costs. These agreements have important implications for the nature of the production function, since they reduce heterogeneity among firms and have somewhat alleviated the problems of small size.

(a) Spare Parts Pool

The most important type of agreement pertains to the pooling of spare parts. The first such pool was formed in 1954 for the Lockheed 749 and 1049. The Beneswise Agreement among KLM, Sabena and Swissair (later joined by SAS and Air France) was another early agreement. This agreement involved common maintenance service, mechanics, workshops, and spare parts for the DC-3, DC-4, Convair 240, and DC-6. Many such spare parts pools providing service for a particular plane type have since been established. Many but not all carriers using such equipment participate in these pools, which essentially allow participants to draw on a common inventory of spare parts. For example,

the Boeing pool involves member carriers paying an "availability charge" annually for the right to draw parts when needed, with repair and replacement in the inventory of any borrowed piece to be made as soon as possible.[32] These spares pools have produced considerable cost savings Furthermore, an airline can contact for either a dedicated pool of refurbished parts or become a member of a pool with several participants. The concept involves establishing a spare parts pool by means of a use factor for each part plus its projected turnaround time at a repair station. The use factor also is used to determine the exchange fee the customer is required to return the non-serviceable part to aviation sales, and to pay for the repair.

(b) Equipment Pool

This type of pooling arrangement involves the leasing of equipment; for example, a new subsidiary carrier may lease equipment from its parent company until it can afford its own. This is an effective means of circumventing capital constraints and is often used by developing countries Crews and other technical personnel may or may not be included in the lease arrangements, although technical advisory service almost always is.

(c) Maintenance Pool

Cooperation of a bilateral nature also exists, as exemplified by the many sub-contracting and leasing arrangements made among firms. Reduction in maintenance expense has been a major objective. A large number of these maintenance agreements exist, generally involving small carriers sub-contracting maintenance work to larger ones. The smaller carriers save on fixed costs and reduce capital requirements, while the larger firms earn additional revenue by employing their fixed inputs more effectively.

In maintenance sub-contracting agreements of this general type, one party is often a smaller carrier of a less developed nation. Philippine Airlines

was able to begin jet service with one DC-8 because of a pooling arrangement with KLM; KLM agreed to maintain the Philippine Airlines' DC-8 and to further guarantee that one plane would always be available.[33] Without such an agreement this small airline would not have been able to enter jet service.

4. Globalization

Strategic planning is difficult even in the short term when trends are clear. In the long term successful planning depends on well-developed forecasts of the future. The process of forecasting is complex and it begins with a clear complete understanding of the present. At one time all regional carriers were independent operators. Today, to survive, a regional carrier must develop a code-sharing relationship with major carriers. In large measure, the explosive growth of the regionals can be attributed to their increasing role as providers of traffic feed at major carriers' hubs.

This transformation of the regional industry has occurred largely because computer reservations systems (CRSs) give priority to code-sharing connections over interline connections. Airlines began to use marginal revenue pricing and yield management techniques to maximize profits. All of these things required intensive and advanced computer capability. Advanced CRS's were thus born. Today, CRS's have become a vital resource in airline marketing. A CRS facilitates yield management, aids in setting marketing strategy, satisfies customers with complete travel services, generates revenue, and builds passenger revenues for the host carrier the CRS owner, but the future of international code-sharing is not entirely clear. Many industry consultants feel a carrier without CRS cannot survive.

The uses of CRS's as a crucial management tool and a major revenue producer do not alone make it a requirement for airline survival. Instead, the most important use of a CRS lies in its ability to create and maintain market power for its owner, the host carrier. A carrier without any CRS access is

unable to market its product. Regional carriers best demonstrate the market power of CRS's. They have been forced into code-sharing relationships with major carriers to be able to access the travel agent distribution network. Airline industry globalization begins with transnational relationships, agreements between carriers of different nationalities. The result in many ways is the same, transnational relationships extend the global market power of each participant and set the stage for the emergence of global mega-carriers. By carefully forgoing transnational alliances in different regions of the world, a mega-carrier assures itself of becoming a survivor, a global airline.

During the next five years, more and more continental mega-carriers will enter transnational relationships, some of which will be marketing agreements (with or without code-sharing) and others will involve equity participation or equity swaps. These transactions will produce global mega-carrier networks. Global CRS networks will become the glue that binds global mega-carrier networks together. In 1988 the first annual international CRS symposium provided a glimpse of what the future world traveller will encounter by the mid-1990's. By the year 2000, global industry consolidation will be complete, and perhaps six to ten global industry mega-carriers will remain, each owned by a multinational holding company.[34]

5. Aircraft Interchange

An airplane in commercial service only earns money for its owner when it is in the air. The longer the aircraft can be kept in the air the better the bank balance is likely to be, always provided that the operator has got all his other sums right. Aircraft utilisation can be improved by raising the level of revenue flying and reducing capital outlay on owner occupied equipment by interchanging aircraft between two or more operators whose routes and schedules dovetail so that aircraft down time to one operator can be made available to fill the capacity requirements of another. There is today another

reason for embarking on equipment interchange and that is the development of supersonic aircraft.

I suppose it is fair to say that interchange is as easy or as difficult to achieve as the various factors like to make it, meaning that although the infrastructure, legal, technical and regulatory is not geared to promote interchange, it also does not prohibit it. The technical side of aircraft operation is controlled by the state of registry; while recognizing the sovereignty of a State over its own air space. Article 33 of the Chicago Convention provides for recognition of certification or validation requirements at or above the minimum standards established under the Convention. All the parties to an interchange arrangement have to make sure that all personnel concerned in the operation of the aircraft were duly licensed by the State of registry so that all personnel licences and aircraft documentation and certificates issued by the State of registry would be recognized regardless of the nationality of the operator.[35]

It is both technically and legally possible to surmount these difficulties over sovereignty and the recognition of licences and certificates etc. by changing the registration of the aircraft at the point of interchange so that the question of recognition of foreign certificates and licences does not arise.[36] However, the process was tedious and was abandoned as soon as the necessary permissions had been obtained to enable both carriers to conduct the interchange with aircraft confined to a single State register and for their respective certificates, crew licences and so on to be recognized.

It seems likely that the pursuit of ever cheaper travel will compel operators to pursue interchange arrangements on a more vigorous scale in the future than they have in the past, in order to raise utilisation and thus reduce operating costs per revenue flying hour.[37]

6. The Airlines' Cooperations

The patchwork of states in the developing world results in diseconomies of scale which can be attenuated only by inter-state cooperation, or reorganization on the basis of several multi-airline groups, as in the case of Air Afrique. The rules to be respected in achieving successful cooperation are essential: cooperation means altruism; and, it must be to the advantage of each party and this advantage must be seen from top to bottom of the scale in every sector. A good driving force must be found and a maximum dimension selected.

In the case of cooperation between developing countries, the economic and financial advantages are considerable (for example, Asecna, Air Afrique). This makes it possible to eliminate duplication, limit financial risks, improve stock and infrastructure management as well as the economic situation of the parties involved.

Cooperation in undergoing change. From a policy of donations from North to South, it went into a vertical form between quite unequal partners; then certain developing countries acquired direct interests, becoming increasingly involved with the future stages and risks in such cooperation.[38] Moreover, there is a real need for increased cooperation in many areas between developing nations' airlines in order to improve their economic performance The integration of airline operations on a regional basis is of prime importance in such areas as reservations, automation, the acquisition of aircraft and spares, maintenance and joint use of training simulators.[39] Apart from the cooperative arrangements, several airlines throughout the world unilaterally reduced frequencies or capacity available on a number of routes in order to conserve fuel to improve their financial position. They also favoured creation of multinational airlines and called for cooperation, including joint operation of international services by airlines of African countries, co-ordination relating to schedules, reduction of fares, standardization of equipment and joint

maintenance and training facilities. Moreover, the Arab Air Carriers' Organization (AACO) which is composed of 16 Arab airlines, developed a seven-point blueprint for long range cooperation and standardization among its members. The cooperative projects now being examined by the airline association are in the area of costing, data processing, training of pilots, cabin crews and ground personnel, maintenance and overhaul, standard insurance provisions and joint operations.[40]

For thirty-six years aviation has made considerable advances in developing countries. Most of them have already achieved a high degree of independence in many civil aviation fields. They are now better equipped for cooperation among themselves and for action to cut costs through international operating bodies, pooling arrangements, equipment standardization, joint maintenance services and regional training centres.

On the other hand, there are problems arising from technology transfers and training and cooperation problems in general.

Unfortunately, cooperation often creates confrontation. There are conflicts in interests and technology transfer between industrialized countries themselves, and from such countries to developing nations, or even between the developing nations themselves. There are drawbacks with regard to sovereignty which is protected through the presence of a country's nationals within the partnership and through financial solidarity among members. The breakdown of costs and benefits gives rise to problems for the richest states pay the most. Cooperation is undergoing change.

FOOTNOTES

Chapter 4

1. P. Arnaud, "Third World Debt", The Courier, No. 97, May-June, 1986, at 62.

2. G.K. Bouey, "The International Monetary System: Key Issues", in A New Decade in Banking: Papers and Reports on discussions from the 33rd International Banking Summer School held at the Banff Centre for Continuing Education, Banff, Alberta, Canada, September 1980, Toronto, Ontario: Canadian Bankers' Association (1981), at 13.

3. J. Cheval, "Financing the LDC's: How the Banks are Reacting", The Courier, No. 97, May-June (1986), at 85.

4. For a detailed breakdown of debtor and creditor total in 1983, see "International Debt: Banks and the LDC's", 10 AMEX Review Special Papers, March, 1984, at 3.

5. On Eastern Europe in general see Williams & Keller, "Eastern Europe and the International Banks", in International Monetary Fund, External Debt in Perspective, September, 1983.

6. On Latin American debtor countries see survey, "The Rescheduling Countries of Latin America", in Euromoney, March, 1983, at 55.

7. Flight capital from developing countries in 1975 - 83 was an estimated US $120 billion. $71 billion is said to have come from the seven largest debtor countries (including Mexico, Argentina, Venezuela and Nigeria) in 1979-82.

8. N. Horn (ed.), Adoption and Renegotiation of Contracts in International Trade and Finance, 1985, Vol. 3, Deventer. Boston: Kluwer Law and Taxation Publisher, at 298.

9. Charles W. Hultman, The Environment of International Banking, Prentice Hall, Englewood Cliffs, New Jersey, 1990, at 193.

10. Antoine Blanca, "Recovering the Lost Decade", Development FORUM, Vol. XVIII No. 1, Jan.- Feb., 1990, at 1.

11. This view is openly espoused by the Governments of the U.K., Sweden, and a number of other countries.

12. A.M. Solomon, "The Developing Country Debt Situation", ed. by S.H. Goodman in Financing and Risk in Developing Countries, New York: Praeger, 1978, at 27.

13. Klaus M. Leisinger teaches development policy at the University of Basle, Switzerland, "Debt forgiveness is no solution", Development FORUM, Vol. XVIII No. 1, Jan.-Feb. 1990, 3 at 4.

14. James K. Boyce is a professor of economics at the University of Massachusetts, U.S.A., "The Third World Debt: It should not be repaid", Development FORUM, Vol. XVIII No. 2, March-April, 1990, at 3.

15. Blanca, supra, note 10, at 14.

16. Agreements have been signed with Benin, Cameroon Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, Nigeria and Zaire. Eligible countries that have not yet concluded agreements include Cote d'Ivoire, Niger and Uganda.

17. Development FORUM, Vol. XVIII No. 2, March-April, 1990, at 8.

18. "Airlines Pursue Creative Finance", Lloyd's Aviation Economist, October, 1983, at 18.

19. A. Thomson, "Financial and Economic Environment of Air Transport", ITA Bulletin, No. 23/19, July, 1978, at 565.

20. "ICAO Report says Airline Finances Remained Healthy in 1989", Interavia Air Letter, No. 11, 989-May 7, 1990-5.

21. E. Wessberge, "The World Bank and Aviation Development" ITA Weekly Bulletin, No. 3/19, January, 1981, at 55.

22. A.M. Ellie, "Air Transport and Development", Paris Air Show, 31 May-June, 1983, ITA No. 7, June-July, 1983, at 33.

23. For example, supra, Ch. III, Note 51.

24. P.P.C. Haanappel, "Air Transport Deregulation in Jurisdictions Other than the United States", A.A.S.L., Vol. XIII (1988), at 96.

25. Bradley, supra, note 23, Ch. I, at 15; for example: Gulf Air's plans to sell 94% of its stock to Gulf Nationals has been put on hold. The airline decided to wait for a better "window of opportunity", Interavia Air Letter, No. 11, 322, September 1, 1987-A.

26. "Financing Needs May Force European Privatization", AD, December 15, 1988, at 397.

27. N.W. Lyon, "The Battleground of Lease Finance", Airline Executive, January 1987, 28 at 43.

28. Such as the MD80 Series, the Boeing 737-300 and 400, the Fokker 100 and the Airbus A320.

29. C. Barrington, "Operating Lease Financing", IATA Review, October-December 1986, at 16.

30. S.B. Rosenfield, "International Aviation: A United States Government Industry Partnership", International Lawyer, Vol. 16 (1982), at 473.

31. J.C. Martin, "Airlines: From Cooperation to Risk of Conflict", ITA No. 2/14, January, 1980, at 27.

32. "BOAC Reports on Savings from Spares Pooling", International Aviation Supplement to AD, Vol. 141 (August 6, 1952), at 95.

33. S. Wheatcroft, Air Transport Policy, London, Michael Joseph Ltd., 1964, at 105.

34. C.J.L. Robinson, "Airline Industry Globalization: A Ten-Year Forecast", Airline Pilot, October, 1988, at 24.

35. It does not work in the U.S. because its laws prohibit the use of foreign registered aircraft by operators whose principal place of business is in the United States.

36. This was in fact done in the past by one of British Airways Predecessors for a short time.

37. M.J. Lester, "Aircraft Interchange", Airlaw, Vol. IV, No. 1 (1979), at 8.

38. Ellie, supra, note 22.

39. A. Ghandour, "Programme for Developing Nations' Airlines", IATA Review 4/87, 43rd Annual General Meeting, at 19.

40. "More Capacity Reductions and Joint Ventures Resulted from Interairline Cooperation during 1975", ICAO Bulletin, May, 1976, at 45.

CHAPTER V

THE PROBLEMS FACING THE ASSET FINANCING OF AIRCRAFT IN THE THIRD WORLD AND POSSIBLE SOLUTIONS

Third World countries need airlines of their own as they do not want international air communications with the rest of the world to be entirely in the hands of foreign carriers, because this would put contact with the rest of the world outside the country's control. Moreover, an airline is a good way of introducing high technology and modern management techniques to an LDC and provides career opportunities for a variety of specialist professions and trades. There are often problems, not the least being a lack of hard currency to pay for aircraft and fuel, and a lack of trained personnel.

An LDC airline can buy old, second-hand jets but these have disadvantages in terms of fuel burn, maintenance cost and noise (services to noise-sensitive airports in developed countries may be at risk). Modern, high-technology airlines burn less fuel and are a hedge against a rise in fuel prices given that they have lower maintenance costs and comply with world-wide noise regulations. But new aircraft are expensive and, even if an LDC airline is credit worthy, it is not assured that the country in question will be. A lender may not be able to provide finance to the airline because it has already lent too much money to that country.

If an airline wants to buy an aircraft, up to 35 per cent of the purchase price may have to be spent in pre-delivery payments. While the view that aircraft are excellent security for loans has steadily gained ground, lenders are still worried about the risk of not being able to repossess the aircraft from an LDC airline in the event of default.

Speaking from the perspective of the LDC airlines, Makonnen Eshete[1] has succinctly captured the dilemma that Third World airline companies face:

> "we have to pay a large spread on borrowings [higher interest rates than are charged to developed countries' carriers], and higher insurance premiums; at the same time we charge the same ticket price as Lufthansa for example, but pay ten times the insurance premium per unit of hull value!"

These are simply a few aspects of the many problems facing the financing of aircraft in the Third World, which will be the theme of this chapter. The Third World angle on aircraft finance in Section I, asset finance problems in Section II, and possible solutions in Section III will be discussed.

SECTION I: THE THIRD WORLD ANGLE ON AIRCRAFT FINANCING

The majority of Third World international flag carriers are owned by the State and their debt financing has to be guaranteed by their respective governments. These carriers are more than just airlines, for they represent an integral link within a network of services that support vital tourist industries. Within the national economies they often represent important means of earning foreign exchange which invariably places them high on the priority list of government policy and financial support. As relatively small aviation enterprises operating international air transport services within economies plagued by capital shortages and limited availability of foreign exchange, these airlines face difficult problems with respect to aircraft financing, as has been pointed out in the previous chapters. As public enterprises, they are subject to policy and economic goals determined by governments to serve the national interest, and these will at times conflict with enterprises goals to maximize profits and the rate of return on capital. The nature of these enterprises often means that there is no access to equity financing. Their size and limited revenue base implies that even more so than large commercial carriers, the financing of their capital needs has to be met by borrowing at currently high interest rates and within an uncertain financial climate where lenders are reluctant to treat with indebted, no growth, airlines with large operating deficits. They have also been adversely affected by the large increases in fuel and other operating costs, fluctuating and

uncertain exchange rates and declining revenues. The circumstances facing these Third World flag carriers are somewhat different from those facing large commercial airlines.

A. INADEQUATE CAPACITY GROWTH

Most Third World flag carriers have found it difficult to expand capacity growth, to finance replacement of fleets with either wide-bodies or narrow-bodies and to re-engine older aircraft. Limited access to financing, in fact, has not permitted adequate capacity growth within the Third World's flag carriers because of high and prohibitive interest charges, high risk ratings for borrowing, and their limited market share of the world's airline industry.

In the current context of the world recession of projections for small growth rates in world air travel, and of the enormous excess capacity in the airlines in the industrial countries, a strong case can be made for some of that excess capacity to be made available to Third World flag carriers on more attractive loan and credit terms. This would hopefully lead to more optimal and rational use of that global carrying capacity. Increased facilitation of aircraft leasing, more shared use of carrying capacity by counter-seasonal leases, blocked time agreements and through-plane arrangements are all going to be necessary to reduce surplus capacity in the industrial economies and increase the carrying capacity of the inadequate fleets of the Third World's flag carriers.

B. DIFFICULT ACCESS TO LOAN FINANCING

Access to loan financing and the cost of loans to Third World flag carriers invariably become problematic because of the state-owned character of most of these enterprises. The tendency is to ignore the viability and credit-worthiness of the enterprise and to determine credit-worthiness mainly with reference to the assessment made of the respective country. Decisions on such loan proposals or requests are treated by lenders virtually as a loan to the

respective country, in which case criteria applied to sovereign risk lending become operative. The long-term nature of such financing induces even greater caution; this means that the Third World aircraft enterprises that might be good financial risks based on enterprise performance will very seldom be by-passed for loans because of factors related to assessments of political risks involved in sovereign lending. The total impact is a distortion of capital flows within the global airline industries. The secondary effect is the present imbalance of large excess carrying capacity within airlines in industrial economies and the under-financing of fleet replacement and capacity growth among most of the Third World's flag carriers.

C. ASSESSMENTS

Given the close links between third world flag carriers and tourism in some countries, assessments of the rate of return on capital investment purely in terms of revenue generation within the airline's enterprise, are often quite misleading.

There is a clear need, therefore, for lenders to take a more comprehensive view and assessment of the national value and contribution of Third World flag carriers. This is especially true given that lending risks are related only in part to the credit-worthiness of the enterprise, since the economic and financial viability of the respective national economy is of major importance. A realistic appraisal of the risks involved in such lending should take into account the importance of the airline and related areas of the economy to the government. Moreover, the adoption of such additional criteria combined with the other usual factors (rate of return, debt-equity ratios, operational performance, cost management, etc.) will serve to improve the availability of capital financing for the more viable of the Third World's flag carriers.

On the other hand, Third World governments have to do more to induce a more favourable climate for capital borrowing for the aircraft industry by

promoting economic policies that inspire the confidence of international lending agencies. Over-valued currencies, failure to contain inflation, inadequate incentives for investment and export expansion, combined with excessive levels of government spending, deficit budgetary gaps and public borrowing at levels far beyond reasonable projections (for growth of foreign exchange earnings), are all areas of policy weaknesses which induce excessive caution on the part of lenders. Moreover, the airlines have to pay more careful attention to cutting costs, improving yields or the rate of return on capital, trimming capacity to market needs, optimizing route schedules, and generally making these enterprises more credit-worthy.

Where state ownership is the dominant pattern, staff lay-off, wage freezes or reductions, cancelling or postponing orders for new aircraft and co-operative sharing of aircraft with non-national airlines all require a minimal level of political will to implement. However, all this pruning and cost cutting has to be achieved without impairing either safety or efficiency levels.

In a nutshell, improved operational performance is a necessary prerequisite for raising the credit-worthiness of Third World airlines.

D. ADEQUATE PROVISION

It is important, in making projections for capital requirements for the global airlines industry, that adequate provision be made to take into account the needs of those smaller national airlines whose survival is of vital importance to Third World economies.

Flexible lease arrangements, accommodation for the acquisition of equity interests in these enterprises by aircraft manufacturers or by financial intermediaries and more favourable interest terms that take the larger economic environment into account will be necessary to permit these aviation enterprises to survive in a highly competitive market where replacement of obsolete and

outmoded aircraft will be necessary to maintain a competitive edge in the market.

The problem is, of course, compounded by the large build-up of international debts by Third World countries, the decline of their foreign exchange earnings due to the effects of the global recession, and the nervousness of international lenders to extend their loan and credit facilities, either to the ailing airline industry, as a whole, or to heavily indebted Third World countries.

However, it is important that lending policies keep an eye to the future and adjust or accommodate themselves accordingly. Third World flag carriers must be in a position to formulate long- and medium-term projections of their capital and borrowing needs and to relate these to likely trends in the travel market, notwithstanding the evidence of declining rates of growth over the past five decades. Such projections linked to past operational performance and the economic and fiscal policies of their respective governments will help the prospective lenders to make more realistic appraisals of which enterprises are risk-worthy for capital loans and which are not, and what interest rates represent a realistic appraisal of the risk involved.[2]

In conclusion, an invaluable opportunity may be lost if careful attention is not given to facilitating access to capital on favourable terms that meet the requirements of both lenders and borrowers in the Third World.

SECTION II: THE ASSET FINANCING PROBLEMS

The capital markets are made up principally of banks, trust companies, insurance companies, pension funds, venture capital, and the general public either through private placements or public offerings. Each participant has its own criteria for investment, reflecting a need for varying degrees of diversification, tax write-offs, security, capital gains, long term earning and

outright adventure. While the excitement of aviation enterprise often helps attract small groups of early-stage investors, this investment alone is inadequate for the large multi-tier financings required by most projects

Consequently, major aviation financings, at one stage, require the senior financial institutions like the banks and insurance companies to participate. However, these institutions are much more "risk-averse" than equity investors, and the attitude of the banks fairly represent the practice of the other institutions with respect to risk taking[3].

Althougn asset financing of aircraft is most common in the United States, in recent years the Third World carriers have made increasing use of leases and secured transactions in financing their aircraft A major portion of such transactions have involved American lenders and lessors, often in cooperation with European and Japanese financial institutions. While it is not possible to generalize with respect to international financing transactions, which must conform to the laws of individual countries, there are few key risks which any financier should consider before financing international aircraft transactions.

A. POLITICAL RISKS

Political, economic, monetary and military instabilities in many developing countries interfere with, and create risks in, trade finance. Such risks affecting aircraft financing can take many forms. They may affect the physical condition of the aircraft or merely its market value; they may hinder repossession or merely affect the health of the aircraft. Some risks may be insured against and others may be mitigated by creative structuring of a transaction Many cannot be mitigated except by constant awareness and being sufficiently prepared to terminate or restructure a transaction at a sufficiently early stage to avoid disaster.[4] The transaction may present political risks - either in the country in which the aircraft is registered or in those where it will be customarily operated. Such risks, which are often a factor in international transactions, may be

magnified by the presence of the collateral in such jurisdictions. In addition to risk of war and hijacking, which can be covered by commercial war risk insurance, they include risks of requisition, nationalization, expropriation or confiscation, and non-convertibility of local currencies into dollars. Finally, the lender must take into account any possible action or inaction on the part of governmental authorities in preventing or delaying the realization of the creditor's rights of repossession and export of the assets from the jurisdiction.[5]

Political types of risks are of major concern in projects in both developed and developing countries. It is virtually impossible to protect against these risks by contractual arrangements or covenants in loan agreements. Therefore, to help lenders overcome their hesitation to advance funds in the face of political uncertainty, governments have developed insurance schemes to protect against political risks and/or currency inconvertibility, which lead to a problem of overcapacity for Third World countries.

B. FOREIGN EXCHANGE RISK

The international system of foreign exchange is based on the exchange of one country's currency for that of another. Such transactions have been a part of commerce since parties initially traded goods having different denominations of value. The values that are assigned to these different national currencies are subject to periodic changes because of fluctuating national and international economic conditions. These changes in currency value can and do have significant impact on the value of foreign investments. Foreign exchange risk, therefore, can be defined as the exposure to loss due to change in the relative value of a currency in which an investment or trading transaction is denominated, it can also be defined as a consequence of the foreign exchange losses incurred from parity changes in the currency in which an investment is denominated.[6]

Moreover, by reason of the local laws of a particular country, currency

control restrictions may prevent payment in full of the purchase price of goods. A prudent seller would normally inquire prior to entering into a contract whether there were any applicable currency control restrictions or restrictions on his ability to obtain judgement in a foreign currency.[7]

The risk that banks may incur losses on their foreign exchange business can be broken down into three separate categories: the risk of dealing and taking a position; the risk of losses caused by delinquent employees acting in excess of their authority; and the risk of default by the counter-party in either spot or forward transaction.[8]

In the aviation industry, the IATA traffic conference system effectively maintains international airlines income on a trade-weighted or "basket of currencies" basis, using Special Drawing Rights (SDRs) which are simply the expression of all major currencies on a trade-weighted basis.[9] Consequently, although an airline may sell tickets in twenty different currencies, its income is relatively immune from the effect of continual currency adjustments.[10]

C. SOVEREIGN IMMUNITY

One should begin by noting that it is particularly difficult to distinguish sovereign risks from country risks. Sovereign risks arise only in transactions with a sovereign, such as lending, whereas country risks involve the whole host of credit risks peculiar to transacting business in a particular nation. In practice, however, there is a great variety of transactions involving sovereign risks and many so-called country risks arise solely from the potential acts of sovereigns.[11]

Country risk has been defined as "the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfill their foreign obligations for reasons beyond the usual risks which arise in relation to all lending."[12] The idea behind this definition is that there may no longer be redress against a foreign borrower that chooses to renege on its

external obligations, and that whereas private sector borrowers are subject to legal process, they may be prevented from obtaining the necessary foreign exchange to service their foreign debt. As sub-categories of country risk, sovereign risk may be viewed as the special risk arising from the sovereign borrower's immunity from legal process,[13] while "transfer risk" refers to the danger that otherwise solvent entities may become bad credits because of local foreign exchange restrictions; in other words, the possibility that ordinary credit risk may be switched into country risk.[14]

Since most of the Third World airlines are government-owned, there is often concern that they may be entitled in an enforcement proceeding to raise the defence of sovereign immunity. As a general rule, the conduct of air commerce by airlines and the purchase and financing of aircraft by them are considered to be commercial transactions. Accordingly, the defence of sovereign immunity is unlikely to prevail in most countries. It is of course customary to obtain waivers of sovereign immunity and an agreement on the part of the carrier to subject itself to the jurisdiction of the courts of a specified jurisdiction; and where a sovereign entity is involved, to lend substance to the waiver provisions, the loan or lease documents should include a warranty to the effect that the actions involved in the transaction represent private and commercial acts rather than governmental or public acts.

D. INSURANCE

The history of aviation insurance is naturally closely associated with the development of civil aviation. Prior to the Great War, a few insurance policies had been issued in London to cover crash and third party liability, but it was only after the Second World War with the formation of commercial aircraft operators that insurers were faced with the problems of underwriting risks associated with large passenger and cargo carrying aircraft. It was natural that the combination of pooling of aviation insurance interests took place to spread

the high risks as widely as possible. The insurance pool has remained a feature of aviation insurance to this day.

The contents of aviation insurance policies vary according to the risks being covered, and, in some respects, according to the underwriter providing the cover.

The Third World carriers frequently require protection against the possibility of having to bear a proportion of a loss due to the application of the deductible under their all-risks policy.[15]

Moreover, hardest hit by the insurance rate increases have been Third World carriers. This has angered IATA which claims that these carriers are simply not in a position to bear the extra cost. Because of this, there has been some suggestion that IATA launch a form of airline self-insurance. Yet the aviation insurance market does not seem overly perturbed. Most underwriters in London do not believe that the carriers, acting as a group, have a sufficient sense of purpose or the financial strength to commit the amount of funds necessary to launch such a scheme. As for their hardline stance towards many African and Asian airlines, insurers insist that it is based on experience rather than prejudice. The safety records are there for all to see: the age and type of aircraft in many LDC fleets do not merit low rates. Moreover, because the value of outdated equipment is generally low, insurers are not lured in by the investment potential of big up-front premiums.[16]

E. MAINTENANCE COSTS

Every aircraft must be maintained and overhauled to keep it in safe condition to do its mission. In the airline industry, safety has always been the prime objective of maintenance activities but cost is an important constraint and, since maintenance is still a very labour-intensive activity, manufacturers and operators are continually trying to simplify and automate the maintenance

process. But there seems to be a finite floor to the cost of maintenance, not least since maintenance is also a legal requirement. Over the long term, it is reasonable to expect maintenance spending to grow in line with airline traffic, given that the planned frequency of inspection and overhaul is tied to the number of flight hours or flight cycles. Worldwide, there seems to be no shortage of capacity to meet demand as most carriers which have maintenance facilities of any note offer these to outside customers, either to fill troughs in their in-house work or as separate profit-oriented ventures. If the independent maintenance organizations are taken into account, then there is probably a substantial excess of capacity over demands.[17] Moreover, the maintenance and support of aircraft represents a high-cost item in the budget plans of any airline and any savings which can be achieved may well be significant. Modern airliner designs have been developed with a view to reducing maintenance demands, but there are many unavoidable actions which must be taken in order to keep the high safety standards essential for all airlines. Understandably, there is a strong desire for the Third World carriers to achieve self-sufficiency in most aspects of airlines maintenance, but some tasks are likely to remain within the province of specialist firms in Europe, the United States or even Asia. Computers, CRTs, and other "high-tech" components are better left to those companies which have the necessary skills to provide maintenance. For example, African airlines as well as Arab and Latin American airlines should pool their resources by setting up repair centers which could deal with such components as avionics. This offers considerable potential for development because failure rates in this field are higher than for mechanical components.[18]

The establishment of in-house maintenance and overhaul capabilities development of such capabilities on a progressive basis, while representing a prudent approach, require major manpower resources involving long training programs that need to be carefully planned. Furthermore, significant capital is required, interest rates, currency fluctuation and pay-back periods are risk

elements to consider when obtaining loan capital.

From the practical point of view, the Third World carriers are having difficulty in providing the necessary capital to set up the repair centers. Furthermore, even if they are able to provide that capital, what about their ability to pay for their shares in it which is problematic in light of their poor economic condition and unstable governments' political policies.

F. DEREGULATION

The romantic notion that deregulation would lead to permanent competition from lots of little start-up airlines was never more than fantasy. It is totally against the experience in other industries where the trend has been to big, bigger and biggest, with size conferring massive competitive advantages.[19]

Whether deregulation is good is a matter of debate; whether it is good for everyone is not. The facts are that deregulation turned the airline industry upside down. Cutthroat competition replaced placid regulation, and bankruptcies and mergers became commonplace. In this tumultuous process, employees lost jobs, were furloughed, and were forced to relocate; concessionary agreements and inequitable two-tiered wage scales became the rule; and seniority and other rights built up over many years were threatened or wiped out completely.[20]

Most nations possessed one flag carrier with a monopoly or quasi-monopoly of scheduled air services. Several countries adopted the system of one flag carrier for scheduled international air services and another for domestic air services. Internationally, flag carriers competed as much as permitted under more or less restrictive bilateral air transport agreements between states, and under the umbrella of the price-fixing traffic conferences of IATA, the trade association of the world's scheduled international airlines. In most nations, private initiative was relegated to the non-scheduled (charter) component of the

industry, which was allowed to blossom in some countries and markets, but not in others.

Deregulation of the airline industry, in its various forms, made many international and some large domestic air transport markets much more competitive than before. Less than ten years after the inception of deregulation, the business failures it caused and, more importantly, the generally increased competitive climate in the airline industry began to lead to large-scale industry concentration in the form of airline mergers, take overs and other co-operative inter-airline arrangements. This development began in the United States and Canada, and has now spread to Europe and will no doubt soon reach other parts of the world. The period of 1975-1990 may tentatively be characterized as the "transitional period", a time of deregulation, increased competition and concomitant airline industry concentration.

Largely freed from traditional forms of government economic regulation, many nations and, indeed, the world may be ruled by a limited number of "mega-carriers", some of which may be multinational companies of conglomerates, and several of which may be privatized, formerly state-owned flag carriers. Smaller airlines, including many traditional flag carriers, may then serve as feeder airlines for the mega-carriers. In regular passenger air transportation, the distinction between scheduled and non-scheduled air transport may have virtually vanished. Instead, there may be some space for smaller, independent and specialized "niche" carriers in markets or market segments not served by the mega-carriers and their feeder airlines. If what was originally a regulatory oligopoly will have turned into a natural oligopoly in the 1990's, the question arises as to whether new forms of government control and intervention are required to keep the airline industry competitive enough, for the benefit of both the airlines themselves and their uses.[21] Thus, it appears that deregulations cannot be applied to domestic air transport. Applied to international air transport, deregulation does not seem likely to be accepted as

a doctrine since it would result in the disappearance of African national carriers. It would mean these countries, as well as other Third World countries, would lose part of their identity.[22]

In conclusion, a few airlines of developing countries have been able to exploit the advantages of these new regulatory conditions. For example, Malaysia Airlines, because it has low labour costs and excellent in-flight services, offers highly competitive services to Europe and Australia.

In general, however, the governments of most developing countries have resisted the implications of liberalized regulation and have continued to protect their national airline by limiting the operations of foreign airlines and pursuing capacity sharing agreements.

It seems more likely that unrestricted foreign operations would perpetuate the past pattern of North-South routes linking Africa with Europe. Despite the apparent validity of these concerns, it is unlikely that the governments of developing countries can achieve long-term success in protecting their national airlines against the changes occurring in the international aviation system.

There are internal contradictions in their policies, for example, they need to promote tourism, but protectionist aviation policies are in conflict with this objective.

Moreover, the competitive positions of their national airlines in the major traffic-generating markets of Europe and North America will be progressively weakened by the growing strengths of the mega-carriers, which are emerging in the liberalized aviation system.[23] Furthermore, the regulatory reforms of the U.S., Europe and other regions of the world have their inherent characteristics which will determine the net outcome of the changing face of the airline industry. The multilateral framework on which the global airline business depends would need to survive as a key prerequisite to a stable system. Furthermore, the industry is high competitive and subject to rapid technological

change. It is difficult, therefore, to correctly forecast the extent and timing of future profitability, particularly in the deregulated environment.

G. DRUG TRAFFICKING

The trafficking and illicit use of drugs has affected peoples' lives throughout the world, and the aviation industry has not escaped the disease. Leaving aside the problem of drug use by air-crews, the problem of drug trafficking is starting to have a worrisome effect on aviation and the financial community which supports it. In recent months, there have been a number of seizures of commercial aircraft by drug enforcement and customs authorities where parcels of drugs have been found on board. These problems have been centred primarily on flights originating from the Caribbean or South American countries with destinations to North American cities, but flights from the far East have also been involved Avianca, Worldways, Air Canada, and Air Jamaica are but a few of the innocents who have suffered seizures of aircraft recently, with the attendant embarrassment, cost, and inconvenience to passengers. While the larger carriers might be capable of suffering a high fine and the financial inconvenience of an aircraft seizure, a smaller carrier might not, and third-party creditors with security interests in aircraft will have to pay attention[24].

Moreover, the growing worldwide spread of drug abuse and illicit trafficking has been for years in the forefront of attention and concern in the entire United Nations (UN) system. It is also important to note that drugs are produced largely in the developing world.[25]

The prevention and suppression of illicit drug traffic is closely connected to the safety and security of civil aviation. General aviation, which accounts for some 80 percent of the total estimated air transport of narcotic drugs, is typically a sector where safety of air navigation is directly at risk. In the field of commercial aviation, the connection between drug smuggling and aviation safety and security is less prominent, but is certainly not negligible. Some 66.5

percent of the narcotics seized in commercial aviation were hidden in the luggage of passengers; 23.1 percent were concealed on the person of the passenger, 9.2 percent were "internally" concealed "body cavities or ingestion" and 1.2 percent were concealed in the air frames and other locations accessible only to the carrier's personnel.[26]

However, under an agreement between the UN and ICAO,[27] ICAO is obliged to co-operate in establishing effective co-ordination of the activities of specialized agencies and those of the UN. In particular, ICAO is obliged to consider the recommendations made by the UN and to furnish relevant information. The Chicago Convention,[28] the basic constitutional instrument of ICAO, is broad enough to permit the adoption by states of effective legal and technical measures for suppressing the illicit transport of narcotic drugs by air.

The existing framework of the Chicago Convention appears to be fully sufficient to enable states to take any necessary action for prevention and suppression in the field of civil aviation. Moreover, the existing technical standards, if applied properly and enforced by states, would go a long way toward eliminating the improper and unlawful flight operations involved in drug trafficking.

Enforcement by states of measures to prevent drug trafficking is assuming gradually more and more rigorous forms, and has most recently been labelled "Zero Tolerance" in the U.S. Individuals found in possession of narcotic drugs for the purpose of trafficking at the time of entry into the country are exposed to severe penalties, while the means of transport may be impounded and forfeited. Many incidents have occurred in several countries where it was alleged that commercial air carriers or their employees or agents were guilty of importing narcotic substances by air from abroad. In several cases, airlines had their aircraft grounded (impounded) pending a decision on the penalty, usually a high pecuniary sanction. Impounding a commercial airliner, even for only a few hours, let alone days or weeks, could have devastating effects on the

scheduling of flights. For example, two South American airlines have been fined more than $3 million U.S. after drugs were discovered by U.S. customs hidden on board their aircraft. An ARCA Airlines jet from Bogota, Colombia, had 160 lb. of cocaine concealed inside a box of flowers which was opened by inspectors at Miami International Airport. ARCA was fined $2.5 million U.S. Later the same day, customs officials found 40 lb. of cocaine in a cardboard box on board an Ecuatorian cargo aircraft from Quito and Gunyaquil, Ecuador; and the carrier was fined $640,000 U.S. Both airlines were warned by U.S. customs that any further discovery of drugs could lead to their aircraft being impounded.[29] However, air carriers should not be victimized by the process of drug interdiction and should not have their aircraft seized, unless there is evidence of their fault or that of their employees or agents, or unless it is proved that they are accessories to the offence of drug trafficking. An air carrier should not be penalized for actions of the passengers and shippers over which he has no control.[30] The 27th Session of the ICAO Assembly of 1989, adopted two resolutions on this issue. As to the second resolution, the Assembly declared as detrimental to the principles established in the Convention on International Civil Aviation any improper detention of an aircraft assigned to commercial air transport, where there is no evidence or presumption of negligence or guilt on the part of the air carriers concerned.[31]

H. GOVERNMENT APPROVALS AND ENFORCEMENT

The transaction may require specific approvals from one or more government agencies. Typical requirements include (in addition to those required for certification and operation of the aircraft): (1) approval by the national aeronautics authority (or other agency with jurisdiction over the carrier) of the acquisition by the carrier of the aircraft and the existence of any ownership or security interests retained or created in favour of a lessor or secured party; (2) approval by the fiscal authorities, Ministry of Finance (or

equivalent) of the financial obligations to be incurred by the carrier in connection with the transaction; and (3) foreign exchange approvals and assurances with respect to payment in foreign currency of the carrier's obligations under the agreements. If approvals are required, experience suggests they will usually take longer to obtain than estimated. Moreover, enforcement of a lease or security agreement after default is a major concern. Many Third World countries jurisdictions do not permit self-help remedies, but rather require that closure, repossession or other enforcement action be taken under judicial auspices. Summary procedures may not always to readily available, even for egregious breaches such as failure to maintain insurance. In some countries, procedural delays may mean months or years to complete repossession and/or sale of an aircraft. If an aircraft is distrained during judicial proceedings, there may be no procedure for keeping the aircraft productively employed to offset its custodial costs.

I. THE CREDIT

The credit can be found at least 3000 years ago in the civilizations of Babylon, Assyria and Egypt. The fundamental nature of credit is that an element of trust exists between buyer and seller, the very word credit derives from the Latin credere, to trust. Without this trust the development of the modern industrial community would have been impossible.

One of the principal objectives of credit is to achieve the highest possible debtor figures for the shortest possible time.[32]

The challenges of the 1990s will place an increasing burden on exporters. Debt - servicing problems will undoubtedly be a dominant factor in years to come as debtor nations strive to curb imports while striving to improve their export performance.

In view of the world's current and future economic and political

environment, it is important to stress the need on the part of credit managers to not only properly assess the creditworthiness of foreign customers, but to assess the country risk conditions as part of their credit decision - making process to assist their companies in promoting exports.

Selling or entering into large sales contracts without knowing or having any idea about the financial strength or creditworthiness of the foreign customer puts the credit manager in the position of making a hasty credit decision.

In domestic credit, credit managers determine the ability and willingness of customers to pay by carefully considering certain basic facts:

1. Character It consists of an account's reputation for honesty and dependability and the willingness of the foreign customer to pay promptly.

2. Capacity or Capability This is the ability to conduct business successfully. Training experience, aggressiveness, and proven judgment are all important factors affecting capacity to operate. A lack of these qualities may result in a poor financial performance.

3. Capital Important information on capital can be obtained directly from financial statements of the foreign customer or indirectly from other sources such as credit reporting agencies. Many foreign customers in different countries have two or three different financial statements.

4. Conditions External influences not traceable to any of the other credit factors which might aid or hinder the success of a foreign customer are referred to as conditions. Such influences may be good or bad, permanent or temporary. A credit decision in such cases must take into consideration whether or not the venture may be expected to overcome the handicap.

In international trade, the credit manager should consider four additional facts:

1. Country Those conditions within a country that could prevent or delay payment. It is the need to evaluate a foreign customer's risk within the context of the country's political, economic, social, and regulatory risks.

2. Currency Currency concerns foreign exchange risk as it pertains to country risk conditions, including both a country's sovereign and transfer risks, in addition to exchange controls.

3. Computers The automated systems used by a foreign customer. They demonstrate a commitment to better record keeping or accounting of income statements, balance sheets, budgets, analysis of the business, controls, and audit trails and evaluation of performance.

4. Collateral To ensure payment, minimize a potential write-off, and to secure (security/collateral) the amount of credit extended, special written legal arrangements are made when a foreign customer appears weak and unacceptable after an evaluation of character, capacity, capital, and conditions. Although collateral normally consists of a pledge of assets to secure the amount of credit extended by an exporter (such as, accounts receivable, inventory, or fixed assets)[33].

In the last three decades, competition for export markets has led directly to the provision of official financial assistance by governments to encourage and support international trade, particularly for sales to developing countries and the communist bloc. Most industrialized countries have specific government departments or agencies with the responsibility of developing, promoting and financing export sales of that nation's products. Through insurance, loan and guarantee programs, the official export credit agencies seek to ensure that, to the extent practicable, sellers of national goods and services who are otherwise internationally competitive remain so when financing of the sale is taken into account.[34] One feature common to all the systems is the assumption, by or on

behalf of the government, of the bulk of the credit risk inherent in extending finance to foreign buyers. Every system has a specialized institution for this purpose, either an official body or one that acts in the state's name. These institutions are members of the Berne Union (International Union of Credit and Investment Insurers), through which they exchange creditworthiness information and seek to harmonize general policy in the field of credit and investment insurance.

The scope and degree of credit cover available to exporters is broadly similar in each country, with the basic purpose of facilitating the mobilization of funds for the extension of credit. Typically, the institution will issue credit insurance to the exporter covering both political and commercial risks of non-payment by the buyer, and will also issue a guarantee to the financial institution providing the required funds. Some countries, however, offer additional insurance facilities in such areas as security requirements (e.g. performance bonds), foreign exchange risk and cost escalation.

In a few OECD countries, official support for the bulk of export credits is restricted to the provision of insurance and guarantees as just described. Intense international competition for the sale of capital goods on credit has resulted, however, in the prevalence of export credit offers at interest rates that are at or near the minimum "Consensus" rates, and that are fixed for the duration of the credit, which may be as much as ten years or, in certain cases, more. Such terms cannot be provided by the banking systems in most countries, without official financial support, (i.e. some form of subsidy). Most OECD governments, to keep their exporters competitive, have therefore developed mechanisms to ensure that funds will be available for export credit at competitive terms. In the majority of these countries, official financial support is provided to the banking sector, either direct to individual banks or through a specialized intermediary. In the remaining countries, the bulk of longer term export credits are provided direct by government agencies.[35]

1. The Governmental Support

(a) CANADA

The Export Development Corporation (EDC), which is a Canadian crown corporation, wholly-owned by the Federal government, was established by the Export Development Act in 1969 (The "Act") as a successor to the Export Credits Insurance Corporation. The new institution was given a larger autonomy than its predecessor by adding a long term financing facility to the previous mandate of providing protection against non-payment for Canadian exports by foreign buyers.[36] All loans prior to October 1, 1969 were made for the "Canada Account" and funded out of the consolidated revenue fund. Under the new act loan funding became the responsibility of the board of directors of EDC and the government account remained only for contracts in the "national interest".

There is no minimum value of export business required to qualify for support. Canadian firms of any size may insure their export sales against non-payment by foreign buyers.[37] EDC normally assumes ninety percent of the commercial and political risks involving insolvency or default by the buyer, as well as blocked funds, war, cancellation of import licenses and other such events in a foreign country, and the cancellation of import licenses in Canada. Insurance is available to cover sales of general commodities and services normally made on short credit terms of up to one hundred eighty days and capital goods and services made on medium term credit of up to five years.

The power of EDC to lend is limited by a monetary ceiling, measured in Canadian dollars. This limit is the aggregate of all transactions outstanding at any time under section 29 of the Act, and includes foreign principal repayment obligations under loans made and potential liability of foreign customers under written agreements entered into by EDC but as yet unexecuted. The limit under the Export Development Act of 1969 was $600 million, including outstanding

loans under the Export Credits Insurance Act.[38] The current ceiling is stated to be an amount which is ten times the authorized capital of the corporation which in 1987 is $1.5 billion and the ceiling is therefore $15 billion.

(a-1) The Canadian International Development Agency (CIDA)

The Canadian International Development Agency is the primary vehicle through which Canada's international aid money in channelled to recipient countries. In addition to straight aid funding made available to promote Third World economic development, the Agency provides funding to assist Canadian firms in performing feasibility studies for projects in developing countries and in providing technical assistance. It also participates in parallel financing arrangements with the Export Development Corporation, under which it provides funds on an aid basis and the Corporation provides funds on export credit terms, with the total package being used to support the international sale of Canadian goods and services[39].

(b) FRANCE

In France, facilities for export credit extension involve close co-operation between the commercial banks and three official bodies: the Banque de France, the Banque Française du Commerce Extérieur (BFCE - the French foreign trade bank) and the Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE - the French foreign trade insurance company). The formulation of Government policy on export credits and the co-ordination of official support in this area are the province of the Direction des Relations Economiques Extérieures (DREE - External Economic Relations Directorate) of the Ministry of Economic Affairs and Finance. Official support is based on refinancing commercial banks at preferential terms, rather than on direct low cost lending to buyers or exporters.

The funds required for export financing are provided by the banks in the

form of either supplier credits or buyer credits. For credits with a maturity of less than two years, except for the COFACE guarantee, no officially supported refinancing facility in the form of an interest rate subsidy is available. Banks draw on their usual sources for the necessary funds. Credits with a maturity of two years or more may be refinanced at preferential rates by the Banque de France or the BFCE. The terms are in conformity with the rules set out in the OECD Consensus[40].

In order to qualify for preferential refinancing the export credits must have obtained an official guarantee or insurance from COFACE, which operates on behalf of the Government under the direction of the DREE. COFACE also extends guarantees and insurance for export credits with a maturity of less than two years.

The practice of mixing export credits[41] with development assistance has been continued. The majority of officially supported export credits are not, however, mixed credits.

French exports are often payable in foreign currency. As a result, COFACE provides a program of insurance against exchange risks designed to complement the forward exchange market. It also operates a cost escalation insurance scheme as well as various bond insurance programs.

(c) GERMANY

Finance, including long-term credit, for German exports is provided mainly by the banking system at market rates. To a lesser extent funds are made available for export financing through two Government supported preferential resources. AKA - Ausführkredit-Gmbh, a private company, has access for a part of its export financing to a rediscounting facility of the Deutsche Bundesbank. The Government-owned KFW (Kreditanstalt für wiederaufbau) with two Government supported promotion funds extends credits

for exports to developing countries.

Official export credit insurance and guarantees have been provided since 1926 by two companies (Hermes and Treuarbeit), which make contracts for this type of insurance in the name of and on behalf of the Government.

Apart from these Government facilities, export credit insurance is also provided by insurance companies for their own account, but is limited to commercial risks, and involves mainly trade with other developed countries.

Mixed credit financing has been provided occasionally but the grant element has always been at least 25 percent and thus the funding is considered as part of the German financial assistance to developing countries.

(d) JAPAN

The bulk of funds utilized in financing Japanese exports is provided by commercial banks. The Export-Import Bank of Japan (EXIM) extends export credits of preferential rates in participation with commercial banks in particular in connection with large sales of capital goods or complete plants. The EXIM part of the credit amount financed is typically 70 percent for supplier credits and 60 percent for direct loans.

The Export Insurance Division (EID) of the Ministry of International Trade and Industry (MITI) insures repayment of export credits. Thus commercial banks which normally would be unwilling to assume the risk of foreign long-term financing can in light of the Government-backed insurance fund overseas projects. The close co-operation between EXIM, commercial banks and the business community ensures the availability of funds for export financing.

Japanese exporters and banks are free to express their contracts and credits in a foreign currency and slightly less than one third of total export credit extension is in fact in a foreign currency. Exchange risks may be covered on domestic or international forward markets or by an exchange risk insurance

issued by the EID. Unfair calling of bonds may also be covered with the EID.

(e) UNITED KINGDOM

Since 1961, the United Kingdom clearing banks (the prime source of funds), together with other banks, have financed exports sold on credit of two years or more at fixed interest rates under arrangements concluded with the Government and operated by the Export Credits Guarantee Department (ECGD).[42] On their fixed rate lending, banks are guaranteed a commercial rate of return.

(f) UNITED STATES

The Export-Import Bank ("Eximbank") of the United States, chartered in 1934 as an independent Government agency, administers the official export credit and insurance programs of the United States. Eximbank co-ordinates its various programs with the Foreign Credit Insurance Association (FCIA), a group of more than fifty of the nation's leading private marine, property and casualty insurance companies and the Private Export Funding Corporation (PEFCO), a private corporation owned by fifty-four commercial banks, seven industrial firms and one investment banking firm. The coverage offered by the FCIA/Eximbank program on both short and medium term transactions is designed to protect the exporter against certain political and commercial risks. PEFCO is a major source of capital for medium and long term fixed rate financing. Eximbank also frequently co-operates with private commercial banks in financing export transactions.

2. Subsidies and Export Credit Competition

Competition between states in connection with export credit terms has led to multilateral attempts to limit the level of such official assistance. The most important accords are the General Agreement on Tariffs and Trade

(GATT) and the informal arrangements developed under the auspices of the Organization for Economic Cooperation and Development.

Both the GATT and the OECD are hostile to subsidies, and have attempted to differentiate between a state absorbing the risk of export financing and actually subsidizing the exports themselves.

Both organizations see subsidies as undesirable interferences with the free flow of goods and except with respect to sales in developing countries, believe that they should be eliminated. By the early 1970's it became apparent that export credit support by governments or their agencies were in effect a form of subsidy, and in order to stabilize the export credit field, the OECD members reached a consensus with respect to guidelines for export credits resulting in the signing of an arrangement (the "Consensus") between the members in 1978 with respect thereto[43].

However, the ongoing heated debate with respect to what is called "mixed credits" which essentially is the blending of aid with export finance. On the one hand are those who say that mixing aid funds with commercial credits are an underhanded way of lowering interest rates in violation of the Consensus, while on the other, there are those who contend that mixed credits are an efficient way of making aid go further. The United States believes that trade motivated mixed credits are wasteful, but countries have continued to use them in the scramble for the few big projects which are still being contemplated by the developing world.

In November of 1983 the OECD was able to reach an agreement among its members to establish a system of minimum fixed interest rates which are automatically adjusted semi-annually in accordance with an index of market rates[44]. The Arrangement on Export Credits covers most industrial products other than agriculture or military products, and there are separate sector agreements for nuclear power, ships and aircraft. The Sector Understanding

on Export Credits for New Civil Aircraft come into force on March 10, 1986 and involves essentially two separate agreements, one involving wide-bodied aircraft and the other involving all other aircraft and helicopters.[45]

The Understanding regulates the provision of officially supported export credits for the sale or lease of new civil aircraft (including helicopters) and for component parts (engines, sub-assemblies and spares) which are ordered at the same time as the aircraft or ordered for their manufacture or assembly.

The large Aircraft Sector Understanding was negotiated between the countries of the European Community and the United States in 1985 and is now incorporated into the main OECD Sector Understanding. By 1987, volatility in interest rates brought changes to the LASU interest rates and the rates as of May. 1987 for ten and twelve year borrowings were set as follows:

Currency	Up to Ten Years	Ten -Twelve Years
DM	7.20	7.75
FFR	9.95	10.50
£	10.00	10.55
ECU	9.05	9.60
US$	9.10	10.30

Medium and small aircraft and helicopters are divided into three categories, based on size, seating capacity and engines. All non-turbine powered aircraft are in category C.

Cash downpayments and credit terms are roughly similar to those of the consensus.

A minimum cash payment of fifteen percent of the total price is required, pre-credit risk cover may be given for this portion, but officially supported

financing is not allowed. The maximum repayment terms are:

ten years for Category A,
seven years for Category B, and
five years for Category C.

However, unlike the Consensus, the Sector Understanding does not differentiate among buyer countries according to their per capital GNP.

Offers of repayment terms over longer periods must be notified in advance to all participants in the Understanding when the offer is made. This system of prior notification seems to work well.

The terms available under the LASU are somewhat more flexible than those of Consensus. After the 15 percent downpayment, the buyer can choose either 42.5 percent or 62.5 percent of the total in fixed rate officially supported credits, with the balance being financed commercially. If the buyer takes the 62.5 percent option, repayment of both commercial and supported loans must be made over the same credit period. If the 42.5 percent option is preferred, the commercial loan must be repaid first.

A constant complaint from the manufacturers has been the shortness of the credit period which bears no relationship to the likely life of the asset. Their pressure has been successful in raising the present maximum to twelve years but this advance was matched by increasing the applicable interest rate.

For ten year loans, the rates of interest are based on the yields of ten year government bonds of the appropriate currency, plus a surcharge of 1.2 percent. For twelve year loans the surcharge rises to 1.75 percent.

As world interest rates fell, commercial financing packages became more attractive. But the Europeans have been reluctant to follow suggestions of a reform because of two major problems: the difficulties of finding deep dollar funds and then of covering the exchange risk over such a period.

The 1.75 percent surcharge was required by the European agencies in return for the lengthening of the credit period. However, it was agreed at the time that adjustments might be necessary in the light of future experience, and discussions resumed in April 1987, but without any further amendments.

The system of locking in fixed interest rates is complicated by the frequency with which the LASU rates are fixed. These change every two weeks when the benchmark yields more than 0.1 percent; in contrast, Consensus interest rates are changed only at six monthly intervals.

The period of locking in runs for ninety days. The first agency to make the offer is committed to the rate but, if another agency offers a new rate, the first is allowed to match and both offers are locked. The agencies have agreed that the understanding will be reviewed annually.[46]

In summary, the entire international trading community is based on elements of trust, goodwill, and prudent judgement. Without these, international trade would deteriorate to the point of no return. It is important for credit managers to remember these elements because of the distance between buyer and sellers and the lack of sufficient amounts of credit and financial information on foreign customers. Credit inquiries should be conducted to determine if a foreign customer is acting in good faith and is not overestimating its future ability to pay.

However, a bank begins an international trade transaction with a credit investigation and evaluation of the prospective customer and his beneficiary, and any special administrative regulations demanding full pre-payment of the amount involved. The flexibility of arrangements predicated not only upon the customer's credit standing but also upon the solvency of the beneficiary, the liquidity of assets position of the bank and of the country of issuance ranges from clean (unsecured) credits to fully secured undertakings. From the banker or merchant's point of view to finance a business transaction would be no

substitute for the borrower's ability and willingness to repay the loan or purchase price.[47] Moreover, credibility is the most significant instrument in the financing and payment of international sales, which is however not the situation of most Third World carriers.

J. THE NOISE REGULATIONS

The International Organization for Standardization (ISO) work with regard to noise began to cover a wide range of test methods and specifications relating to noise from aircraft. Noise is now considered a basic factor in pollution of the environment and as having a detrimental effect on individual health and comfort and, further, a burden on the economy of the countries of the world.[48] As well, it is a major problem for airlines due to the need for airport curfews and other operating restrictions which result from aircraft noise. Operating curfews were established at many airports when turbo-jets arrived. Aircraft noise has been reduced substantially in the past few years due to new technology. International noise control standards are usually divided into those for non-noise certificated aircraft and those for aircraft complying with the two noise standards specified in Chapter 1 and 2, Volume I of Annex 16 to the Chicago Convention. The United States has adopted the same criteria, but expresses them as stages 1, 2 and 3.[49]

The very success of aviation technology in producing these quieter aircraft has ironically increased the demand that all older aircraft, which cannot meet the best standards achieved by the latest aircraft be withdrawn from operation prematurely. Forced retirement of those older aircraft which are still economically viable would be a particularly harsh penalty, when both the vast productivity of just one of them is considered and the enormous purchase price of between 20 and 120 million dollars each for new production models is taken into account. Another aspect of restrictions on older aircraft is their discriminatory effect on developing nations, whose airlines cannot always afford

the latest aircraft. The impact can be particularly severe if these rules prevent service to developed countries such as Europe, since this prohibition could cut off a major source of foreign revenue to help the trade balance. Furthermore, this noise can be further diminished only by sacrificing significantly the economic and social benefits which aviation has brought to the world at large. Noise reduction, like any other aspect of human affairs, is a matter of balance. With regard to future world-wide noise regulations and their cost benefit, IATA strongly supports the role of ICAO in providing an international basis for regulations and decision-making regarding appropriate environmental limitations.[50]

The International Civil Aviation Organization's 27th Assembly in September, 1989, did not reach agreement on noise restrictions before adjourning, which makes it more likely that some nations will unilaterally limit the use of all but the quietest transport aircraft. A working group of delegates from Western Europe and developing Nations in Africa and Latin America, tried to craft a compromise during the last week for the 27th Assembly, but they were unable to reach agreement.[51] Furthermore, the discussion during the Assembly was centered on the possible starting date, the length of a possible exemption period for airlines facing economic or technical difficulties and the age of aircraft at which the operating ban would apply.

Following the failure of the 27th Triennial Assembly of ICAO to reach consensus regarding aircraft noise restrictions, the topic has been scheduled for an extraordinary session of the Assembly in October 1990. Although ICAO requested governments not to take unilateral action in the interim, some states formally indicated that action to introduce operating restrictions could not be precluded.[52]

Finally, at the 28th session (extraordinary) of the ICAO Assembly which was held in Montreal in October 1990. The Assembly adopted a resolution which provides an internationally agreed framework for the phase-out of Chapter

2 aircraft. States are urged to apply restrictions only after April 1, 1995 to Chapter 2 aircraft of not less than 25 years of age. Affected Chapter 2 aircraft would all be phased out by April 1, 2002, although certain exceptions are provided for in the case of developing countries airlines with replacement aircraft on order. Exemptions are provided for Chapter 2 wide-body aircraft or aircraft fitted with high by-pass ratio engines, which would be restricted after year 2003[53].

As Aruna Mascarenhas has stressed, over ninety percent of the problem of aircraft noise at airports in the U.S. and Europe is caused by aircraft operated by their own airlines and is therefore directly within their control. As Third World airlines' share of operations at these airports is five percent or less, there is no justification to bring this small share of Third World airline operations within the purview of noise restrictions as the economic cost involved could be crippling to Third World airlines - and is totally out of proportion to the marginal improvement in noise levels that this will provide.

The last ten years have witnessed an erosion in Third World airlines' share of world air transport activity. The coming decade will bring challenges in the form of competition from supra-national mega-carriers and the formation of a Single European Market. An exemption from noise legislation could prove to be the deciding factor in the continued survival and growth of several Third World airlines.[54]

In general, the consequences of noise regulations for developing nations airlines are to weaken further their competitive positions and to increase their financial problems.

SECTION III: SUMMARY AND POSSIBLE SOLUTIONS

The extent of external funds necessarily depends on a number of factors, namely: the relative earning power of the carriers, low debt, high profitability, and investment policies that are closely tailored to their financial ability. Weak carriers with relatively high debt burdens could experience a shortage of investment capital needed to maintain their relative market positions.

The suggestion that the first step for a developing country is to create a domestic and transborder network, is belied by the facts. The national carrier ("national" in terms of its geographical basis and not its status) should play an international role, and from this viewpoint, only the best equipment - if not the costliest - should be bought. The fact that second-hand aircraft are ostracized is not necessarily a reflection of their intrinsically worthless character. In fact, they may prove to be the optimum solution for airline companies, provided the management has no preconceived ideas about aesthetic details.

New techniques for minimizing project risks must be considered. The country risks concerning unpaid sums are presently covered by export credit insurance. It would be possible to envisage regional coverage of risks through a body which would guarantee credits, to which governments in a region would subscribe. Another possibility would be for a world agency such as the IMF or the World Bank to refinance credit operations affected by problems. Similar solutions have long existed in the insurance field; in that case it is simply a question of covering physical risks which can be assessed on the basis of probabilities, but here it is quite a different matter. To reduce the insolvency risk, it is necessary to make sure that the project is adapted to present needs, that it is not over-ambitious and that it does not involve unnecessary costs.

Third World flag carriers should seek creditworthiness in order to be able to finance there fleet expansion replacement and upgrading.

To maximize these opportunities, however, a number of factors have to be taken into account.[55] These include the following:

1) de-regulation policies permitting airlines more access to the foreign exchange they earn by appropriate changes in government policies;
2) legislative changes to conform to the Geneva Convention on Property Rights in Aircraft and the provision of such devices as security registers and aircraft mortgage registers, as well as bilateral and multilateral conventions concerning the subject matter;
3) Borrowing countries must understand that the most essential aspect of borrowing is a track record in repaying; if an airline uses expensive commercial aircraft for the transportation of its army or its president, then a bank will not see potential cash flow.

It is time that borrowers start looking at themselves since the policies aimed at genuine economic development are an essential precondition for any fundamental solution to the external debt problem.

There are several methods of limiting the extent of the cash flow risk:

1) by obtaining a confirmation from the Central Bank of the airline's country to the effect that foreign exchange will be available to honour the lease or loan payments;
2) by attempting to secure direct access to IATA funds as opposed to merely taking an assignment (reliance on an assignment will only provide for funds once the other IATA members have been paid);
3) by securing a blocked deposit at closing which will provide for continuing debt servicing for a period should the airline go into default;
4) by keeping the repayment periods short; and
5) by devoting time to monitoring the trade debts and cash flow for the airline with a view to detecting a potential problem before it actually occurs.[56]

Parties to an international commercial arrangement such as a license agreement-sales contract, or distributorship contract often include a clause providing for the settlement of disagreements by arbitration. In fact, an arbitration clause can be very finely attuned to the preferences of the parties, especially if one of the parties possesses sufficient bargaining power to coerce the other into accepting a solution which is perhaps both distasteful and inconvenient to it. It is usually possible to incorporate, by reference, elaborate procedures for arbitration that have been developed by such organizations as the International Chamber of Commerce. Although the path towards international arbitration has been marked by serious obstacles, as of the 1980's, arbitration has become an established institution, as a result of treaty developments.[57]

Besides the considerations outlined in this summary, there are other solutions to facilitating loans to Third World airlines without proportionally increasing the financier's risk.[58] First, the World Bank's proposed Multilateral Investment Guaranty Authority (MIGA) scheme would make it easier for operating lessors to lease aircraft to Third World countries by giving better insurance against political risks than is now available from commercial insurance. Second, Boeing's idea for the International Equipment Trust (IET) envisages a legal entity which leases aircraft to customers and collects payments - these being passed on to the aircraft producer and financiers. The IET would coordinate the interests of producers (a single aircraft type can have several major contractors), export credit agencies and financiers. Boeing has already used the IET method to finance sales to Varig of Brazil and Royal Air Nepal.

Given that the same phrase may have different meanings in the laws of the different countries, a specific system of laws, legal principles and precedents is chosen as a point of reference, in order to avoid doubt as to which meaning was intended. These rules for determining the governing law vary in the

different countries. Rules ensuring the ability to sue in a jurisdiction where the judgment could be enforced against the property of the borrower are one alternative. However, if the borrower has no assets or transfers his assets out of that jurisdiction, one may want other options, such as the adoption of bilateral and multilateral agreements.[59]

As to the problem of drug trafficking, joint actions, especially multilateral, within geographic regions and spheres of interest, can enhance and make more effective the best of the national and bilateral efforts. A variety of programs have been launched in the Caribbean and in Central America, including efforts to improve radar surveillance and interdiction capabilities in the Bahamas and Jamaica. A similar pattern has been seen in South West Asia. A key element in worldwide advances in narcotics control has been the expanding role of the UN fund for drug abuse control. The U.S. believes that strong regional, cooperative efforts are the key to lasting progress against narcotics trafficking.[60]

In conclusion, the world wide environment of cross border leasing is in a state of reorientation and is moving toward asset-based financing transactions for reasons other than taxation.

In the first place, many state-owned airlines have been, or are in the process of being privatized. This will undoubtedly result in less sovereign guaranteed loans and more activity in the use of cross-border leases as a means of security to replace the sovereign guarantee. Thus, the risk in aircraft financing is gradually shifting from airline balance sheet risk to aircraft or asset risk.

Furthermore, in view of the financial difficulties the Third World carriers are facing, and from the practical point of view, the political benefits of showing the flag and of advertisements abroad are the major considerations for Third World carriers. This must be weighed against possible operating subsidies and foreign exchange costs, both of which can be substantial.

FOOTNOTES

Chapter 5

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2. Horace Barber, "A Third World Angle on Aircraft Financing", African Air Transport, November, 1983, at 12.

3. Bunker, supra, Ch. 1, note 14, at II-1.

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37. EDC services are available to foreign corporations or individuals so long as they carry on business in Canada. Section II of the Act as amended by S.C. 1980-81-82-83, C. 163.

38. Export Development Act, s.c. 1968-69, C. 39, s.30.

39. Bunker, supra, Ch. 1, note 14, at II-36.

40. Supra at p. 124 and subs.

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CHAPTER VI

SECURITY INTERESTS IN AIRCRAFT UNDER SELECTED ARAB AND MUSLIM COUNTRIES' NATIONAL LAWS

Security is one of the basic considerations when a financial institution is contemplating the advance of funds. Financial markets, in most Islamic countries are either non-existent or has developed to only a limited extent. Government securities are traded to only a small degree, and those instruments which are marketed often carry interest (riba). Equity markets are also under-developed, though from the point of view of Islamic financial institutions, such investments are of potentially greater interest than conventional government securities. Stock market development in many Islamic countries has, however, been impeded by nationalization measures, although this type of state economic involvement is now less emphasized, and in some Muslim states privatizations are being implemented, as in Turkey or Bangladesh, or are being considered as in Egypt. In this chapter, I will discuss the Western banking techniques utilised in the Arab World in Section I; I will examine the Islamic banking problems and its future prospects in Section II; the Islamic modes of financing is discussed in Section III; Section IV deals with the problems of choice of law clauses in Islamic law; Section V sets out the aviation finance transaction in accordance with Islamic principles; and finally, certain Arab and Muslim countries' national laws which can effect aircraft security will be discussed in Section VI.

SECTION I: WESTERN BANKING TECHNIQUES UTILISED IN THE ARAB WORLD

The vast majority of financing transactions in the Arab world have always been and are still financed by conventional Western banking techniques. These

techniques are used as much by banks established outside the Arab world as those established within the Arab world. Some of the more recent innovations (by way of example some of the more innovative financial engineering practised by Western bankers) have yet to be widely practised in Arab world, although several dual currency loans have been seen in the last few years.

However, it is probably still true to say that when a banker in the Arab world talks about "treasury operations" he is probably referring to foreign exchange operations and not to swaps, options, forward rate agreements, caps, collars and floors, etc.

The principal constraining factors faced by bankers operating in the Arab world are, and continue to be, the recoverability of interest, although this presents a problem more in certain countries, e.g. Saudi Arabia, than in others, and the taking and enforcement of security.

The recoverability of interest has always been more of a problem in some of the Middle Eastern Countries where the Sharia is a primary source of law rather than the Mahgreb countries in North Africa.

Currently, we can get a judgment for contractually agreed interest in most countries in the Middle East, with the exception of Saudi Arabia. Some countries such as Bahrain impose, formally or informally, an upper limit - in Bahrain it is currently 15%; and some countries such as the United Arab Emirates impose a fixed rate of interest from the date of commencement of proceedings in place of the contractually agreed rate - in the United Arab Emirates such fixed rate is currently 9%.

In Saudi Arabia interest obligations remain unenforceable. Awards made by the relatively new Saudi Arabian Monetary Agency (SAMA) Committee to which all disputes involving bankers, including foreign bankers, and their customers which do not involve commercial paper, must be referred have tended to be for global settlement sums well below the amounts claimed by the

plaintiff banks and thus interest has not really been a factor. In Saudi Arabia, however, bankers have tended to request their borrowers to issue promissory notes both for principal and interest on the basis that enforcement proceedings can be taken before the Commercial Paper Committee. It is conceivable that you might get a judgment for payment of interest before this Committee if the fact that a promissory note represents an obligation to pay interest is not brought to its attention.

Some of the traditional Western banking techniques utilized in the Arab world may perhaps be conveniently grouped under the following headings:

I) Trade Finance

Involving the issue and confirmation of letters of credit, the issue of guarantees, warehouse receipts, trust receipts, etc. This is perhaps the traditional avenue by which many banks have been introduced to the Arab world and is still obviously will utilized today.

II) Working Capital

Involving the granting of overdrafts, short term loans, etc. local banks and branches of overseas banks with full local licences clearly remain providers of this sort of finance although, given the experience of the eighties, are perhaps more selective in their choice of customers. Unlike documentary letters of credit, where some security may be obtained through Bills of Lading, security for short term advances is more problematic and often takes the form simply of a personal guarantee from the owner of the business. In the heady days of the early 1980's legal due diligence was sometimes skimped, both in relation to the terms of the loan documentation and also the taking of any security, but in the more difficult economic climate today, more attention is paid to these details.

III) Medium/Long Term Finance

Even in the boom days there were few corporate credits in the Arab world to which Western bankers were prepared to extend medium/long term finance. Most of the deals that were done were to sovereign or quasi-sovereign borrowers. Obvious difficulties were and still are encountered in relation to available security for such loans, and, even where security is given, in relation to its enforcement, given that any assets pledged to secure the loans were/are directly or indirectly owned by the State and thus probably not subject to attachment.

Having briefly looked at some of the more traditional but nevertheless still current techniques utilised by Western bankers in the Arab world - techniques which are based on the provision of finance in one form or another on traditional terms i.e. including an interest or other like commission charge (even in Saudi Arabia, although in the latter case such interest obligation may not be enforceable) - I will now examine some of the more recent developments in the region:

I) Dual Currency Loans

There has been a steady, if limited, stream of dual currency loans over the last few years whereby the loan is denominated in one currency at the outset but may be redenominated at the option of the banks (in practice at the option of the lead bank which sold the currency option at the outset) during a limited period of time. The amount received by the lead bank on sale of the original option is rebated to the borrower in one form or another, e.g. by way of reduced margin, but the corollary of this is that if the exchange rate moves in favour of the counter-party to the option (and thus by definition away from the borrower) the counter-party will exercise his option and the borrower will then have to repay capital and pay interest in the new currency but measured by reference to the exchange rate at the date the option was sold.

It represents a reasonably bold play on the exchange rate between two currencies in as much as each of the counter-party and the borrower are taking different views of the likely future exchange rate.

Practically there is no legal problem in the use of dual currency loans in the Arab region, although it must be arguable that, as a matter of Sharia Law, the redenomination might be unenforceable by virtue of it deriving from a form of gambling.

The use of this technique therefore in countries where the Sharia is a primary source of law will probably not materialize.

II) Local Investment Funds

There are still many high net worth individuals, whether indigenous to the area or working there on expatriate contracts, which have led to a fairly rapid growth in the establishment and sale of investment funds targeted to such individuals. There is nothing particularly innovative about such funds which are structured as closed end investment funds and sometimes carry a "guarantee" of repayment of the initial capital invested. Such a guarantee can be afforded by the purchase with part of the original subscription monies of a zero coupon bond yielding at maturity an amount equal to the original investment. The balance of the subscription monies is then used to invest in whatever the stated objectives of the fund are with a view to realising a profit which itself will be distributed to the investors at maturity. Alternatively, of course, the guarantee of capital repayment may be provided by a bank.

III) Offset Programmes

Projects under these programmes are likely to be a major source of new investment in the region, or at least in Saudi Arabia, in the years to come and thus the offset programmes can be expected to feature prominently.

The typical financing of a project under one of the programmes will involve up to 50% of the project costs being provided by the Saudi Industrial Development Fund on an interest free basis with the balance being made up as to half be equity investment by the parties and as to the remaining half by way of other debt finance.

There is nothing particularly innovative about the financing of projects proposed under the offset programmes - notably the Peace Shield programme associated with the AWACS' sale to the Kingdom of Saudi Arabia, the Al-Yamamah offset programme associated with the sale of Tornado and other aircraft and equipment to Saudi Arabia and a rumoured offset programme to be associated with the supply by France of certain naval vessels and missiles to Saudi Arabia.

Any project proposed under one of the offset programmes must meet the normal criteria established by the Foreign Capital Investment Regulations in Saudi Arabia and must involve the transfer of technology and not involve the extraction of oil or minerals (1).

Finally, I will set out briefly two financing techniques which are providing a positive input in the third world debt crisis, and just beginning to emerge in the Arab world:

I) Debt-equity Swaps

Swaps are seen as valid transactions as they encourage developing countries to open up certain sectors of their economics to foreign direct investment and to reduce debt. A number of countries in South America have successfully implemented swap schemes and now other countries are looking at these possibilities, often in the context of privatization programmes. A number of countries in the Arab world have debt problems and debt-equity swaps may become a topic for greater consideration in the region.

As an example the enactment of the new foreign investment law in Egypt, Law No. 230 of 1989, debt-equity swaps became legally possible.

In most of the Latin American countries, regulations have been introduced dealing with eligible debt, eligible investors and eligible investment. Unfortunately no further details were involved when the execution regulations of the new investment law were issued and therefore proposed swaps will be subjected to ad hoc approval processes of the appropriate authorities on a case by case basis.

II) Employee Share Ownership Plans (ESOPS)

This has to be considered in the context of privatization - a buzz world in the UK and elsewhere in Europe - but a concept becoming of increasing interest in developing countries. Debt-equity swaps have a role to play here but there can exist an obstacle in local opposition to foreign control of domestic industries or assets. One way of dealing with this is the introduction of ESOPS.

Although privatisation thinking is still in its formative stage, no doubt debt-equity swaps and ESOPS will remain on the legal and financial agenda for most of Arab countries and they will play a role.

SECTION II: THE ISLAMIC BANKING PROBLEMS AND ITS FUTURE PROSPECTS

A. INTRODUCTION

The resurgence of fundamental Islamic values in many parts of the world has manifested itself on the economic front as well, with a number of Muslim countries moving toward the transformation of their economic systems - especially their banking systems - to conform more closely with basic precepts of Islam.

Islam does not condemn the principle of putting capital to work to create

new private wealth, but in order to qualify as lawful (i.e. "halal" in Sharia terms), there must be a partnership between capital and labour, the latter including managerial skill and trading enterprise. From the earliest days of Islam, devout Muslim jurists have sought ways of employing capital profitably without breaking the Islamic principles prohibiting interest (riba).

In broad terms, the transformation of banking from an interest-based system to one that relies on profit-and loss-sharing makes an Islamic banking system essentially an equity-based system. In such a system, depositors are treated as if they were the shareholders of the bank, and consequently are not guaranteed a nominal value or a predetermined rate of return on their deposits.

However, the supporters of the Islamic banking movement are confident of the future and go so far as to see it as being an effective alternative to the Western system in the fight against inflation and stagnation. Western economists on the other hand are not lacking in scepticism. They doubt whether there can be any real modus vivendi between Islamic and Western banks; they foresee that the Islamic banks will have severe and continuous liquidity problems, and variable rate of return on equity capital.

In the following I will discuss the general problems facing the Islamic banks.

B. THE GENERAL PROBLEMS

Islamic banks suffer from a number of problems - operational, legal, and infra-structural, such as:

1. Loss of Opportunity

In the event of failure on the part of the client to repay its fixed obligations to an Islamic bank on due date, damage are permitted under Islam for payment to the Islamic bank. However, these are subject to the following conditions:

i) Several warning letters are sent over a certain period of time requesting overdue amounts.

ii) The first request for payment will not be sufficient for exacting damages.

iii) It is to be ensured that the client has the financial capacity to meet his commitment. Temporary cash flow problems will not be termed as the client's genuine inability to repay but be rather treated as financial mismanagement on its part.

iv) Such damages will be equal to the rate of profit which the Investors under the relevant Modaraba or portfolio would have otherwise received had the repayments been made on time.

These conditions being protracted contribute to inefficiency in collection of dues from customers. Particularly in retail trade, this process will considerably increase the costs of Islamic banking. When larger amounts are involved, a remission in the first period of default will mean substantially in monetary terms. Since margins of profit in international trade are highly competitive and thin, Islamic banks cannot afford any opportunity loss. Accordingly, this subject needs considerable further study, discussion and review by the Islamic jurists.

2. Sharia Law's Admissibility in International Courts

The matter of admissibility of legal contracts bound by Sharia laws in international courts has many implications. Even when contracts between two parties may be acceptable in certain courts, in the event of dispute, should any of the Sharia provisions violate the relevant provisions of the local law the provisions of the latter will prevail. If such determination of the local law violate Sharia law itself, the determination will not be acceptable to Islamic banking. That leaves the Islamic bank in a great quandary as it may not be able to obtain full recourse against the client under the contract prepared in accordance with the requirements of Sharia.

3. Manpower Shortage

Unwillingness on the part of many to move away from the mainstream of conventional banking is a situation Islamic banks are faced with today that is hampering building of their manpower resources and further development. This is because Islamic banking as an alternative financial system is not considered by many in the conventional banking as a well established phenomenon. No Islamic establishments have such wide network and scope that a professional in the conventional banking may comfortably look to a future career in the same sense as he looks to the conventional ones. Unless he himself committed to Islamic religion, a conventional banker opting to change over to Islamic banking is considered to have sacrificed his long term career interests in the conventional banking field. In this situation, manpower development in Islamic banking is faced with added difficulties on that account alone.

4. Track Record

Only about a couple of decades old, Islamic banking in practice is relatively very young. Lack of a long established track record of Islamic banking itself does not provide an adequate sense of comfort to investors Therefore, even a slight negative movement in their results may trigger a run on deposits. In order to meet such an eventuality, Islamic banks are, therefore, forced to maintain unusually high level of liquidity which may adversely affect their profitability.

5. Undeveloped Interbank and Financial Markets

Inter Islamic-bank markets are almost non-existent so that Islamic banks cannot place or raise funds among themselves on any established pattern. Only in Pakistan and Iran, do such markets exist but these are relevant to the local currencies alone.

On the other hand financial markets as exchange systems that allow for

trading of financial instruments are not yet well developed in the Islamic financial world. These markets comprise persons, agents, brokers, institutions and intermediaries who operate under laws, contracts and extensive communication networks all of which are not ideal for Islamic financial instruments or else ideally developed within the Islamic world. Islamic financial institutions are, therefore, hard-pressed to produce instruments as will function and achieve their objectives within the contemporary situation or in a more restricted environment such as limited secondary trading within a certain group of financial institutions supporting a certain instrument. With the development, overtime, of Islamic banking in general, and their instruments in particular, as well as change of regulation within Islamic countries will in the longer run contribute to the development of Islamic financial markets. Stock exchanges are obtaining existence in many Islamic countries as are certain instruments but there is still a long way to go before the Islamic financial markets attain maturity.

6. Lack of Uniform Accounting Standards for Islamic Banking

Among Islamic financial institutions, there is generally no uniformity in the accounting policies and standards. As a result, there is no consistency in the accounting treatment of various operations; even in the presentation of their financial statements. In this situation, the reader of financial accounts of an Islamic financial institution finds it hard to relate the results of one institution with another. For example, investment funds in one institution may be expressed as the funds under management and reported below the line of its balance sheet on the basis that such funds being invested for the risk and benefit of investors are fiduciary in nature do not form part of Islamic bank's liabilities. Another bank may, however, report these above the line within its balance sheet forced by the requirements of the regulatory authority in whose jurisdiction it operates. Similarly, the treatment of Morabaha profit accrual over the period of the transaction also differs. While one Islamic bank may book the entire profit on

the transaction date, the other may amortize it over the transaction period in order to provide stable income on investment throughout the transaction period.

However, Islamic banks have recently agreed to establish an accounting standards board in Bahrain which should ultimately solve this problem.[2]

C. THE FUTURE PROSPECTS

Despite the weaknesses, handicaps and problems faced by Islamic banks, and which are many, they have proved themselves by their viable operational existence in the past about two decades. The future looks promising for them if only they will adhere to the ethical and professional codes of their trust functions and hold dearest to them the objectives of Islamic banking.

Although the Islamic banking movement has been tremendously successful, it is important not to be complacent, and merely review the encouraging progress of the 1970s and 1980s. There has already been much imaginative thinking in the field of Islamic finance, and some of the ideas have given non-muslim observers considerable food for thought. Indeed many of the economic problems of the Western World may stem from an excessive on riba finance, and the narrow and unhealthy obsessions which that seemed to bring.

Now that Islamic banks have proved themselves to be viable retail financial institutions within individual Muslim countries, there is a need to look to the broader horizons of international finance. Some Islamic institutions with western basis have already moved in that direction. An effective Islamic inter-bank market will, however, require tradeable instruments. This is one area where further thinking is needed.

The creation of other instruments may well be feasible and Islamically permissable. The Islamic Development Bank (IDB) has already taken the first tentative steps. Debate on such matters may be one way of moving Islamic

finance forward into the 1990s, and of providing a welcome alternative for Muslim financial dealings to the riba based international status quo.[3]

However, the key to the future is not just credit and deposits but confidence. Like many international banks Arab institutions have worked themselves through a wave of loan-loss provisioning in recent years. But with the end of the Iran-Iraq war and better prospects for regional economies, they have of late slowly been feeling more optimistic. Iraq's invasion of Kuwait in August 1990 put an end to that and has exposed many of the underlying weaknesses of Arab banking[4], which will also affect the Islamic banking future.

SECTION III: THE ISLAMIC MODES OF FINANCING

As against the wider scope of the Islamc bank financing responsibilities and operations, Islamic banking even now has access to very limited modes of financing such as follows:

A. Mudaraba financing (trust financing)

Mudaraba is a contract between an Islamic bank and client whereby the Islamic bank provides specific amount of funds to the client for an enterprise for defined purposes in exchange for a reasonable and highly predictable profit. The client receives a share in the profit as compensation or fee for his know-how and management.

The Islamic bank allows all costs of production including management expenses of the client himself and his labour as deductible expenditure. In addition, the client is permitted a fixed percentage of profit as fee for his know-how and management without which the enterprise would not be in existence and producing. It is normally 15-30% of the profits depending on the extent and quality of technology, management efforts and expertise involved.

However, it remains to be a high risk financing mode. Although the client has sufficient incentives to make the unit a success, he has no capital

committed to the enterprise. Islamic bank, therefore, puts in extraordinary efforts to carefully scrutinize feasibility and projections provided by the clients using most sophisticated credit risk evaluation, analysis techniques and criteria for its decision - making process.

Cross-border Mudaraba financing entails varied type of risks. Political and regulatory risks are among the most important as are tax burdens. Consequently this most desirable form of Islamic finance has not found favour in stable societies in the west and in unstable environments of developing countries. Local laws in certain countries do not permit banks to take equity stake in the manner prescribed.

However, a commentator[5] stated his belief that since Mudaraba is used both as a mode of financing and as an instrument for resource mobilisation. It is, therefore, gaining increasing popularity as it provides Islamic banks with an opportunity to leverage their funds. The Mudaraba concept is similar to the investment funds which have gained considerable popular appeal in recent years. The Mudarib plays the role both of the manager and the trustee.

B. <u>Musharaka Financing</u> (partnership)

It is the same financing contract as Mudaraba except that the client also provides a part of capital in addition to providing management and know-how. On the other hand, the Investor may provide a part of management and know-how in addition to capital. In that case, the sharing of the profit from the unit is adjusted accordingly on both sides and discretionary authority of each partner and relationship framework is clearly defined.

Musharaka financing corresponds closely to an equity market in which shares can be acquired by the public, banks, and even the central bank and the government. For example, firms desiring to raise funds for investment could use this mechanism and offer Musharaka certificates in the market. Such

certificates would be, in effect, transferable corporate instruments secured by the assets of the company. Their price and the implicit rate of return would be determined by the market.

There is a Sharikat Al-Amwal (partnerships of property where each partner contributes money), Sharikat Al-Amal (partnership of labour, where each partner contributes his labour, such as, for example, a partnership between artisans of the same or different vocations) and Sharikat Al-Wijuh (a partnership of credit-worthiness i.e. partners who are credit worthy will be able to get goods on credit to sell them and share the profits and losses).

In a partnership of property, (Sharikat-Al-Amwal) the partners share the profit in accordance with a predetermined percentage but share the losses on pro rata basis.

Though it is often said that risk taking is the raison d'etre of Islamic Banking, the use of Musharaka on a scale evolving extensive risk exposure has been minimal.

C. Murabaha Financing (cost plus financing)

Under this contract, Islamic bank purchases goods, raw material, equipment, machinery or any other items of economic significance from a third party at the request of a client and sells such goods to the client on spot or deferred payment basis at its own sale price. The difference between the purchase cost of the Islamic bank and the sale price to the client forms the profit available to the Islamic bank from the relationship.

The contract normally caters for short-term financing requirements of clients through legitimate trading practices. Murabaha contract provides mostly for short-term financing needs of the clients. Due to inherent liquidity element that this form of financing carries with it, Murabaha financing has been quite widespread with Islamic banks. Unfortunately, due to non-existence of inter

Islamic-bank market, Islamic banks are hard-pressed to maintain higher liquidity positions than their conventional counterparts and, therefore prefer Murabaha, also due to the fact that compared to Musharaka and Mudaraba, Murabaha is a low risk instrument.

D. Loan Financing

This mode of financing is used by IDB though not used by other Islamic banks. For a development bank whose membership is composed exclusively of developing countries, loan financing for infrastructural projects is inevitable. However, the obligation of the borrower in Shariah is to pay the principal amount of the loan only. Yet, Article 20 (3) of the Articles Agreement of IDB obliges it to levy a service fee to cover its administrative expenses. The first question for which IDB has to find answer is whether this service fee, which in effect obliges the borrower to pay more than the principal amount of the loan, is consistent with Shariah? The answer is that though the general view in Shariah is that a borrower could not be obliged to pay more than the principle amount of the loan, an exception is made as regards the actual expenses pertaining to the making of the loan. Any amount beyond the actual expenses will constitute interest.

In consultation with a distinguished group of jurists IDB devised a formula which represent the nearest approximation to the actual cost This formula uses the actual administrative expenses of the bank during the preceding five years and the operational balances (i.e. the difference between disbursements and repayments) to arrive at the cost of each Islamic development of financing[6].

E. Ijara Financing (lease)

Leasing in Islamic banking is relatively a new but very premising financial product because of its flexibility and the added features it offers both to the bank and its customer, especially when compared to the Murabaha contract.

The use of leasing is expected to grow in the Middle East as the needs of Islamic banks and their customers get more sophisticated.

In the classical manuals of jurisprudence, leasing is defined as "a sale of the usufruct (manfa) for a consideration". It does not follow from this that every leasing transaction will be consistent with Islamic law. For example, the absolute obligation of the lessee to pay the rent whatever happens (the hell or high water clause) which is a feature of some of the financial leasing agreements will definitely be repugnant to Islamic law.

An Islamic leasing contract is normally quite similar to the conventional banking contracts. However it has its differences stemming from differences in the definition of a lease between the two financial systems. The Islamic Sharia defines a lease (Ijara) as a rental contract, while conventional banks consider it as merely an off balance sheet asset based financing.

Islamic principles of finance permit the purchase of asset for subsequent rental which may include certain profit to the investor. A commercial or individual client wishing to acquire the use of capital equipment may request the Islamic bank to purchase such asset and oblige itself to rent such asset from the Islamic bank.

Subject to fulfilment of certain conditions, the client has the option to purchase the asset during the term of the lease. The optional purchase price declines over the term of the agreement. As the customer is not obliged to purchase the asset financed under the Ijara contract at the expiry of the leases, Islamic bank will not normally take a substantial risk with respect to its residual value at the lease expiry.

Two most frequently used types of lease are the operating lease and the financial lease. Full amortization of cost differentiates financial lease from the operating lease both of which are acceptable under Islamic principles of finance under specific conditions.

The Islamic bank's standard Ijara (lease financing) contract differentiates between operating and financial lease with regard to its own responsibilities and liabilities. In the former, the Islamic bank is essentially acting as warrantor of the asset leased although the client makes undertakings as to the utilization of the asset and its maintenance etc. In the financial lease, the client must deal directly with the manufacturer or supplier in all matters relating to the goods and assume risk of loss on receiving possession in terms of the stipulations of the lease contract.

The Ijara wa iqtina (hire-purchase) type lease is a variation of the standard financial Ijara agreement. The Islamic bank purchases the equipment and leases it to the client but the client is obliged to purchase the equipment at the end of the lease term.

Due to good quality of the asset, the financial institution may not have to rely for recourse so much on the acceptability of credit risk of the lessee as on the asset itself. This will allow an ability on the part of relatively weaker credit risk clients to obtain financing.

These considerations make leasing an attractive mode of finance for Islamic banks. At present, the Islamic banks tend to opt for commercial passenger aircraft although it is a big-ticket item and its financing is normally for very long periods. Also important is the question of taxation since income from leasing is taxable in most developed and under-developed countries[7].

Basically, there is one major limitation of a lease contract when compared to a Murabaha contract and this is the purpose for which the asset is to be used by the lessee. For in a Murabaha contract the asset is sold for a different payment and title to the assets is passed on to the buyer. There is no restriction on the asset's usage as long as the asset is clearly sold to a business that is devoted to an Islamically allowed activity.

However, an Islamic lease transaction involves the added constraint

requiring lessees to strictly agree and never use the asset for an Islamically prohibited activity such as devoting a leased aircraft to mainly transport alcohol.

Secondly, if one or more payments are delayed, the lessor has the right to renegotiate these terms to reflect an agreed upon payment/pricing formula or the lessor can break the contract and renegotiate its terms allowing him to build in the added cost, but in most cases it can not be claimed except for legal and other expenses incurred in the process of collection.

However some Islamic scholars are now of the opinion that a claim for lost opportunity can be charged if the delay is intentional or if the lessee is trying to avoid payment while being capable of making the payment on time. Furthermore, all scholars agree that no such compensation is valid if the customer was truly in a difficult financial situation[8].

SECTION IV: THE PROBLEMS OF CHOICE OF LAW CLAUSES IN ISLAMIC LAW

The issue which appears to generate considerable debate in the context of Islamic finance documents is the question of the appropriate governing law.

One would assume that, for a purist, the governing law of any Islamic finance document should be the sharia itself but it would seem that this is not always the one which is chosen (assuming a choice exists). There may be a variety of reasons for this which might include:

i) in the case of murabaha contracts, the lack of protection available to banks, as vendors of goods, under Sharia;

ii) the difficulties in interpreting Sharia in the context of modern day commercial transactions;

iii) the diversity of scholars' views as to the interpretations of the Sharia in particular context; and

iv) the recognition of the Sharia as the governing law of a contract in the potential jurisdictions of suit.

Regarding (iv) above, it would seem that there is a very valid concern. The commentator[9] stated his belief that the question of whether a religious law would be upheld as the governing law of a contract is far from clear, save in the case of those countries where Islam is constitutionally one of the principal sources of law.

Even then it seems that, in some jurisdictions, the parties cannot be sure that the Sharia will necessarily be applied. For example, it appears that in the United Arab Emirates there has been an edict to the effect that all banking matters should be dealt with by the civil court and not the Sharia court and it is thought that there is at least some possibility that the civil court would apply civil laws notwithstanding that the Sharia may be expressed to be the governing law.

So far as the English courts are concerned, there would appear to be no problem, save in so far as Sharia contained anything which was illegal under English law or contrary to public policy. As for France and Belgium on the other hand, it seems that the election of a religious law as the governing law would not be upheld, save to the extent that Sharia was part of the domestic law of a country the laws of which are expressed to govern the contract

Furthermore, in most international lease contracts the governing laws can be those of any reasonably developed legal system However there remains the problems of how can the courts deal with a clause such as "As long as it does not contradict with the Islamic Sharia".

A commentator[10] stated that the only solution here is to refer it to an arbitration panel or an identified and acceptable international Islamic body if a problem occurs. However this remains to be a wholly untested phenomenon so far.

SECTION V: THE AVIATION FINANCE TRANSACTION IN ACCORDANCE WITH ISLAMIC PRINCIPLES

The Middle East continues to be a major consumer of transportation assets[11]. Some of these assets will be purchased for cash, by means of counter-trade, and by resort to old fashioned secured bank lending. Others will be leased or otherwise acquired by the least elegant financing devices created by imaginative financiers, competitive manufacturers and builders, and their "high-tech" lawyers, including "double dips" and other cross border leasing structures, FSCs, and operating leases with residual value guarantees.

It is true that there is the problem of enforcing the payment of interest in certain parts of the region, chronic uncertainties as to repossession, and the drama we all hope to avoid of having to litigate sophisticated financing structures in jurisdictions having unsympathetic or undeveloped laws.[12] There is also the challenge of transacting business in politically difficult areas.

While it may be common knowledge that both Iran and Pakistan have adopted at least ostensibly "Islamic" systems of banking and finance,[13] neither country is considered a particularly significant factor in the international financial community, and thus this development has barely made a ripple in the perceptions of the financial institutions and manufacturers who deal in the region.

But should Islamic financing continue to be so quickly dismissed? While anecdotal, the following might be instructive. In 1989, Saudi Arabia's newest "bank", Al-Rajhi banking and Investment Corporation, announced a net profit of U.S. $274 million; 89% of Al-Rajhi total revenue was generated by Islamic financing operations[14]. In the last twelve months, four new Islamic banks were set up in Qatar, Bahrain, the Philippines and India.[15] According to a report issued by the Islamic Banking Association, approximately U.S. $40 billion is being hoarded outside the established Saudi banking system on the grounds that that system was un-Islamic.[16] Finally, at "IATA Aircraft Financing and

Leasing Symposium" in New York during April 1990, a Citibank banker addressing "the State of the International Airline Industry" commented that "imaginative financing techniques" were needed to enable the less strong airlines in Africa and the Middle East to update their aging fleets.[17]

Moreover, a commentator[18] stated that there is nothing in theory to prevent an aviation finance transaction being structured in accordance with Islamic principles. In his view the question is not whether Islamic finance is "relevant", but whether there is a niche for Islamic structured financing for major transportation assets? If there is, should commercial banks get into the business on a project basis when the market calls for it, or should the market be conceded to the present generation of specialists whose experience to date in these types of transactions is limited?

Islamic financing seems mysterious to the uninitiated because the underlying concepts are "different". Once these differences are appreciated and understood, Islamic finance is both straight - forward and logical.

In Western economic system, interest is accepted as the price of (or the return on) capital. The act of lending money is in and of itself deemed to be a productive and desirable enterprise, with interest being the reward.

In the Islamic system, money is not an end but a means: money is not considered capital. Money is transformed into capital by trade or productive enterprise.[19] Trade is encouraged in Islam[20]; unproductive gain such as interest is prohibited.[21]

Islam condemns unjustified or unearned profit or gain, and it is on this basis that interest and speculation are prohibited. In Islamic financing transactions, therefore, "contractual rights and duties must be precisely specified, and any element of risk or uncertainty which would upset the contemplated balance of the rights and duties of the parties under the contract must be eliminated"[22].

It is true that in the Islamic system there is a streak of morality in commercial transactions that may seem inconvenient to the hard-core Western entrepreneurs of the 1990s: one is not, for example, allowed to fleece your contracting partner to quite the extent Western hallowed notion of caveat emptor implies.

Contrary to accepted wisdom, the list of what is permitted in Islamic financing transactions is actually longer than what is prohibited, and many Islamic scholars accept the notion that what is not expressly prohibited is in fact, permitted.[23]

Given the established Islamic financial modes,[24] the commentator stated that the application thereof to an aircraft or ship purchase is not a terribly difficult exercise.

For example: Mudaraba partnership comprised of investors and a manager (perhaps an investment bank of leasing company) would purchase an aircraft or ship. The investors and managers could be individuals or institutions and would need not be Muslim or otherwise "Islamic". The partnership's capital could be raised by a private placement or public subscription, and Mudaraba "certificates" could be issued either in bearer or registered form to represent the investors' interests in the enterprise[25]. In any contract of sale with the airframe or aircraft manufacturer, or with a shipbuilder, the price of the asset would have to be fixed at the time of contract.[26] The aircraft or ship would then be leased on an operating basis (ijara) or a lease-purchase basis (ijara wa-iqtina) to the operator.

If all of this sounds vaguely familiar, it should. In the 19th and early 20th centuries, the acquisition of railroad equipment in the U.S. was financed using a device called the "Philadelphia Plan", in which a trust not unlike, in practical effect, a Mudaraba, was formed to acquire equipment from a manufacturer and to lease it to the railroad. The trust issued certificates which were sold to raise

funds. Title to the asset passed to the manufacturer upon payment of the last lease payment. Distributions to the investors were called "dividends". While there are differences in conception, in overall structure the similarities with a mudaraba are rather striking.

In an operating lease scenario, the mudaraba partnership would assume the risk of residual value[27] of the asset and would sell or re-lease the aircraft at the end of the operating lease. The total of lease payments plus asset sale proceeds less expenses and the cost of the asset would be distributed pursuant to an agreed formula among the mudaraba investors and the managers.

In a lease-purchase similar principles would obtain, and the mudaraba would be closed out at the end of the lease[28].

As in non-Islamic asset transactions, insurance would be purchased to cover the loss of or damage to the asset. Although insurance has a complicated place in the Islamic financial system,[29] in the last several years, insurance based on mutual protection principles takaful has become available and can be readily obtained.[30]

Many Arab Gulf states do not tax the incomes of indigenous individuals and business entities and the absence of such taxes may beneficially impact on the pricing of mudaraba financing of assets.[31]

If it is accepted, at least in theory, that transportation assets are capable of being acquired and financed by Islamic means, the obvious next question is: could Islamic financing either on the basis described above or otherwise become an alternative to the conventional means and sources of asset finance?

Mr. Neal Grenley[32] stated that, a transaction whether in the Middle East or in the middle of Europe - will succeed only if it is economically viable. That viability might involve a number of factors such as availability of finance, freedom from burdensome covenants, security and, of course price.

Where an airline or a shipowner has a choice, it will naturally seek the most economical all-around source of finance available to it. If mudaraba or other Islamic financing devices are competitive with conventional financing, then Islamic transactions will get off scholars, desks and into the real world.

In the commentator's view, there are a number of factors which appear to make Islamic asset financing particularly interesting in the transportation asset context:

i) There seems to be general agreement that there are considerable financial resources available to invest in Islamic financial products. Traditionally such resources have been invested in short-term products, but that may be because no suitable medium or long term opportunities were available.

ii) The Middle East region and the areas contiguous thereto encompass enormous wealth, desperate poverty and governments covering the entire political spectrum from enlighten to murderous. It is likely that the conventional financial markets would not be available to many countries or operators in the region for economic or political risks reasons - or both. In this very same region Islam is a common thread (although by no means necessarily a bond) between rich and poor and the free and the oppressed. In these circumstances, it is possible that the power of religion as well as identified economic need may create a market for Islamic asset transactions which conventional finance cannot meet.

iii) In the region generally, and in Saudi Arabia in particular, interest - fuelled transactions occupy an uneasy place. Interest is tolerated but enforcement of interest obligations by the local courts is often problematic at best and at worst virtually impossible. At the present time, many observers consider it far more likely that Islam will intrude more into commerce in the region rather than less. One virtue of an Islamic transaction is that it would be interest - free and thus enforceable. This element of certainty might well be reflected in the pricing of an Islamic transaction versus a conventional asset financing transaction.

iv) Related to the previous point is the fact that in the region - and again in Saudi Arabia in particular - the court system is populated with judges more versed in Islamic law than in secular artifices

> such as leveraged leases. Would an Islamic transaction gone sour get a better or more comprehending hearing than a complicated, heavily boiler - plated New York or London style transaction? Would repossession of an asset by a lessor in an Islamic lease be viewed with any less suspicion and hostility by local civil or judicial authorities?

Moreover, he believes that, there are a number of factors - some of which are systemic - which might severely limit the applicability of Islamic financing transactions in the "real world".

First among these factors, is the uncertainty as to what is permitted and what is not permitted in an Islamic transaction while the diversity of local laws is a concept with which is familiar to the West,[33] the validity of an Islamic transaction is not tied to geography but to Islamic doctrine The problem thus becomes - which Islamic doctrine applies? There are four main schools of Islamic thought:[34] the Hanafis, the Malikis, the Shafi and the Hanbalis.[35] On a given issue, one school might permit an action where another school prohibits that action. When structuring a multimillion dollar medium or long term transaction, legal uncertainty is as much an area of concern as financial stability. The scope of this problem can be illustrated by two examples of particular relevance to transportation asset financing:

i) In the case of a contract with a manufacturer (istisna), some schools claim the contract is not binding until the manufactured object is in existence; other schools consider such a contract binding at the outset.[36] The implications to an airframe or ship building contract are obvious.

ii) The Hanabli school considers the payment of non-refundable earnest money (irban) to be acceptable; the other schools do not.[37] How then are liquidated damages clauses to be construed?

The lack of an unified approach as to what is "Islamic" in a given transaction has the potential of creating the very type of problems the use of an Islamic financing structure was meant to have avoided. While it is probably unrealistic to expect that these schools will resolve their differences or merge, certainly a

consensus ijmah by scholars as to significant aspects of Islamic financing concepts is a worthy cause if only to propagate Islamic financing generally.

A second factor is the ambivalence local law in the region has to Islamic financing. It has always seemed that in Saudi Arabia, where two of Islam's holiest places are located, where alcohol is forbidden and where the Saudi courts refuse to enforce an obligation to pay interest, the bank regulatory scheme essentially prohibits Islamic banking activities. Under the Saudi Banking Control Law, a bank is prohibited from engaging in trade (which literally could include leasing and resale activities), taking an equity position in excess of 10% in other entities, or having an "interest" in a commercial enterprise (which literally could also include leasing of an asset), subject to certain exceptions[38]. As a result, until the recent licensing of Al-Rajhi Banking and Investment Corporation, Islamic banks had to operate under the "cover" of their local business associates and/or not as banks at all.

Consequently, these institutions have not been subject to the regulatory authority of the Saudi Ministry of Finance or the central bank,and thus have largely been unregulated. This lack of regulation and the resultant "irregular" manner in which Islamic banks have had to do business in Saudi Arabia, together with the comparatively hospitable climate Saudi Arabia has offered for conventional commercial banks, may have stunted the potential of these institutions within Saudi Arabia which ought to have been a natural market.

A third factor is the absence of uniform accounting standards applicable to Islamic financial institutions and Islamic financing structures. In part this is a consequence of the lack of regulation by cental banks (which operate along more traditional lines) or other similar authorities, and in part by the lack of a cohesive vision amongst Islamic financial institutions themselves that would promulgate industry - wide standards of conduct and performance, which in turn would foster confidence in the competence and staying power of these institutions.

While none of these factors is, in the commentator view, fatal to the ability to use Islamic financing concepts for the acquisition of transportation assets, they are nonetheless a significant deterrent to widespread acceptance of Islamic transactions as a viable alternative method of financing

Even in the best of circumstances the Middle East region presents more than the usual challenges to the transportation asset financier On the one hand, in the wealthy states, there is not infrequently an institutional ambivalence to traditional financing transactions involving interest. On the other hand, absent the emergence of circumstances which would prevent the Islamic governments in the region (and their national transportation fleets' from continuing to participate in interest-fuelled financing transactions forbidden by Islam, those transactions will probably continue to be the basis for financed asset acquisitions, notwithstanding that significant elements of those transactions would be unenforceable or misunderstood under local laws One advantage of an Islamic transaction is that, unlike traditional financing involving interest, the underlying concepts thereof would be enforceable both in "Islamic" and "non-Islamic" jurisdictions. However, unless Islamic asset financing transactions are competitively priced with conventional modes of financing, it is unlikely that Islamic financing would be a significant factor even given interest's unholy place in the jurisprudence of the Gulf states

In the less wealthy states of the region or those in which the local brand of politics makes access to traditional finance problematic, Islamic financing may well open new markets for operators, manufacturers and financiers.

The obstacles to Islamic asset financing are formidable but not insurmountable. While Islamic deals can be credibly structured on a theoretical basis, the opportunities for Islamic transactions will be created not so much by the edicts of governments or religious doctrine, but by the financial market place which will judge each Islamic transactions on a costs and benefits basis in much the same way conventional transaction are assessed.

SECTION VI: THE NATIONAL LAWS OF SELECTED COUNTRIES

Three Arab and Muslim countries have been selected for the purposes of analysis for this thesis, namely, Egypt, Pakistan and United Arab Emirates, due to the limited space available. This selection was made on the consideration that they reflect the legal frame work in almost all the Arab and Muslim countries which adhere to the Islamic religion.

A. Egypt

As one of the Islamic countries that has declared that Sharia is the basis of its legal system in Article 2 of the constitution as amended on 22nd May, 1980, Egypt is the most influential Arab country in terms of its civil law. Recourse to provisions of Sharia is to be had according to the Egyptian code, after recourse to customary law.

If one looks at financing techniques over the last decade in Egypt, and in particular project financing techniques, one is of course struck by the over-whelming use of western banking methods. I do not see this changing unless the basic legal structure of the country were to change. There remains the issue of interest and I will revert to this later.

Financing arrangements have involved both domestic and foreign currency lending. In the seventies and eighties, foreign currency was lent for projects from foreign banks with or without a presence in Egypt and from Egyptian private sector commercial banks. As the foreign currency position of Egypt deteriorated during the eighties so banks became reluctant to lend in foreign currency. Many projects had been financed on the basis of dual currency loans, the split usually being foreign currency for the costs of imported plant and machinery and Egyptian pounds for the local construction costs. This sort of financing created serious problems for import substitution projects which had no foreign currency earnings.

However, like other government - controlled airlines based in countries where foreign tourists and business traffic are important to hard currency generation, Egyptair is free to maintain its foreign currency revenues outside of Egypt. Indeed, Egyptair is one of the largest providers of hard currency to the Egyptian economy and needs to show a solid ability to pay to the international financial community order to attract foreign capital.

The Egyptian pound unlike the currencies of the countries in the Arabian peninsula is not freely convertible and has been protected like many developing country currencies by an artificially high exchange rate. Nevertheless the Egyptian pound has devalued consistently during the 1980's so that a foreign currency loan becomes an increasingly large item on the balance sheet. However, effective May 13, 1987, there is one rate of exchange for the Egyptian pound, as determined daily by the Central Bank of Egypt. Prior to this date, there were two exchange markets in Egypt, the unified market and the free transferable foreign currency market. There is no local market for forward dealings in foreign currencies, and no restrictions exist on borrowing from abroad neither from local sources by foreign investors.[39]

Although commercial banks are now reluctant to engage in project lending in foreign currency in Egypt, other institutions do continue to lend - these include the European Investment Bank, the World Bank and the Germany agency, Deutsche Finanziereings - gesellschaft fur Betiligungen in Entwicklungslandern GMBH (DEG). All of these agencies have lent throughout the Middle East not just in Egypt.

In a country such as Egypt, there is a great need for infrastructure projects to be financed. Both the European Investment Bank (EIB) and DEG will fund such projects in principle as well as the World Bank and USAID. Commercial banks will tend not to get involved in these sectors without export credit agency guarantees. This brings us to the problems related to buyer credits and supplier credits.

1. Supplier and Buyer Credits

A buyer credit deal will involve an European export - credit agency such as ECGD (UK), Coface (France), Hermes (Germany) and SACE (Italy). The transaction will involve a loan made from a European bank guarantee of the borrower's country. In Egypt many of these arrangements have been entered into by Ministries or public authorities and as such they are from the view point of constitutional law loans entered into with the executive. Under the Egyptian constitution, such loans must be approved by the people's assembly and published in the official Gazette in the same way as a law. Until these procedures have been completed, the loan agreement is not valid. This requirement has caused serious delays in project implementation.

The supplier credit arrangement on the other hand involves facilities being made available by the exporter to the importer against the provision of promissory notes or bills of exchange which are availed and subsequently assigned to a bank in the exporter's country. But this arrangement also has its problems in Egypt.

The supplier credit agreement will contain provisions for interest at the prevailing market rates. As such, the rate will exceed the minimum laid down for commercial transactions in the Egyptian Civil Code[40]. The appropriate Article 226 in the Egyptian civil code states that the rate of interest for civil matters is 4% and commercial matters is 5%. The parties may agree a higher rate but not exceeding 7% as states in Article 227. Banks are considered exempt from this limitation and they therefore charge international market rates for foreign currency in Egypt and rates laid down by the Central Bank for Egyptian pounds. However, in a supplier - credit agreement the parties are the exporter and the importer. There is no bank party to the agreement and therefore the arrangement appears to be caught by the restrictions contained in the civil code. These agreements are usually governed by a foreign law but since the interest provisions in the civil code would be considered matters of

public policy subjecting the agreement to a foreign law would not obviate the problem. There is no jurisprudence on these questions yet and therefore the situation remains unclear.

The constitutionality of the provisions in the civil code permitting interest, even at the relatively low rates, has come before the constitutional court. In that case (decision of the constitutional court of 4th May, 1985) the Article 226 in the civil code was challenged as being contrary to the absolute prohibition of interest as laid down in the Shria.

The constitutional court held that the interest provision in question (Article 226 of the civil code) was valid and based its judgement on the principle of non-retro-activity of laws. The amendment to the constitution did not abrogate all existing secular legislation. It made the Sharia the main source of legislation for all future laws and as such was a direction to the legislative Hence, the interest provisions in the civil code and presumably the ability of the banks to exceed them remains intact.

Since Egyptian civil code allows for the payment of interest in certain circumstances and not to exceed certain amounts, which is enforceable in the courts in Egypt. In particular, Article 33 of law 26/1976 governing Egyptian aviation has an explicit provision permitting the payment of interest on aircraft - related loans, but limiting it to no more than 12% per annum.

Because aircraft lenders today generally provide finance at floating interest rates based on a spread over eurodollar funding costs, the risk of entering into a long term transaction where the interest rate might, at some point in the future, exceed 12% and thus become illegal under Egyptian law, raised some eyebrows among the financiers. Notwithstanding the limit, it is possible under Egyptian law to pay fees in order to buy what's known as an interest rate cap.[41]

Under Egyptian law, the secured creditor has no right after a default, to

repossess and sell the mortgaged aircraft. Article 36 of Egyptian law No. 261 1976 makes any agreement giving a creditor the right to repossess and sell an Egyptian aircraft, without complying with the procedures in that law, invalid.

However, the airline and the financier could agree to appoint an uninvolved third party as a custodian of the aircraft, as an airline based in Switzerland for example, and that an Egyptian court would enforce the airline's obligation to turn the property over to this custodian in the event of a default. Once this custodian has received possession of the aircraft, a court in Egypt would enforce the obligation of the airline, set forth in the mortgage and the loan documentation, to permit the custodian to sell the aircraft in accordance with the procedures set forth in the Geneva convention.

2. The Legal Nature of the Right of Property

In Egyptian law, there are no special provisions with regard to the transfer of ownership of aircraft. Therefore, the right of disposal of aircraft is regulated by the Civil Code. The owner has the right to dispose freely of his aircraft, which right extends to every part thereof.

Transfer of ownership may arise from any contractual act, i.e , contract of sale or contract of donation, etc. An aircraft is considered a moveable, and therefore the law governing its sales is the law of sale of moveables provided for in the Civil Code. For the same reason, no special instrument is required in order to transfer the property in an aircraft.

A ship, although a moveable, can be mortgaged, unlike other moveables including aircraft which cannot be mortgaged. Any moveable can be pledged,that is to say, deposited with the creditor as security for the debt. In the first place, a distinction should be made between privately-owned aircraft and aircraft owned by public bodies. The latter type of aircraft could not be subject to a pledge and similar rights which are contractually created as security

for payment of an indebtedness. The aforementioned rule can be ascertained from Articles 87 and 88 of the Egyptian Civil Code.[42]

The Egyptian legislator provides in Article 1122 of the Civil Code that in case of special rules governing the pledge of certain moveable things, they will be applied instead of the aforementioned rules. Since Egypt has ratified the Geneva Convention on December 9th, 1969, the recognition of rights in the convention is now considered a national rule, which means that the aforementioned rules do not govern the rights in aircraft in Egypt anymore An amendment of the law on this subject would have been better, but in view of the aforementioned Article 1122 of the Egyptian Civil Code, there is no longer any substantial need for such amendment.

In order to enforce remedies against the aircraft in Egyptian courts Egyptian law requires, promissory notes to be in Arabic. While the law permits mortgages of finance leases to be recorded in English, enforcement would require translation into Arabic.

3. Aircraft Registration

Article 3 of Decree No. 369 under the Egyptian Civil Aviation law requires that aircraft owned, or leased under finance lease by Egyptian operators must be registered in Egypt.

B. Pakistan

The legal system of Pakistan is a mixture of Anglo-Islamic law[43] which grew out of the interaction of English and Islamic laws prior to 1947. In recent years, there has been a trend in Pakistan similar to that experienced in other countries in the Islamic world, towards the implementation of Islamic principles and the de-emphasis of previous western-imposed influences. These changes have included the introduction of Islamic forms of criminal punishment, the

prohibition of alcohol and certain developments in the areas of taxation and interest.

The legal system is administered by Civil and Sharia courts. In general, commercial activities of the type undertaken by most foreign investments are regulated by Western-style laws and by civil courts. As to the contracts for sale and purchase of foreign currencies up to a maximum period of 12 months forward in the case of capital goods and machinery and 6 months forward for other goods can be entered through commercial banks authorized by the state bank, provided the contracts are to cover firm transactions. Forward purchase contracts can be made for only up to four months if goods have already been shipped or are on a consignment basis.[44]

Moreover, the recognition of rights in aircraft, Pakistan ratified the Geneva Convention on June 19, 1953, and it acquired the force of law in Pakistan on September 17, 1953.

The form of Pakistan Civil Aviation Authority ordinance of 1982 gave birth to an autonomous Civil Aviation Authority having much needed financial and administrative powers and relying almost entirely on its own financial resources. This was to facilitate the Authority to carry out its objectives with maximum efficiency and speed without let or hindrance from the built-in delays of the normal government machinery.[45]

Pakistan International Airlines Corporation was incorporated on April 18, 1956 under the Pakistan International Airlines Corporation Act, 1956 and its shares are quoted on the stock exchanges in Pakistan.

1. Aircraft Registration

The Director General of the Civil Aviation authority shall maintain a register of aircraft registered in Pakistan. The new owner of the aircraft shall, within two weeks of the change of ownership, apply to the Director General for registration of the aircraft.

An application for registration of an aircraft may be made by or on behalf of two or more persons who, jointly or in common, hold an interest as owner, purchaser under a hire-purchase agreement, hirer or charterer of the aircraft and if such an application is made, the applicant shall, in the application nominate one of them as the person to whom the Director General may issue the certificate of registration in respect of the aircraft.

Where an aircraft is registered under a joint registration plan or an international registration plan, it shall, to the extent set out in the Resolution on Nationality and Registration of Aircraft operated by International Operating Agencies adopted by ICAO on the fourteenth day of December, 1967, be deemed to have the nationality of each of the contracting states to Chicago Convention, which constitute the International Operating Agency by which the aircraft is operated. No registered aircraft whether its certificate of registration is in force or not. Shall be leased outside Pakistan, nor shall there by any change, partial or otherwise, in its ownership. The possession or use of the aircraft otherwise transferred to any person, company or corporation, without the previous permission in writing of the Director General.[46]

2. Protection of Foreign Investments

The government has enacted two laws in an attempt to promote the confidence of foreign investors. These laws are the Foreign Private Investment (promotion and protection) Ordinance[47] and the Protection of Rights in Industrial Property Order.[48]

3. Exchange Controls

The Government of Pakistan controls the outflow of foreign currency through a series of detailed exchange control laws and regulations.[49] All borrowings from abroad require prior approval of the State Bank. Such borrowings are usually permitted for renewable terms of one year under

guarantee of repatriation. During the investment approval procedure, the foreign investor should obtain certain consents with regard to the repatriation of capital and profits subject to any specific approvals contained during that procedure and the provisions of other laws.

The state bank is empowered to implement the exchange control policies of the government and has delegated certain of its functions to a number of banks and financial institutions (authorized dealers) The state bank fixes the rates at which foreign exchange may be sold and bought and foreign exchange transactions may only be effected through an authorized dealer. Controls are also imposed on the import and export of currency notes and bank notes, whether Pakistani or foreign, gold, silver, and precious stones. Securities are likewise subject to controls and may not be transferred to a person resident outside Pakistan without prior permission.

A foreign resident in Pakistan and a Pakistani company that is controlled by non-residents are, for this purpose, deemed to be non-residents. In addition, a company that is controlled by Pakistanis may not cease to be so controlled except with prior state bank permission. Permission is also required for loans to be made or securities to be issued to any company other than a bank which is controlled by non-residents.

4. General Banking Structure

Commercial banking in Pakistan is governed by the Banking Companies Ordinance of 1962.[50] This ordinance establishes the minimum paid-up capital in reserves required for banks in Pakistan, the cash reserves required, and other organizational requirements. In addition,it sets forth the standards required for a banking company to receive a license from the state bank of Pakistan, which is necessary in order for a bank to do business in the country. The state bank was established by the State Bank of Pakistan Act (No. XXXII of 1956), and supervised the activities of all commercial banks in the country as

well as regulating foreign exchange.

In 1974, an act of the Pakistani Parliament provided for the nationalization of the entire banking business. Since that time, all of the banks in the country have been owned by the Government of Pakistan, although they continue to act as independent legal entities.

5. Interest

Because Pakistan is an Islamic country, the provision of interest on deposit accounts has presented a theoretical dilemma. Other Islamic countries have dealt with this problem by having banks pay "commissions" or "service charges" which are actually pegged to prevailing interest rates.

In 1979, Pakistan began a program to establish true interest-free Islamic banking. As part of this program, since July 1, 1985, predetermined interest-bearing accounts in domestic currency are no longer available, and any payment to depositors at the end of the year is based on the profit or loss experienced by the bank during the year. Similarly, domestic currency loans to companies are possible only on a quasi-equity ownership basis.

These provisions apply, however, only to deposits in Pakistani currency. The provisions will not apply either to foreign currency deposits held by banks in Pakistan or to foreign currency loans made by banks to Pakistani borrowers. Interest will continue to be payable on such loans and deposits.[51] Trade-based financing in foreign currency, letters of credit and guarantees which do not involve an interest payment should not be affected by the new regulations.[52]

C. United Arab Emirates (U.A.E.)

The U.A.E. is a federation comprising seven Emirates each with its own legal system. There is a provisional Federal Constitution which delegates certain specified powers to the federation but leaves all other powers with the

individual Emirates and, even provides for individual Emirate legislation on matters within the scope of the specified delegated powers to remain in force until the Federation enacts conflicting legislation, which then takes precedence.

The origins of the legal systems in the individual Emirates vary for historical reasons. In fact, most of the legal area within the scope of the specified powers delegated to the federation has not yet been covered by the enactment of Federal legislation.

1. The Banking Scene in the Emirates

I will select three topics to illustrate the variable degree to which Western Banking has become accepted in the Emirates. These are respectively, interest before the Civil Courts, the impact of the Sharia Courts and the choice of governing law.

(a) Interest before the Civil Courts

In the past, the civil courts of certain of the Constituent emirates of the U.A.E. (including Abu Dhabi but excluding Dubai) have, in many instances, refused to enforce in full interest obligations arising from commercial financing arrangements.

Under the Abu Dhabi Code of Civil procedure of 1970, the courts in Abu Dhabi were not permitted to fix interest rates for commercial transactions in excess of 12% simple per annum. Although this restriction was removed as from August 1987 by Abu Dhabi law No. 3 of that year, there is still a statutory restriction under Abu Dhabi law No. 4 of 1987 in all cases prohibiting interest in total exceeding the amount of the principal debt.

In contrast, the Dubai Civil Courts have upheld, and continue to uphold, commercial interest obligations at their full agreed rates and without any restriction related to the amount of the principal debt.

(b) The Sharia Courts

Islamic Sharia jurisprudence has been interpreted to preclude the enforceability of interest obligations and contracts of indemnity and insurance.

Accordingly, in proceedings arising from commercial financing arrangements before the Sharia courts of any of the constituent Emirates of the U.A.E., it is unlikely that obligations relating to interest, insurance could be enforced.

In Abu Dhabi there was considerable doubt as to whether any particular dispute arising from a commercial financing arrangement would go before the Sharia courts or the civil courts and this situation was often used by defendants to their advantage.

Although it is true that the position has been improved by the instruction issued by the presidential court in April 1987 stating that all cases involving banks are to be heard solely before the civil courts, the uncertainty has, in practice, only been somewhat diminished.

In Dubai it has, for many years, been a well established practice for any dispute arising from a commercial financing transaction to be heard before the civil courts rather than the Sharia courts.

The civil courts have always had great regard to equitable principles of international commercial practice and taken not of the position of banking and financial institutions doing business in Dubai generally.

(c) Governing Law

In Abu Dhabi, the courts normally in practice apply the law of Abu Dhabi and the Federal law of the U.A.E. notwithstanding any express choice of a foreign law.

In Dubai, provided there is some appropriate nexus between the particular contract and any foreign governing law system expressly chosen (e.g.

because of the location of the financial market to which the contract relates or the location of the principal offices of those parties to the contract outside Dubai) the courts will recognise that choice of foreign governing law subject only to the relevant provisions of that law not being contrary to public policy in Dubai or to any mandatory law of, or applicable in Dubai. It must, however, be admitted that for this purpose public policy may be interpreted in a broad rather than a restrictive sense.

Although Federal laws are generally applicable throughout the U.A.E., there are significant differences between the local laws and practices of individual Emirates.

2. The Types of Security Available

Securities are divided into two categories: personal rights of action and real rights against property. Personal rights include guarantee or surety, a contractual obligation to be collaterally answerable for the debt or default or obligations of another person. Real rights on the other hand are rights taken against property by way of security for performance of contractual duties and include pledge, mortgage (or charge) and lien.

There is a variety of laws in the U.A.E. both general and specialized which govern securities. For example, the Federal Civil Transactions Code 1985 (as amended) has extensive provisions on pledge, mortgage and guarantee; the Federal Maritime Law 1980 (as amended) governs the specialist subject of maritime mortgages and liens. The individual Emirates also have applicable laws; for example, the Sharijah law of Mortgage of Real property 1973 as amended (1989) with regulations, and the law of Contracts in both Dubai and Sharijah.

Also of note is the Federal Commercial Companies Law 1984 which sets out special registration requirements for corporate securities.

Where there are no statutory provisions (federal or Emirate) then commercial customary law applies together with the Sharia law and general principles of justice.[53]

(a) I will deal first with three somewhat anomalous forms of security since, in the strict legal sense of a mortgage or charge, they do not constitute security at all these are:

I) Post-dated cheques

Under the U.A.E. Federal Penal Code of 1987, it is a criminal offence in bad faith to draw a cheque against insufficient funds or to stop a cheque prior to payment. This offence is punishable with imprisonment or a fine. This criminal sanction gives post-dated cheques a more real value than they enjoy in England as example.

II) Pre-judgement attachments

In any case where the court in any relevant Emirate can be persuaded that there is a real apprehension of the defendant's assets being removed from the jurisdiction of that court, it will usually grant a provisional attachment order over the defendant's assets and, if the defendant is a foreigner, even over the passport of the defendant or its foreign general manager. This order can be obtained ex-parte and is, in practice, a powerful bargaining tool, though the court will require the plaintiff to whom the attachment order is granted to provide a guarantee or other security for the damage which results if it turns out that the underlying claim is unsuccessful.

III) Guarantees and their consequences

These are of special importance in the Emirates because, in view of the different origins of the legal systems, it is uncertain whether or not a partnership (which is probably the most common form presently adopted for the conduct of any business in which both locals and foreigners are involved) is a separate

legal entity. The only wise course is therefore to take personal guarantees from each of the partners in all cases.

However, early in 1987 the Civil Code was amended with retrospective effect so as to be inapplicable to commercial transactions. In Dubai it is generally accepted that transactions involving banks are commercial in nature (unless related to an underlying transaction which is civil in nature) and therefore not subject to the Civil Code and this was recently confirmed by the Dubai Court of Cassation. Further, in a 1989 Sharjah case, the Sharjah Federal Court of Appeal held that a guarantee which is ancillary to a commercial act is itself commercial in nature.

Nevertheless, certain of the other Emirates take a different view. For example, the Federal Court of appeal in Abu Dhabi (which will be remembered has no jurisdiction in Dubai) has recently held that a guarantee is an act of Charity, Civil in nature and therefore subject to the Civil Code.

The Civil Transaction Code (CTC) considers two types of guarantees: (1) personal or direct security and (2) satisfaction.

(1) A guarantee in person (or what might be translated as direct security) binds the guarantor to produce the party guaranteed at a specific time at the request of the party in whose favour the guarantee was given failure to do so results in a fine is relieved for cause (CTC 1068). such a guarantee would seem to be the civil law equivalent of bail.

Where, however, the guarantor undertook to pay the indebtedness of the party guaranteed but cannot now produce him, the guarantor is bound to make such payment (CTC 1069). If the party guarante d has died the guarantor is usually relieved of his liability to produce the person or pay in default (CTC 1070, 1072). Death of the guarantor does not, however, release the debtor (CTC 1084).

When it is not clear from the contract of guarantee whether the guarantee

is in person or is a financial guarantee, the matter will be determined by independent evidence failing which the guarantee will be taken to be financial. However, this presumption may be rebutted by a statement on oath by the guarantor which will then be conclusive (CTC 1073).

(2) A guarantee of satisfaction is a guarantee for payment of the price of goods sold if it transpires that the seller did not in fact have good title to or right to sell those goods. However, such a guarantee is enforceable if and only if there is a judgement to the effect that: (1) the seller did not have good title, and (2) the seller must repay the purchase price (CTC 1075-6).

The guarantor is bound to fulfil his obligations to the limit undertaken in the guarantee only upon expiry of the relevant period and fulfilment of any conditions precedent (CTC 1077, 1080, 1081). The creditor has a right of recourse against either the principal debtor or the guarantor or both of them jointly (CTC 1078). If there is more than one guarantor the creditor may usually proceed against any of them for the entire sum of the guarantee without prejudice to his rights against the others. An exception to this rule is joint (not being joint and several) guarantee for a single debt in which case recovery from each guarantor is limited to the extent of his share (CTC 1085).

If prior to a personal guarantee a debt is secured by a mortgage (or other security which carries with it rights of priority or tracing), it is not permissible for the creditor to seek enforcement against the assets of the guarantor before proceeding against the property given in security (CTC 1082).

Where the guarantee by real security is subsequent to the personal guarantee. The creditor may seemingly elect his remedy. Where the guarantor satisfies the indebtedness of the principal the creditor is bound to release any real security to the guarantor (or transfer the right thereto in the case of real property CTC 1091).

Where a creditor accepts something other than the original debt or

obligation in satisfaction both the guarantor and the principal debtor are relieved from liability (CTC 1088).

The guarantor is also released from his guarantee where the creditor fails to claim his debt from the guarantor within six months from the date the debt falls due or matures (CTC 1092).

This is a surprisingly short time limit and is without statutory exception or relief. However, it is argued that a creditor may formally "claim" his debt either orally or (preferably) in writing to the guarantor; it may not be necessary to "claim" by way of commencement of a legal action.[54]

(b) Floating Charges

The floating charges (which is over all or a particular class of the assets of the chargor, which assets the chargor is free to alter without specific approval unless and until an event of default occurs and the charge crystallizes) are not possible in the U.A.E. This is as especially important point to bear in mind when considering charges on cash balances and debts.

(c) Mortgage

Mortgage or charge is rather different from pledge. Under a mortgage (or charge) the debtor usually retains possession of the security, the creditor receiving certain proprietary rights (including the right to sell in default).

Article 1399 of the Civil Transactions Code defines mortgage of real property as an agreement whereby the creditor obtains rights over land (including building or corps therein) allocated for the satisfaction of his debt with a priority over ordinary creditors to satisfy his debt out of the value of that plot, whoever has possession of it.

The legal validity of a mortgage rests on its registration (CTC 1400). There is no concept of equitable mortgage but a mortgage which is not registered may rank as a pledge (although it would not be effective against a

third party (CTC 1484-6). The debt must be liquidated and in existence at the time of the mortgage or the mortgage must be for some consideration specified at the time the mortgage agreement is concluded (CTC 1409). Registered mortgages are effective as against the rights of third parties from the date of registration and the creditor has priority for his debt the same date (CTC 1422, 1425, 1427).

The Emirate of Sharjah has a special law governing registration of mortgage (and enforcement by sale) Sharjah law No. 11 of 1973 on Mortgages of Real Property (as amended by Sharjah law No. 2 of 1989) sets out, with admirable detail, the requirements for registration and enforcement. However, a mortgagee is entitled to:

1. assign his rights but only with the consent of the debtor and upon registration of the instrument of assignment at the lands Registration Department (CTC 1418);

2. obtain satisfaction of his debt from the mortgaged property on maturity of the debt but only in accordance with the terms of the mortgage agreement and the requisite proceedings before the Civil Courts; any term which purports to vest the land in the mortgagee immediately the debt matures or without legal proceedings in void (CTC 1419, 1420).

3. Trace or follow the mortgaged property into whosoever's hands it has fallen (CTC 1429); the possessor who then discharges the debt may recover from the debtor being subrogated to the rights of the creditor (CTC 1432); where a third party has acquired possession for value or by way of gift that third party has a right of recourse against the former owner (CTC 1439).

(l) Mortgages of Aircraft

There is a U.A.E. Federal register of aircraft which is maintained by the U.A.E. Federal Directorate General of Civil Aviation (DGCA), the status of the proposed U.A.E. Federal Civil Aviation law is still uncertain at the present time. However, the DGCA is in practice prepared to note the interest of an aircraft mortgagee on the register and to agree to consent to de-registration of the

aircraft by the mortgagee upon enforcement of the mortgage.

Nevertheless, although the U A.E. has ratified the Chicago and Warsaw Conventions, it has not yet ratified the Geneva Convention of 1948 concerning the international recognition of rights in aircraft.

(d) Pledge

Pledge or possessory attachment is sometimes viewed as a specialized form of bailment under which the debtor (pledgor) delivers goods (or documentary title to goods) to his creditor a security for a debt The pledgor retains general property in the goods whilst the creditor acquires a special property. Article 1448 of the CTC defines pledge as an agreement which creates a right of retention of an asset in the hands of a creditor (or, if agreed, a disinterested stakeholder) by way of security for a right capable of being satisfied by payment (of all part of the cash value thereof in priority to all other creditors.

It is a fundamental prerequisite of a complete and irrevocable pledge that possession of the pledged property must pass to the creditor or a disinterested third party (CTC 1453).

In addition pledge must be in consideration of a fixed debt or a specific promise made at the time of the pledge or for some moveable object given by way of security (CTC 1452).

Generally, the pledgor must be the owner of the pledged item with capacity to deal therewith but property on loan may be pledged with the consent of the lender-owner (CTC 1458, 1466). Where divisible assets are owned in common, a joint owner may pledge his share (CTC 1460, 1408)

The pledgor cannot deal with the pledged property save by agreement with the pledgee. Where such dealing takes the form of sale the right of pledge then attaches to the price paid for the pledged property (CTC 1467).

The pledgee for his part is not entitled to profit from the pledged property (moveable or immoveable) without permission of the pledgor. Where such permission is granted any profit must generally be applied first to the expenses of the pledge and, secondly, to the principal of the debt (CTC 1474).

Pledge may relate to moveable or immoveable property with respect to immoveable or real property (including structures built on the land or crops growing therein) a pledge is not effective against third parties except when registered (as a mortgage). The creditor-mortgagee then has the right to loan the land or lease it back to the pledgor without prejudice to the effectiveness of the pledge as against third parties (CTC 1484-5).

When the pledge involves moveable property it is not effective against third parties except where the pledge is evidenced in writing and dated (together with possession having been transferred to the pledge) CTC 1487. Should the moveable property be threatened with destruction, damage or depreciation, the pledgee may request other security (CTC 1488). In addition either of the parties can apply to the Court for sale of the threatened asset, the rights of the creditor then attaching to the sale proceeds.

(e) Liens

Liens may be defined as a right of retention exercised by a person in lawful possession of property entitling him to continue in possession until the debt due to him is paid. In the U.A.E. liens arise only by law (including commercial customary law) or under an agreement. The general provisions on liens are set out in Article 414 to 419 of the CTC.

A lien arising by law may generally be negated, discharged or superseded by agreement. There are no implied liens and no concept of equitable lien. Generally a lien does not give a right of sale. Alien is lost by payment of the debt or by surrender of possession of the property or by abandonment of the debt.[55]

3. Enforcement of Security in U.A.E.

The enforcement of mortgages of ships, aircraft or motor vehicles and pledges of shares in U.A.E. companies, court order following substantive action is required. The sale will be by public auction under the court's supervision.

Exceptionally, under Sharjah's special law on mortgages of land, the Director of Registration is required to sell the property by public auction without the institution of court proceedings.

Pledges of other moveable assets, in practice the situation is the same despite the apparent express power of sale contained in the Dubai and Sharjah Contracts Acts.

In an attempt to avoid this situation, pledgees sometimes require the pledged assets to be held outside the U.A.E. but it should be noted that this will not, no matter what the documentation contains by way of choice of law or jurisdiction clauses, in practice exclude the jurisdiction of the relevant Emirate/U.A.E. courts if:

i) the defendant (whether borrower or lender) is resident in the Emirates; or

ii) the pledge or any related facility documentation is executed in the Emirates; or

iii) the relevant transaction is performed in the Emirates.[56]

FOOTNOTES

Chapter 6

1. Rodney Short, "Western Banking in the Arab World", seminar, on "Islamic Finance", Paris, France, June 21, 1990.

2. Paper submitted to the International Bar Association (IBA) seminar, on "Islamic Finance", by Imtiza A. Pervey, Paris, France, June 20-22, 1990.

3. Rodney Wilson, "Islamic Financing Techniques", paper submitted to the IBA, Paris seminar, June, 1990.

4. Gavin Shreeve & Stephen Timewell, "Summer wishes, winter dreams", The Banker, November, 1990, at 74.

5. Mohamed El Fatih Hamid, Legal Adviser of Islamic Development Bank (IDB), paper submitted to the IBA Seminar, on "Islamic Finance", Paris June, 1990.

6. Ibid, at 12.

7. Imtiaz, supra, note 2.

8. A. Al-Bahar, Adviser on Int. Banking to Kuwait F. House, "Islamic Leasing", paper submitted to IBA Seminar on "Islamic Finance", Paris, June, 1990.

9. Peter C. Taylor, partner, Clifford Change, ["Mudaraba, Musharaka and Murabaha" Their Western Equivalents and Legal Issues Arising], paper submitted to the IBA Seminar on "Islamic Finance", Paris, June, 1990.

10. Al-Bahar, supra, note 8.

11. See generally, Airfinance Journal, April, 1990, at 4.

12. Saudi Arabia and Bahrain as example each have ship mortgage laws but no aircraft mortgage laws. Kuwait has a ship mortgage law and a rarely used aircraft mortgage law. Few states in the region have a central registry for the registration/recordation of security interests in personal property.

13. See generally Iqbal, "Islamic Banking", IMF occasional paper No. 49, March, 1987.

14. Saudi Economic Survey, April 18, 1990, at 2 and Middle East Economic Survey, April 23, 1990, at 3.

15. International Trade Finance, February 22, 1990, the Qatari bank will have significant minority government ownership, and at least two of these institutions will float shares to the public.

16. Id.

17. Remarks of Mr. Frederick W. Bradley, Jr., Senior v.P. - Aerospace, Citibank, N.A.

18. Neal Grenley, at the IBA seminar, on "Islamic Finance", Paris, June 1990.

19. N.A. Saleh, Unlawful gain and legitimate profit in Islamic law, 1986, at 8.

20. Ibid, at 10.

21. Qu'ran 2: 275. See also M.A. Saud, "Money, Interest and Qirad", in Studies in Islamic Economics, K. Ahmad ed. 1980.

22. N.J. Coulson, Commercial law in the Gulf states: The Islamic Legal Tradition, 1984, Graham & Trotman limited, London, at 87.

23. Qu'ran 6: 120; see also Ibid, at 102.

24. Supra, at p. 153.

25. Saleh, supra, note 19, at 102.

26. Ibid, at 62. If the aircraft were purchased directly from the manufacturer (istisna), the fixed price requirement could be problematic as manufacturers not infrequently include escalation clauses based on various economic indices.

27. Residual value guarantees would probably not be acceptable under Islamic law, but a properly structured option granted to a manufacturer to buy back the aircraft at a certain time for a certain price would probably be acceptable so long as the manufacturer had the opportunity to inspect the aircraft's actual condition at the time the option was exercisable.

28. See discussion in M.N. Siddiqi, "Muslim Economic Thinking: A Survey of Contemporary literature", in studies in Islamic Economics, K. Ahmed ed., 1980, at 216.

29. Saleh, supra, note 19, at 100.

30. The National Company for Cooperative Insurance was established in 1986 in Saudi Arabia with substantial Saudi governmental involvement.

31. For example, the only tax currently applicable to a whally - owned Saudi business entity is Zakat, an Islamic "wealth" tax at the rate of 2.5% imposed on accumulated net worth.

32. Supra, note 18.

33. In the U.S., for example, each of the fifty states has its own particular set of laws and constitutions, and in addition there is an overlay of a federal constitution and numerous "federal" statutes.

34. Saleh, supra, note 19, at 15, four schools are considered.

35. For a general discussion see Coulson, supra, note 22, at 14.

36. Saleh, supra, note 19, at 61.

37. Ibid, at 67.

38. Royal Decree No. M/15 dated 22 Safar 1386 (June 11, 1966), Articles 10 (1), (4) and (5). Kuwait has a similar law: Law No. 32 of 1968, as amended by law No. 130 of 1977, Article 66.

39. Exchange Rates and Currency Symbols, Information Guide, 1989 Ed., Price Water House, London, England, at 58.

40. The Act No. 131, 1948 in the official Egyptian Gazette No. 108 of 29/7/1948.

41. A cap is a financial instrument providing for the payment of a one-time fee by the purchaser, in return for the promise of a financial institution to pay the purchaser the difference between the capped rate of 12% and the floating rate if it is higher.

42. Ismail, supra, note 18, ch. III, at 171.

43. Esposito, "Perspectives on Islamic Law Reform: The Case of Pakistan", 13 Int'l law and Politics, 217, 1980.

44. Supra, note 39, at 139.

45. Civil Aviation in Pakistan, printed by Elite publishers limited Karachi, 1988.

46. The Gazette of Pakistan 2637 Ex-Gaz, Part III, 1979.

47. The Foreign Private Investment (promotion and protection) Act, 1976 (Act No. XLII of 1976).

48. President's Order No. 5, February 9, 1979.

49. Foreign Exchange Regulation Act of 1947, as amended by act, 1973.

50. Banking Companies ordinance (Ordinance No. LVII of 1962). The most important Pakistani banking laws can be found in K. Saeed-uz-Zafar, Banking Laws Manual, Lahore, 1985.

51. Jaffer & Anar, "Interest-free Banking in Pakistan", Int'l Fin. L. Rev., Dec. 1984, at 24.

52. R. De Belder & M.A. Khan, "Legal Aspects of doing Business in Pakistan", The International Lawyer, Vol. 20, No. 2, Spring 1986, at 535 and subs.

53. Priscilla J. Wood & Michel A. Chalhoub, "Securities in the U.A.E." Guarantee, pledge, Mortgage, lien", Butterworths Journal of International Banking and Financial Law, August, 1990, at 363.

54. Ibid at 364.

55. Wood & Chalhoub, supra, note 53, at 367.

56. Richard H. Turner, "Security and enforcement in Dubai and the other United Arab Emirates", Seminar on "Islamic Finance", Paris, June, 1990.

CHAPTER VII

SECURITY INTERESTS IN AIRCRAFT UNDER SELECTED AFRICAN COUNTRIES' NATIONAL LAWS

In Africa, airlines are proliferating because "every nation wants its own flag carrier". At present, there are about 80 airlines in Africa. Economic conditions in Africa have restricted airline development in recent years. African airlines' total passenger traffic currently amounts to about 35 billion revenue passenger-miles per year, which constitutes only about 2.5% of the world total. The airlines of the Arab countries in the North are in general larger and better equipped. In Black Africa airlines are smaller and have aging fleets.[1] Most intercontinental traffic moves to and from Europe, and airlines find it difficult to compete with the major European carriers on these routes. The Arab countries of Africa have good links with the Middle East, but few with Black African countries; the latter have few transatlantic or trans-Indian Ocean services.[2] African airlines face enormous foreign competition - the continent is served by 48 foreign carriers - and can no longer count on protection by their governments. Some individual airlines in North America and Europe perform more tonne-kilometers than all the African airlines combined.[3] Few African air carriers consistently earn a profit. Airlines in other regions of the world may talk of prospering. Yet, whether on a human or a corporate scale, the goal in Africa is more basic: to survive.

To date, African airlines have escaped most of the worldwide upheavals in civil air transport. Deregulation is viewed as a heresy, not as a competitive challenge. Yet, whether imposed internally or by outside forces, reform is inevitable. For in Africa, there are many airlines losing too much money by flying too few passengers on too many aging airlines. Barring an economic miracle, the 1990s will probably see the collapse of many - perhaps most - of the African carriers now in existence.[4]

For African airlines, the problems involved in the international transfer of aircraft are becoming increasingly evident as more and more carriers seek new equipment on the used aircraft market.

In conclusion, without change, the majority of African airlines will be left with only 3rd and 4th freedom traffic rights - and without links with a major CRS system, they may find themselves unable to take even a meaningful share of the 4th freedom rights, ultimately ending up with more financing problems. In this chapter, I will examine the concept of regionalism in Section I; the economic difficulties and limited prospects for recovery in Section II; the financial liquidity and need for a practical approach in Section III; the future for African Aviation in Section IV; finally, the national laws of selected countries as a broad view on the securities which can affect the aircraft in Section V.

SECTION I: THE CONCEPT OF REGIONALISM

Regionalism has been associated with cooperation between states of a particular geographical area of the globe, in contrast to world-wide multi-literalism, whereby such cooperation would involve a majority of world states.[5]

The more important factors that contribute towards the growth of regionalism are: the drive for peaceful external threats, affinity in ethnic origin, culture, language, tradition, ideology, economic inter-dependence or sufficiently important common interests.

The primary motivation for regional integration, particularly among Third World countries, has been the alleviation of the economic circumstances of the participants. Julius Okolo[6] has observed, however, that while regional integration efforts have been fairly successful among the more advanced countries, no scheme in the Third World has yet achieved concrete success.

The application of the concept of regionalism to civil aviation on a wide scale is a fairly recent occurrence. The trend originated in the early 1950s to

formulate a common policy towards non-scheduled air transport and has since been extended to include cooperation in areas such as: establishment of joint air transport organizations to exploit the economic potential of air services; and commercial air transport matters such as the setting and enforcing of tariffs, a common regional approach on the exchange of traffic rights, etc.; finally technical matters such as common overhaul and maintenance centres, regional training centres, joint navigational centres, etc.

Regionalism in civil aviation has been applied through consultative organizations among states, or between airlines.

A. REGIONAL AVIATION COOPERATION AMONG STATES

1. ICAO's Assistance to Regional Organizations

The foremost grouping of states for purposes of coordinating civil aviation matters on a worldwide basis is ICAO.[7] Its activities span both the technical and economic fields and, in the circumstances, it may be asked what role regional civil aviation organizations should play. In the technical field, ICAO plays a role that is more or less comprehensive and leaves little scope for supplemental contribution by states on a regional basis, other than in a few areas such as air traffic control and training or else in overseeing the implementation of ICAO standards and recommended practices on a regional basis.

In the economic field, ICAO's endeavours toward securing a multilateral regulatory regime did not succeed. Neither has bilateralism been entirely successful particularly in organizing aeronautical relations between states of unequal bargaining strength.[8]

Furthermore, there are significant problems that the Chicago Convention was unable to provide for, and which may be more susceptible to resolution on a regional basis. As Rosenfield[9] observes:

> "Different areas of the world have particular aviation problems which are peculiar to the region. These problems are better tackled by the aviation agencies of the governments of the area than by an international organisation such as ICAO. These regional problems vary widely, from those of Africa, also common to other developing areas of the world with young and relatively inexperienced underdeveloped national and international support systems, to those of Western Europe whose regional problems stem from the sheer quantity of international commercial traffic and highly sophisticated systems, which, from sheer volume in relation to the size of the count ies requires a great deal of close cooperation."

However, ICAO has played a very important role in encouraging the development of regional civil aviation organizations. Article 55(a) authorizes the ICAO Council, where appropriate, to create subordinate air transport commissions on a regional or other basis through whom it may deal to facilitate the carrying out of the aims of the conventions.

This article has been liberally interpreted by ICAO to allow for sympathetic treatment of inter-governmental civil aviation organizations by ICAO in various ways. Article 83 of the Chicago convention permits states parties to the convention to conclude agreements that are not incompatible with the aims of ICAO. Such incompatibility could involve duplicating ICAO's functions or undertaking activities that frustrate ICAO's effort.

In order to strengthen its capacity to assist the regional organizations, the ICAO Assembly adopted resolution A12-18 directing the ICAO council, inter alia, to keep in close touch with regional organizations and give sympathetic considerations to requests for assistance received from such bodies[10].

ICAO has continued to demonstrate a keen interest in the activities and role of regional organization in confronting the problems facing international civil aviation.

2. The United Nations Economic Commission for Africa

The United Nations Economic Commission for Africa organized a conference in Yamoussoukro, Ivory Coast in 1989, to discuss the future of the Continent's Civil aviation industry. In total 36 African transport ministers attended the conference and they agreed on a policy to restructure the industry. The policy was outlined in a paper issued at the end of the conference (the Yamousscukro Declaration).

The ministers were particularly concerned about the possibility of the European carriers forming so-called mega airlines.

The ministers also noted that only Ethiopian airlines is a profitable operation. This results in African carriers being unable to modernise their fleets both to reduce costs and provide more appeal in the market. As 80 percent of African international traffic is tied to Europe, the airlines are worried both by age of their fleets and the possibility of European mega carriers turning their continent into battleground.

Given the reality the European carriers cannot be forced out of the market due to bilateral considerations, the ministers agreed that the answer was for African airlines to form groupings to better resist the power of the northern operators. They gave African eight years to develop integrated airlines and the Yamoussoukro Declaration identified five main regions - north, south, east, west and central.

The declaration was adopted by a broad consensus but it remains to be seen if the governments of Africa will adopt the policy, given the "necessity" many states place on the ownership of a flag carrier.[11]

B. REGIONAL COOPERATION AMONG AIRLINES

Another form of regional civil aviation organization is that one created to serve the interests of airlines based in one region. Cooperative arrangements

between such airlines have taken several forms including combined maintenance and training, pooling agreements, blocked space agreements, interchange of aircraft, joint airline purchasing and financing, and the creation of a single multinational airline to operate as the "chosen instrument" of a number of regional governments, etc.[12]

Regional airline organizations exist in all regions of the world: in Africa, there is the Association of African Airlines (AFRAA); in Europe, the Association of European Airlines (AEA); in Latin America, the Association of Latin American Airlines (AITAL); in Asia, the Orient Airlines Association (OAA); and in the Middle East, the Arab Air Carrier Organization (AACO); in the United States, the Air Transport Association of America (ATA) and in Canada, the Air Transport Association of Canada (ATAC). The membership in all these organizations is commonly limited to airlines engaged in scheduled operations only.[13]

1. Regional Airlines in Africa[14]

The thrust of attempts to form regional airlines into stronger units in Africa, although aimed at optimizing the resources and existing assets of the fragmented, weak, and unprofitable national airlines of Africa, also seeks to improve intra-African lateral links between countries and cities. The aim of the regional airlines concept is in essence to see the formation of integrated feeder operator airlines interlining with trunk-route operators. Both segments must be made up of African airlines in a geographically and economically feasible area.

Dedicated efforts are being made by sub-regional organizations and increased attention is being given to the concept of the development of regional airlines. A comfortable and workable framework design should allow some measure of country-airline identity and/or an equitable share in the operating revenue from these bodies.

A framework in needed which will rationally addressed the sensitive

question of sovereign interests in the current situation of differing levels of economic development of the states which would form the regional airline groups. This situation would place the African sub-regional airlines, as would emerge in time, on a stronger bargaining platform to be able to compete, pool or mutually nurture and take advantage of the potential which its own market provides.

Once these stronger sub-regional airline companies are created, their commercial viability would afford them some surplus to devote to developing essential new trade routes under the African Airlines Association Grid System network. This network would be supported by coordinated scheduling to reduce waste in empty seats and poor loads on certain route sectors, and by development of new routes. It is expected that the existing liberalized rights, a better coordinated network and operating schedules will lead to the gradual reduction of tariffs in the market. These more viable units of regional airlines would better attract capital for financing more modern fleet acquisitions; the establishment of better utilized and cost-beneficial major regional maintenance centres to contribute to lower operating costs, and reasonable insurance premiums.

The net effect would be to reduce the level of tariffs under the African Air Tariff Conference umbrella.

In conclusion, the operating cost factor is a major market requirement for a regional airline of the new generation. The frequently narrow financial cover of small regional carriers work in two ways: a high investment is necessary for buying an aircraft, while on the other hand, the direct operating costs are to be kept as low as possible. In order to remain competitive, aircraft manufacturers have to go for minimum values both in price and in the direct operating costs.

As a target value for a new aircraft, the customers ask for an average direct operating costs advantage of at least ten percent compared with the

nearest competitor.[15]

Although regional authorities are capable of participating financially in the creation and/or operation of air networks involving regions, in light of the problematic African financial situation, they are not likely to be an active source of finance to regional airlines.

SECTION II: ECONOMIC DIFFICULTIES AND LIMITED PROSPECTS AIRLINES' RECOVERY

Africa, more than any other region, is gravely threatened by economic crisis. It is the only area of the world where national growth rates are often negative. The causes of this crisis - aggravated by the severe drought of the past several years - are many and complex. African countries came to independence, by and large, less developed than countries on other continents, and have suffered from deteriorating terms of trade during the last several years.

The average African today is poorer than he was in 1970 According to World Bank data, average per capita gross domestic product in Africa has declined by about 4.5% since 1970. Unless current trends are reversed, African standards of living will continue to deteriorate. Without renewed growth, the threat of famine and starvation will continue, and they will increasingly be subject to political upheaval and instability.[16] The fortunes of the airlines are inexorably tied to those of the continent's economies.

Although most Africa-Europe bilateral air agreements specify an equal capacity share to the host countries' airlines, many African nations lack the number or the type of equipment to match the frequency of European rivals. No carrier based in Black Africa can afford to buy planes with internally generated funds. Without more equipment, the airline cannot improve its earnings; yet lacking sufficient profits, banks and other lenders refuse to provide the funds, especially for wide-body jets that cost up to U.S. $125 million each.

The African Civil Aviation Commission estimates that during the next 20 years African carriers will need to spend U.S. $32.5 billion for an additional 650 jetliners. Some of these planes will be used for expansion; others will replace inefficient first-generation jets such as 707s and DC-8s, over 100 of which are still operated by African carriers. Although such planes are pariahs at virtually all airports outside the Third World, they still form an essential backbone of the African air transportation system.[17]

The share of world air transport demand carried by airlines based in Africa is small and,because of the continent's geography and history, tends to be further divided amongst a multiplicity of carriers. These characteristics, when combined with the fragile state of many African economies and the lack of air transport infrastructure, sum up the problems which continue to face operators. The total air transport output of Africa is currently below the output of individual key airlines like Air France, British Airways, Lufthansa, and Pan American, and yet is these kinds of international operators which are in head-on competition with emerging African participants. While smaller, specialist regional or charter airlines in Europe or North America can compete with the established giants by picking on weak points in their networks, the Africans have to match the giants on long-haul, international services. Factors such as these explain the general African preference for the IATA system of tariff co-ordination and for restrictionist bilaterals usually including a requirement for pooling. It also explains not always successful attempts for interairline co-operation.

Within the continent itself, there is a wide disparity of carriers and states. The group, including Egypt, Algeria, Morocco, Libya and Tunisia, has many of the characteristics of the Middle East. The group of Black African states south of the Sahara also has a mixture of members with some having successfully banded together to produce the multinational airline Air Afrique while one other, Nigeria, is an exception because of its large population and its oil wealth. Nations in the middle of the continent have the lowest per capita incomes and

generate the lowest levels of travel per head of population. Air Afrique provides the Yaoundé Treaty states (Benin, Central African Republic, Chad, Congo, Ivory Cost, Mauritania, Niger, Senegal, Togo and Upper Volta) with longer-range international services. It is the largest Black African operator, being larger than Nigeria Airways, and has demonstrated a cohesion that East African Airways, which had provided a joint airline operation for Tanzania, Uganda and Kenya until it collapsed in 1976, failed to develop.

The airlines based north of the Sahara are generally larger than their southern neighbours and tend to look either north to Europe or east to the Arab states for technical cooperation.

African airlines, generally government controlled, fulfil the role of national flag carriers and as such have bought flagships on which to display their nations' colours and promote national prestige. Several airlines are therefore personified by a solitary 747 or DC-10-30 heading a small fleet often without the traffic or the utilization to justify its operation.

Financial results, however, are not necessarily the driving force behind airline decision making. With large land masses and poor ground communications, the airlines provide a social service to many areas, and with low domestic fares, heavy subsidisation occurs. Fares to and from Africa tend, however, to be high by international standards and there are some arguments that this holds back growth. The nature of the traffic, largely business but with clearly identifiable flows of leisure travellers to particular points, often places the receiving nations at a disadvantage. This is another reason why tight bilateral treaties tend to be the rule and why most African countries continue to restrict the activities of charter airlines.

A high proportion of the fleet, particularly of the Black African group, is not noise certificated and have been progressively banned from European and North American airports over the years 1986-88. However, when the nature of

the debt is examined and the fragility of the economies considered, the figure takes on a greater significance and will be a major restraint on fleet replacement. The nature of the debt changed significantly during the 1970s so-called soft loans, such as those from the International Development Agency - 50 years with a ten-year grace period, and a service charge of 0.75% - dwindled from over half the continent's total debt in 1971 to 38% in 1980. With Western economies governed by austerity-minded administrations cutting back severely on such concessionary loans, African countries have borrowed more under harder terms to make up the difference.

The hardest of these terms are those with a variable interest rate. This form of credit grew from 3% of the total debt in 1971 to 21% in 1980, and now with interest rates at high levels the burden of debt has proved too much for several countries to bear. Such countries have traditionally had relatively little access to loans from private banks, and therefore have been somewhat protected from fluctuation in the minimum lending or prime rate. Private banks have stricter lending criteria which few African countries can meet.[18]

It is against these kinds of statistics that problems - frequently highlighted by IATA - of blocked remittances have to be judged. The airline association has its own list of offending nations and has attempted to plead on its members' behalf. Apart from the problems for the African airlines of funding new equipment, airlines serving the continent find it more and more difficult to convert their earnings in local money to hard currencies.

SECTION III: FINANCIAL LIQUIDITY AND NEED FOR A PRACTICAL APPROACH

Africa represents the least developed of the world's aviation markets, yet its financing requirements probably demand more innovation, greater risk assessment and evaluation, and certainly greater grit and determination on the part of financiers than any other geographic sector of the aviation market.

A. PAST EXPERIENCE

We have to understand this massive requirement for finance in the historical context of aircraft financing arrangements in Africa. Both the airlines and the financial institutions in the coming years will have to learn new approaches; in particular, both sides are going to have to address the conflicts that arise from current practices. Already, some major shifts in financing are under way. Some very large foreign banks have become players for the first time. Finally, asset-based finance has become a major mechanism in structuring these transactions.

This move to asset-based finance is good for African airlines, because it increases their choices among lenders and enlarges the global pool of funds from which they can draw. It is also good for the banks, because they can lend to airlines that would not have been on their calling lists a few years ago. Although asset-based finance has been highly appropriate in Africa and therefore essential to the success of some aviation transactions, it is not a cure-all. It often creates as many problems as it solves. In particular, the airlines complain that it restricts their freedom of action. The reason for this is that the financier tries as much as possible to "de-Africanise" such a transaction, eliminating as many elements of African risk as possible. In pursuit of this goal, financial institutions have been following a fairly standard set of procedures:[19]

i) They only finance aircraft used for international traffic. This ensures that the aircraft generates foreign exchange, but more importantly, that it travels outside the borrower's country and preferably outside of Africa, making it more vulnerable to seizure.

ii) They insist upon a lease structure that keeps ownership abroad, thus obviating the need for local mortgage registration;

iii) They demand foreign registration or deprivation-of-use insurance, so as to eliminate political considerations should repossession

become an issue; and

iv) They insist on foreign maintenance standards, or require that the aircraft be serviced abroad, regardless of the quality of local standards and service. This helps to uphold asset value, but once again it provides opportunities for repossession.

Only rarely can an African airline readily comply with these four demands. In almost every case, the airline must alter its service and its established management practices, sometimes at considerable cost. This is particularly aggravating where the financier has not taken the trouble to fully explain his need for these protections.

The financing institution is often much too concerned with political risk, obscuring the more dangerous financial and economic risks. The most important considerations are the viability of the project and the value of the security. The only real political risk is that the airline and the government will refuse to release the aircraft and its records in the event of default.

A key point to remember is that there has never been a successful expropriation of a commercial jet aircraft. The political risk loss experience with aviation has been excellent. Furthermore, if we look at the historical record of economic difficulties in Africa, we find that the airline is immune from financially self-destructive practices. Local pride in the national airline and the high value inherent in aircraft themselves, as physical assets, virtually ensure special efforts to repay loans, so as to protect the asset, the airline, and the nation's self-respect. The airlines themselves are often their own enemies in financing equipment purchases; largely because of national pride, they insist on acquiring new rather than used aircraft. Experience shows that a stand-alone acquisition of a new aircraft rarely satisfies the economic and business criteria for an asset-based financing facility. New aircraft is so expensive that the down-payment or equity contribution necessary to support the deal is beyond the airline's or the

country's resources. Furthermore, new aircraft require an investment payback period of fifteen to twenty years. For the project to be self-financing, financiers must accept repayment over a similar period. However, they are reluctant to build such long terms into transactions, because over time the political risks tend to overshadow the economic considerations. Despite these disadvantages, which make used aircraft much more appropriate from a financial and investment perspective, Africans' experience with the perverse logic of marketing new aircraft supports their natural preference for the new rather than the used.

Today and in the future, African governments and airlines must choose economically-sound options if they are to acquire the number of aircraft they need to meet growing demands for service. The dilemma facing African airlines is how to improve and extend air service during a time of economic and financial crisis all over the continent. A number of different participants in aviation finance can help solve this problem:

i) The airlines can help by accepting economic realities. They must recognize the risks faced by the financiers and adapt to help overcome them. They must abandon their insistence on new aircraft and look instead for the most economical solutions to equipment needs.

ii) Second, the manufacturers must recognize that over time there will be more aircraft sales if the airlines are allowed to expand and develop economically and profitably, building fleets to optimal revenue-generating size rather than spending all of their resources on a few new prestige aircraft. The manufacturers should support sales of their used equipment in cases where the seller cannot: after all, every used aircraft sold from the developed world to Africa creates a replacement need at the selling airline.

iii) The financiers must learn to compartmentalize transactions, bringing in specialists to underwrite each element of risk.

The risks need not be borne solely by the financier and the manufacturer. For example: African bankers should underwrite the purely African risks; asset financiers should underwrite the asset value risks; leasing companies and aircraft traders can take the residual risks; development institutions such as the World Bank, the African Development Bank, and others should provide the so-called "equity" funding to bridge the gap between the cost and the level of asset finance; selling airlines should provide maintenance, training, and spares support during the introductory period.

With special regard to the asset financiers, there is a need for them to become more positive about this market and more aggressive in penetrating it. They cannot continue to rely upon the manufacturer to provide their business opportunities - they must carry their special skills to the buyer. African airlines generally are unaware of techniques and resources available to them, and lack the experience to structure their own financial packages. The financiers thus have a special responsibility to adapt techniques and structures available in industrial countries for application in Africa.

B. FUTURE OPPORTUNITIES

African airlines today possess a good base of aircraft assets, most of them unencumbered and well depreciated. If financiers apply conventional asset finance techniques to the sale and leaseback of these aircraft, they can provide the airlines with cash resources. Many African airline executives are unfamiliar with such techniques, at least partly because few specialists in aviation finance have made the effort to propose them and to educate their clients about their usefulness.

From a practical point of view, however, reality is never as orderly as

theory. No matter how well a financial deal is structured, there are and always will be problems, especially payment problems. Unless the financiers and deficiency/loss guarantors are prepared to be repossessing aircraft constantly, flexibility and understanding of the local political/economic climate are indispensable.

One must understand, first, the African governments, and then the African airline's point of view, in order to play in the African marketing game.

1. From the African Government Perspective

There is a real psychological need to (a) buy a new aircraft, (b) own it, and (c) register it locally; foreign exchange is scarce; ninety percent of the country's foreign earnings come from one or two export products; the national airline is a net foreign exchange drain; the country's foreign debt is probably being rescheduled; the IMF has imposed an austerity package that prohibits government guarantees on medium-term aviation debt; the monthly IATA Clearing House net debit position is a high priority of the Central Bank but remains a drain on scarce resources; and foreign exchange insurance premiums present another major foreign exchange drain, so premiums must be monitored.

2. From the African Airlines' Perspective

Foreign banks and manufacturers are working together to force the airlines to accept proposals that are neither fair nor realistic. As well, they are facing special local problems. For example: devaluation effects on local fare structures; subsidies to Ministries of Tourism or Transport; foreign exchange payments for fuel, insurance, spares; keeping some foreign exchange receipts to pay for daily operations; trying to avoid repossession by unpaid suppliers; aircraft on ground spares requirements 4,000 miles from sources; non-payment of government receivables; non-payment of government capital contributions;

scheduling disruptions due to politicians taking aircraft; political second-guessing on commercial decisions; political orders to buy technically/commercially/ financially inappropriate aircraft; no money to pay for tickets, with two week lead time; illegal local ticket sales; four times the needed manpower, but no authority to fire; and finally, constant pressure to improve yields.

These local conditions, which are common to most of the African countries and other Third World countries, require understanding and flexible treatment on the part of manufacturers, asset financiers, and political risk financiers/insurers; and on the other hand, the countries themselves have to make efforts to eliminate such local problems.[20]

In conclusion, one reason why the aviation finance specialists have avoided Africa is the continent's well-earned reputation as a tough market in which to do business. But air transportation is inescapably the best solution to service Africa's immense distance; and poorly-developed rail and highway connections ensure that aviation's future in Africa will be bright.

Because of this one might inquire as to the necessity of an African country to own its aircraft, what they really need is an air service. Why not contract for the service from others with capability?

However, a commentator[21] stated his belief that there is need for creation of new regional airlines (ideally one for each of the fine existing economic regions of Africa-North, South, Central, East and West) which would provide inter-continental and inter-regional services for their specific region. These airlines would be jointly-owned by the states belonging to the regional economic/trade association, for example ECOWAS, assisted by some private investment.

While many African nations would wish to retain their national carriers certain operating restrictions would be necessary to prevent over capacity. One solution would be to limit national airlines to domestic and intra-regional

services, leaving international and inter-regional operations to the new "umbrella" airlines.

SECTION IV: THE NATIONAL LAWS OF SELECTED COUNTRIES

The sources of Africa's civil aviation law and policy are various. The region's political economic as well as its historic relationship with Europe are significant influences. Its civil aviation law and policy nevertheless cannot be abstracted from the international legal framework. In the following section, due to the difficulty in obtaining some of the existing materials, some legal aspects of the national laws of only two countries, namely: Nigeria and South Africa will be pointed out.

A. Nigeria

Nigeria continues to be governed by the military, which assumed power in 1983, and the economy has continued to experience drastic changes in economic policies.

1. Ownership

The following persons and no other should be qualified to be owners of a legal or beneficial interest in an aircraft registered in Nigeria or a share therein: (1) citizens of Nigeria; and (2) bodies corporate established under and subject to the laws of Nigeria. As well, if an unqualified person residing or having a place of business in Nigeria is entitled as owner to a legal or beneficial interest in an aircraft, or a share therein, and he has the right to register his aircraft in Nigeria. But the person aforesaid shall not cause or permit the aircraft, while it is so registered to be used for the purpose of public transport or aerial work. There is, however, no special statutory protection for an owner of an aircraft.

2. Foreign Exchange

The law is strictly enforced in Nigeria in a bid to check illegal trafficking in currency. There is no doubt that the government through the Central Bank of Nigeria will give its approval for payments outside the country where such payments can be adequately supported by documents and justly defended.

3. Mortgages

Neither the Minister nor Ministry of Transport and Aviation maintains a register of mortgages created in respect of Nigeria-registered aircraft. However, the mortgage may need to be registered with the registrar of companies under the provisions of the Companies Act. Under this act, priority will be determined according to the time of entry of the mortgage on the Register. And failure to register will render the mortgage void against the liquidator and any creditor of the company. It is suggested that a registered mortgage under the Companies Act is subject to: (1) prior registered mortgages; (2) repairers' lien; and (3) certain statutory rights of detention.

Since a mortgage is an interest in the aircraft, any such mortgage must be brought to the knowledge of the Minister as a change that has occurred in the ownership since the registration of the aircraft.

4. Tax Benefits

There is no special tax benefit for the aviation industry. The owner or operator of an aircraft, like any subject to the laws of Nigeria, pays tax in accordance with the Companies Income Tax Act.

5. Registration

An aircraft shall not be registered or continued to be registered in Nigeria if it appears to the Minister for Transport and Aviation that: (1) the aircraft is registered anywhere outside Nigeria; or (2) an unqualified person is entitled as owner to any legal or financial interest in the aircraft or any share therein; or (3)

it would be inexpedient in the public interest for the aircraft to be or to continue to be registered in Nigeria.

Finally, the Federal Republic of Nigeria is a signatory to the Geneva Convention, 1948,[22] which gives any foreign creditor or mortgagee a reasonable assurance that their interests are duly protected, and enforced in connection with Nigerian law.

B. SOUTH AFRICA

South Africa's economic and political dislocation has an adverse impact on the country's aircraft financing as in most of the African countries.

1. Mortgages

In South Africa, it is not possible to register any rights held in or over an aircraft by third persons. The establishment of a register recording certain real rights in aircraft has been recommended to the government by the Commission of inquiry into civil aviation in South Africa; however, it is not known if and when such a register will be established.

2. Registration

Application for registration of an aircraft must be made to the Commissioner for Civil Aviation (CCA) and, except in special cases, a certificate of registration will only be granted to a South African citizen or to any firm, company or any other organization which is registered and has its principal place of business in South Africa and in respect of which the executive head and at least two thirds of the members of the controlling body are South African citizens. The new owner of the aircraft must, within 14 days of the change of ownership, apply to the CCA for registration of the aircraft, and, if he fails to do so, the registration is deemed to have lapsed.

There is no requirement that the legal owner of an aircraft be registered

owner. Thus, where an aircraft is sold under an instalment sale agreement, as is most frequently the case, ownership will remain vested in the seller until the full purchase price is paid. However, the aircraft is normally registered in the purchaser's name with effect from the date upon which the agreement is concluded with the seller.

3. Tax Relief

Any person who is resident in South Africa or any domestic company which, during any year of assessment, concludes a contract for acquisition of an aircraft in South Africa is entitled to an initial allowance of 40% of the adjustable cost of the aircraft. The concept of group relief is unknown in South Africa income tax law and accordingly tax benefits, allowances or deductions cannot be surrendered among group companies.

4. Liability

The Aviation Act of 1964, imposes absolute liability for surface damage on the owner of the aircraft. The word "owner" means the person in whose name the aircraft is registered and includes any person who is or has been acting as the agent in South Africa for a foreign owner. A lessee is liable as the owner where the aircraft has been bona fide leased for more than 14 days and no operative member of the crew is in the owner's employ.[23]

FOOTNOTES

Chapter 7

1. The DC-10 is the most common wide-body type and they have few B-47s.

2. D. Woolley, "airlines", Air Finance Annual 1989/90, at 114.

3. In fact, Africa's share of total scheduled international air traffic in 1986 was barely 4% and such passenger traffic in 1985/86 actually declined by 6% - again the weakest performance in the industry.

4. D. Martindale, "Too Many Airlines", Airline Business, March, 1988, at 38.

5. H.A. Wassenbergh, "The Future of Multilateral Air Transport Regulation in the Regional and Global Context", A.A.S.L., Vol. VIII (1983), at 263.

6. J. Okolo, "Integrative and Cooperative Regionalism: The Economic Community of West Africa", International Organizations, 39, 1, Winter 1985, at 121.

7. On the role and activities of ICAO, see, B. Cheng, The Law of International Air Transport, Stevens & Sons, London (1962).

8. ICAO Doc. 9199, SATC (1977), op. cit., at 14.

9. Rosenfield Stanley B., The Regulation of International Commercial Aviation, Oceana Publications, N.Y. (1983), Booklet No. 14, at 3.

10. Ibid, at 11.

11. CIS No. 4359, January 20, 1989, (payload Asia, January, 1989) at 5.

12. Wassenbergh, supra, note 5, at 268.

13. L.G. Kamau, Recent Activities of the African Civil Aviation Commission (AFCAC) and the Association of African Airlines in the Field of Traffic Rights and Tariffs, LL.M. Thesis, McGill University, Montreal, Canada, August, 1985.

14. F. Okyne, extract from the paper presented at the AMDA Conference on "Deregulated Airline Management Thinking", Montreal, 24-27 May, 1987.

15. J. Simmerl, "Market Requirements for a New Generation Regional Airliner", Dornier Post 2/87, at 6.

16. J.C. Whitehead, "The African Economic Crisis", Department of State Bulletin (U.S.), January, 1986, at 33.

17. Martindale, supra, note 4, at 39.

18. "African recovery restrained by debts", Lloyd's Aviation Economist, October, 1983, at 6.

19. "Africa's Commercial Aircraft Requirement", Interavia Air Letter, No. 11,272, June 3, 1987, at 3.

20. F.H. Kennedy, "Aviation Financing the Need for a Practical Approach", ITA No. 45, September/October, 1987, at 8.

21. John Tambi, Aviation Planner Port Authority of New York & New Jersey, "What future for African aviation?" IATA review, No. 3, 1988, 3 at 5.

22. B. Ajibola, Bola-Ajibola & Co., Mr. Ajibola is the Federal Attorney-General and Minister for Justice in Nigeria. "Nigeria", Airfinance Annual, 1986-87, London, at 164.

23. A. Vardy, B. Gilillan, "South Africa", Airfinance Annual, 1986-87, at 170.

CHAPTER VIII

SECURITY INTERESTS IN AIRCRAFT UNDER SELECTED LATIN AMERICAN COUNTRIES' NATIONAL LAWS

For a generation, from the late 1950's to the late 1970's, Latin America as a whole grew by 6% a year in real terms to restore economic growth. But since the debt crisis erupted in 1982, and despite near-term successes in some countries, aggregate growth has been negative. Per capita income has fallen to roughly 1976 levels, industrial sector unemployment, seldom a problem in the past, has become serious. The Latin American experience is currently marked by the social and political strains associated with the adjustment measures needed to renew growth. Each country must make tough decisions on how to stabilize and restructure its economy. The international community can help in this effort and can cushion the impact of reforms. But domestic adjustment must come first, because international help will fail without it.[1]

Latin American, as a region, continues to struggle with its enormous foreign debt burden. Various nations have enacted or further developed legislation governing "debt-equity swaps".[2] In addition, certain measures have been taken to attract private foreign investment and transfers of technology, particularly within the Andean Common Market (that is, Bolivia, Colombia, Ecuador, Peru, and Venezuela).

Aviation legislation in Latin American countries constitutes in most cases the basis for establishing provisions with respect to security arrangements concerning aircraft. In most cases, the provisions of the aviation acts of such countries will prevail over those contained in their civil codes.[3]

Sources of aviation laws in Latin America may be distinguished in two groups of countries: the first group contains countries where there is no special aviation legislation at all. It is the smaller group and there, aviation matters

including questions of security in aircraft are subject to rules of the general civil and commercial laws.

The other group consists of countries with special aviation acts but containing no provisions relating to security in aircraft. In those countries, the situation may be identical to those above except where non-dispossessory interests in chattels were introduced by special decrees creating the non-dispossessory industrial prenda.

However, the majority of Latin American countries not only adopted special aviation legislation but also enacted provisions regulating security interests in aircraft covering both prenda and hypotheca.[4]

SECTION I: FINANCIAL CONSTRAINT ON THE GROWTH OF LATIN AMERICAN AIRLINES

Commercial air transportation has emerged as one of the most important sources of foreign currency in Latin America, and several countries on this financially-beleaguered continent are liberalizing their commercial air transportation policies by allowing two or more of their national airlines to carry their flags and passengers to foreign destinations to try to attract more outside business. Economic crises have grown even more acute over the past few years throughout the region, a factor that has a heavy impact on the growth of industry across the board, including air transportation. The economic problem is reflected in the generally slow equipment acquisition process that forces airlines to operate inefficient airplanes on both domestic and overseas routes.

Latin American carriers need new aircraft to compete with the U.S. airlines that are controlling almost all air traffic; but financing, even leasing, presents problems. Frequent changes in government and airline leadership, insufficient radio and navigation aids and the need for improved airport facilities are also cited as hindrances to modernization.

Yet there is a high state of morale and a proud heritage in the airline business in Latin America. Total demand for new commercial jet aircraft in the region between new and the year 2006 is forecast in a separate evaluation by Airbus Industry to be 653 units or 6.6 percent of the total worldwide demand. This tallies roughly with ICAO figures showing that Latin America scheduled airline service accounted for 5.9 percent of the total world passenger-kilometers in 1986.

Aircraft operating leases are the obvious alternative for many Latin countries, because leasing does not appear on the debt side of the country ledger, but leases gather no asset value, i.e. no equity buildup.

Countries with balance of payments restrictions must get government approval before they can take delivery of aircraft. Lease companies must also be concerned with the repatriation of funds.

Some countries require that profits made in the country remain there. However, one advantage from the lessor's point of view is the more rapid decisions which result from the fact that a lease is a shorter-term commitment than a purchase. Furthermore, the lease is not a capital expenditure but a periodic payment, thus a smaller amount of money is sent out of the country at any one time, preserving the balance of payments. The difficulty facing both aircraft manufacturers and lessors is that national governments frequently change office. This usually means new senior management for the flag carriers, and often means that the aircraft sales cycle exceeds the tenure of the purchasing executives.

Most private airlines take a long-term view of their business and will listen to arguments favouring long range buying decisions for new aircraft. But a government appointed official at a national carrier may be more concerned with the immediate future - the need to economize today - and may limit his view of the future to his term of office.

New aircraft are rarely, if ever, sold under such conditions because such sales cannot be justified economically.[5]

SECTION II: COOPERATION IN LATIN AMERICA AND ITS FUTURE

The current situation of civil aviation and air transport in Latin America, means that there will be a number of technical challenges to be faced in the 21st Century. These must be met in a pragmatic and courageous spirit if Latin America as a whole is to compete under as favourable conditions as possible, within reasonable limits which stem from the varying levels of development in the individual countries.[6]

The structure of the Chicago Convention of 1944 and its Annexes allows for their adaptation to the potential aeronautical requirements of the 21st Century. Peace and international co-operation are two fundamental principles of the Chicago Convention. Civil aviation can be understood only within this context of peace and co-operation among the peoples of the world, which can help to create a better understanding among them. The message of the Chicago Convention was heard in various regions of the world and, always within the framework of that legal instrument, agreements began to come into being. These agreements, under the same guiding principles of peace and co-operation, enabled the countries of a region to strengthen their bonds of co-operation and to solve problems which due to their regional character, called for more local perspectives and decisions. In the case of Latin America, this effort was embodied in the establishment in December 1973, of the Latin American Civil Aviation Commission (LACAC), whose statute has been approved by 20 countries in the region. LACAC has worked intensively on aspects of common concern to Latin America, largely concerning legal matters, costs and tariffs, statistics, air transport policy, non-scheduled air services, organization of aeronautical courses and seminars, etc.

More recently, LACAC has entered another field: the control of illicit air transport of drugs. This has a significant impact on commercial aviation relations with other countries, particularly with the United States.

Nevertheless, 16 years after the establishment of LACAC, the time has come to think about the need to update the mechanisms provided for in its statute and thus enable it not only to meet the demands of modern technology but also to broaden the scope of its activities so that the cooperation it fosters may be adequately extended to international air law.

Furthermore, Latin American co-operation in the field of civil aviation must address issues of immediate concern and outline certain options to be refined in the years to come. At the conclusion of this century, most of the approximately 400 commercial aircraft currently utilized by Latin American airlines, essentially first-generation jet airplanes, will be unable to fly on routes to the United States and other industrialized countries if no solution is found to certain problems, chiefly related to noise. To this should be added the fact that by that date,these aircraft will have served an average of 20 to 25 years,making their continuing operation risky and extremely expensive.

Consequently, the Latin American countries should begin to study the ways and means of acquiring new-generation equipment, more compatible with the technology of the coming decade, which will enable them to compete with the airlines of the more developed countries. This situation poses serious budgetary problems, especially for the less developed countries of Latin America. Under such difficult circumstances, the only solution would be for groups of Latin American countries to band together for the purpose of jointly negotiating the purchase, lease or rental of these new aircraft. We are not yet speaking here of the possible establishment of a "Latin American Airline" or "sub-regional airlines", but of the economic advantage that results when a group of several countries acquires a common equipment - in this case, for air navigation; such negotiations can lead to more favourable conditions due to the

size of the group involved and can result in better prices and ancillary services. The same considerations also applies inter alia to aeronautical communications equipment and aids to air navigation, which are becoming more and more costly owing to their increasingly sophisticated technology.

The equipment acquired throughout Latin America, both airborne and ground-based, should be of similar make and type, since this would create more favourable conditions not only for its purchase but also for maintenance and repair.

Another important facet of this type of cooperation is the professional training and periodic updating of the pilots who fly these aircraft. This calls for schools offering basic or advanced training, as required, as well as costly equipment; an important component is the flight simulator which enables future pilots to practice their skills and qualified pilots to update their competency or obtain new ratings. Similar measures could be taken in other spheres of aeronautical activity, such as engineering, communications, airport administration, and so on.

If some type of joint programme for civil aviation and air transport in Latin America could be set up through the Latin American Economic System (SELA) in coordination with LACAC, it would be advisable for the Member States to recommend that as far as practicable any air navigation equipment purchased should be of the same make and of similar model, particularly as regards the training of flight crews, aircraft maintenance and purchase of replacement parts. This would result in significant financial benefits for the airlines.

Consequently, the year 2001 should find the Latin American countries well on the way to developing frontier air transport, whether for passengers or freight or for other types of mutually agreed movement in border regions.

However, certain worldwide phenomena which have intensified in recent years, particularly international terrorism and the illicit transport of drugs and

other psychotropic substances, have made it necessary to resort to various security measures, some of which have already been adopted while others are about to be implemented. Therefore, it is more necessary now than ever before for LACAC to parallel the work of ICAO by carrying out tasks more specifically attuned to the realities and limitations of the region. This will bring about an improvement in an area of deep concern to the international commercial aviation community through better coordination between the competent authorities of each country.

This would lead to a standardization of both policies and legislation where circumstances permit, thus facilitating negotiations with third parties and making bilateral aviation relations between Latin American countries more effective.

Furthermore, a multinational commercial airline would place Latin America in a better position to compete with the airlines of other regions at the beginning of the 21st Century. It would be a powerful catalyst to emphasize the concept of Latin American regionalism which, in its essence and aims, would contribute to the development of Latin America and to making this development less dependent in nature. The steps to be taken should be prudently planned, in view of the specifics of the situation and the need to reconcile sometimes divergent interests.

A beginning could be made by sub-regions or groups of countries, with very active participation by governments, by the organizations concerned with the subject, chiefly LACAC; and by the airline associations of the region, such as the Asociacion Internacional de Transporte Aereo de America Latina (AITAL).

The goal of all this co-ordinated activity would be to bring about the establishment of a Latin American fleet by the turn of the century.

In sum, it is necessary to adopt such measures in the field of civil aviation as will permit Latin America to take its rightful place in the international

aeronautical community.

SECTION III: THE NATIONAL LAWS OF SELECTED COUNTRIES

In Latin American countries, as in the majority of civil law countries, enforcement proceedings are regulated by the codes of civil procedure dealing with enforcement of judgements and other claims. In the aviation acts of most Latin American countries, the provisions concerning the enforcement of security interests in aircraft are extremely rare. Three countries have been selected for the purposes of analysis for this thesis, namely Argentina, Brazil and Mexico. The selection was made on the consideration that these countries will give a good inside look at the problem due to the similarities existing between the legal system of these countries and those of the rest of Latin America.

A. ARGENTINA[7]

As an introduction to the system of ownership and of all other rights on aircraft, it must be indicated that same is based on the public accessibility (publicity) of its records, which is one of the main features of the system.

The National Registry of Aircraft in Argentina is not only a record of aircraft nationality but also of all titles and rights over aircraft,and it is specially shaped to provide to any person having an interest in such records the possibility of freely examining them and immediately knowing about the situation of an aircraft and all the limitations and encumbrances existing on its ownership.

1. Aircraft Mortgage

The basic protection an aircraft supplier can resort to in Argentina in order to secure the payment of the balance of price which is unpaid at the moment of delivering it to his purchaser is an aircraft mortgage.

An aircraft mortgage has been defined as a real right (a right "in rem") created to guarantee a monetary loan on an aircraft or its engines, which is retained by its owner (the mortgagor). This means that the owner binds his property in favour of another (the mortgagee) without divesting himself of possession. It is just like a naval mortgage, a guarantee very similar to that regulated by the Civil Code, the basic difference being that the aircraft mortgage does not secure immoveable property as is the case with a Civil Code mortgage but rather secures this special type of registered moveable property represented by an aircraft and its engines.

The Aeronautical Code states that an aircraft can be mortgaged as a whole or in its indivisible parts and even when under construction. Registered engines may also be mortgaged. Registered mortgages will not take priority over registered privileged credits, but will take such priority over mortgages registered later in time and over any other credit.

Mortgage must be executed by means of the so-called "public instruments" which are all those documents recorded with a public officer or notary public. They can also be executed but in these cases, they must be attested by a notary public.

For mortgages in a language other than Spanish, a translation effected by a public sworn translator is necessary. If the mortgage is executed abroad, the instrument must be certified by the Argentina consulate.

The aircraft mortgage does not grant the mortgagee a power to sell the aircraft because, the ownership of the same is retained by the mortgagor and not transferred to the mortgagee. The mortgagee has, instead, the right to initiate a foreclosure suit, just as in the case of any other mortgage on immoveable property. This is a suit with quick and expeditious procedures in which payment of the amount owed is demanded from the debtor and, if not effected, the judge immediately orders the sale of the mortgaged aircraft by

public auction. The creditor then collects his monies from the price obtained at the auction.

A mortgage contract does not constitute an exception to the rule, so it is possible for its parties to choose a foreign jurisdiction provided that such contract meets the requisites mentioned above.

2. Fleet Mortgage

The only possible aircraft mortgage is the aeronautical one, granted by a debtor to guarantee a loan in the manner regulated by the Aeronautical Code. This concept means that other types of mortgages such as the fleet mortgage or the floating charge, legal and equitable mortgage, accepted by the English law and other foreign legislation are not possible under the Argentina legal system.

Nevertheless, nothing in the Code prevents a mortgage being established on more than one aircraft or on all the aircraft owned by the debtor, in this way making it possible to establish a sort of fleet mortgage for all practical effects.

3. Conditional Sales. Reservation or Retention of Title Devices

The Aeronautical Code presently in force, enacted in 1967, distinguishes two different situations for aircraft purchased abroad or locally.

The Code permits provisional registration, in the name of the purchaser and subject to the restrictions of the respective contract, of aircraft exceeding six tons purchased abroad by means of a sale contract subject to conditions or any other contract by which the vendor reserves for himself the aircraft's ownership until the full payment of the price or the fulfilment of the conditions takes place. In these cases, there are certain requirements that have to be met.

Registration of aircraft of less than six tons is also permitted if they are

going to be used for regular air transport services. These two devices are not, strictly speaking, a "real security" because the creditor maintains an absolute proprietary title on the aircraft. However, in practice, they serve an identical financing purpose to that of the aircraft mortgage.

Legal regulations and principles indicated for mortgages apply also, in general terms to conditional sales and all types of retention of title devices.

4. Pledge

In accordance with the Aeronautical Code, registered pledges cannot be established on aircraft and engines.

In conclusion, this is not only as a consequence of the country's internal legislation and publicity of all acts related to aircraft but also by reason of the ratification by Argentina of the 1948 Geneva Convention by means of Decree Law 12359, enacted on October 8, 1957, which gives any foreign creditor or mortgagee a reasonable assurance that their interests are duly protected on registering their mortgages or contracts in the National Registry of Aircraft.

As a consequence of what has been previously indicated, it can be safely assured that Argentina possesses a complete and reliable system for the protection of security interests in aircraft and engines.

B. BRAZIL

As a result of the ever growing air traffic in Brazil, Brazilian airlines have been required to rapidly increase their fleet so as to cover demand and conquer a more significant share of this profitable market.

Brazil ratified the Geneva Convention on October 1, 1953 and its provisions are enforced in connection with Brazilian laws.

The current Brazilian Air Code, instituted by law No. 7565 of December

19, 1986, contains the main provisions of Brazilian aeronautical law and establishes the parameters for legal qualification for the various methods by which aircraft are brought to Brazil.

1. Title to Aircraft and Registration

The Code provides that title to aircraft registered in Brazil is governed by Brazilian law. The law does not restrict the parties eligible for ownership of Brazilian aircraft, thereby allowing title to be held by individuals or entities regardless of nationality or domicile. Registration in Brazil is usually effected by the Brazilian operator. If the operator is not the owner of the aircraft, a notation is made in the registration records of the owner's identity, as well as the identity of any mortgagee or other registered lienholder.

2. Mortgages

The Code allows mortgages to be granted over aircraft, engines and parts, as well as unfinished aircraft in construction. An aircraft mortgage is presumed to cover an aircraft, its engines, and all attached parts, unless the mortgage instrument specifically provides otherwise.

Brazil uses the civil law system, and its mortgages, unlike many common law mortgages, do not allow a mortgagee to take possession of a mortgaged asset in the event of default by the mortgagor. Mortgagees' credits take precedence over all others, except: court costs, employees' credits, taxes, airport fees, amounts relating to emergency services, amounts paid directly by the pilot while discharging his duties when the same are indispensable for continuation of a flight, and amount spent on maintenance.

3. Conditional Sales Agreements

The Code contains no specific provision regarding conditional sales

agreements in which a seller reserves title to himself until such time as the full purchase price has been paid. such agreements, which are governed by the Code of Civil Procedure, are commonly used in aircraft finance transactions.

4. Fiduciary Alienation

The Code also discusses the general requirements for contracts of "fiduciary alienation". Fiduciary alienation is a form of security in which a creditor retains conditional title and indirect possession of the aircraft It is rarely used in aircraft financing and, therefore, due to space limitations, no detailed discussion is included here.

5. Charter Agreements

A charter Agreement is defined in the Code as an agreement between two parties in which one party (the Charterer) agrees to operate one or more predetermined flights during a certain period of time for another party. The Charterer is responsible for all technical aspects of the flights, including those relating to the crew.

6. Lease Agreements

A distinction is made between lease agreements and "mercantile leases". Simple rent agreements are roughly equivalent to operating leases while mercantile leases are roughly equivalent to finance leases. There are no nationality requirements; foreign parties may be lessors of Brazilian aircraft. There is a series of governmental approvals required for aircraft leases that stem from the Code and other laws.[8]

C. MEXICO

The field of aviation and aircraft is governed by the law of General Means of Communication (Ley de vias Generales de Communicacion, Diario Oficial, February 19, 1940, as amended, hereinafter the "communications law").

Although laws such as the Commercial and Civil Codes and the General Law of Credit Instruments and transactions must be taken into account in respect of any commercial transaction.

1. Registration and Ownership

The Communications Law provides that all matters pertaining to the registration, ownership and operation of aircraft are under the jurisdiction of the Ministry of Communications and Transport (the "Ministry"). A permit is required for operating private aircraft, while a concession must be obtained for public transport of passengers or cargo, both of which are issued and controlled by the General Bureau of Aeronautics of the Ministry.

Only Mexican citizen or Mexican Corporations may register aircraft in the Aeronautics Registry. Legislation on foreign investment further provides that air transport activities requiring a concession are restricted exclusively to Mexican citizens or Mexican corporations which specifically exclude foreign shareholders in their by-laws.

Mexico does not recognize any dual registration. A certificate of Mexican nationality and identification is issued upon registration by the registry.

It is pertinent to note that legal possession of an aircraft (as opposed to ownership) may suffice for eligibility for registration as mexican, which may be the case with leases, even though the lessor may be a non Mexican entity. On the other hand, the lessor may opt for not registering the aircraft as Mexican, although the lease agreement itself may be filed with the Aeronautics Registry by the Mexican carrier in question. Air carriers are subject to strict scrutiny and

numerous requirements of the Bureau.

2. Mortgages

Mortgages and instruments creating security interests in Mexican registered aircraft and engines installed thereon must be field with the Aeronautics Registry in order to have priority against third parties. Such instruments must be either notarised in Mexico or be notarised in the jurisdiction of execution and the foreign notary's signature must be further authenticated by the Mexican consulate in such foreign jurisdiction prior to filing with the registry.

If the instruments are not executed in Spanish, an official translation thereof by a court-approved translator must be attached therewith.

Registration is retroactive to the date of filing. The communications Law provides that an aircraft may not be deregistered without the formal consent of all current lien holders.

Registered lien holders have a priority claim in the event of bankruptcy proceedings and rank second only to workers' claims, certain taxes, social security quotas, workers' housing contributions, and limited expenses related to the conservation or salvage of the aircraft.

With respect to enforcement of aircraft mortgages, the security created has the characteristics of a "hypotheque" or chattel mortgage, under with the mortgagee's rights of the enforcement are somewhat more limited than under most common law jurisdictions.

The mortgagee is not regarded as having a direct proprietary interest ("entitlement") in the mortgaged property and is therefore restricted to enforcing the mortgage through a court.

Finally, it is important to point out that Mexico is a party to the 1944 Chicago Convention on International Civil Aviation and the 1948 Geneva Convention on International Recognition of Rights in Aircraft. However, the

following reservation was made by Mexico to the Geneva Convention:

> "The Mexican Government expressly reserves the rights belonging to it to recognize the priorities granted by Mexican laws to fiscal claims and claims arising out of work contracts over any other claims. Therefore, the priorities referred to in the Convention on the International Recognition of Rights in Aircraft, signed at Geneva, shall be subject, within the National Territory, to the priorities accorded by Mexican laws to fiscal claims and claims arising out of work contracts".

3. Taxes

The Mexican Income Tax law does not include any specific benefits to owner or purchasers of aircraft, other than limited accelerated depreciation of new assets, including aircraft. Import duties are assessed on the importation of aircraft, although it is noted that the two major carriers have enjoyed substantial subsidies in connection therewith. Such duties do not apply, however, to temporary importations in respect of leased aircraft.

The Mexican Income Tax Law provides for withholding taxes on interest and lease payments made by Mexican resident entities to foreign payees. If financing is arranged through foreign financial institutions registered with the Ministry of finance and the loan documents are registered therewith, the tax on interest paid is that of 15%. Otherwise, a rate of 35% is imposed, except where the interest is paid to the supplier or manufacturer, in which case the tax rate is 21% deductions are authorized in respect to payments made for the use of aircraft whenever an authorization has been granted by the corresponding administrative authority and the tax payer has proved that the aircraft is necessary for its operations.

Lease payments to foreign entities are subject to a 21% withholding tax; the same rate applies to the interest portion of financial or tax leases. It is noted that the Ministry of Finance, through specific rulings, has in the past imposed lower withholding taxes where payments were made by the

government - owned carriers to foreign entities in connection with aircraft financing transactions.

In any event, tax indemnity clauses and those providing for payments on a gross-up basis in the event of withholding taxes are common and valid in Mexican transactions.[9]

FOOTNOTES

Chapter 8

1. K.W. Dam, "Latin America: The Struggle to Restore Economic Growth", Department of State Bulletin (U.S.), February, 1985, at 37.

2. Supra, at p. 146.

3. The review of several aviation acts of the more important countries in Latin America will show that in the majority of cases, the basic source of law rests with the statutes instead of the general provisions of the civil or commercial codes.

4. The following countries have enacted special laws concerning encumbrances on aircraft: Argentina, Bolivia, Brazil, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Peru, Uruguay and Venezuela. See Bayitch's text at pages 23 and following, supra, Ch. III, note 1.

5. M.W. Lyon, "Finances Threaten Growth of Latin Airlines", Airline Executive, April, 1988, at 22.

6. J. Garland Combe, "Civil Aviation Co-operation in Latin America and its Possibilities in the 21st Century", ICAO Bulletin, November, 1988, at 24.

7. R.N. Maciel, "Security Interests in Aircraft and Engines. Their Recognition and Protection under Argentine Law", Airlaw, Vol. XIV, No. 2, 1989, at 88.

8. M.B. de M. Vinagre, "Brazil", Airfinance Annual, 1989/90, at 132.

9. Thomas S. Heather & Ritch Heather, Y. Mueller, "Mexico" Airfinance Annual, 1989/90, 219 at 220.

CONCLUSION

The aircraft financing in developing countries is more complex and challenging than in the rest of the world. The world airline industry cannot replace its fleet from earnings since aircraft financing is a very complex and constantly changing business.

Financing any growth and fleet modernization will continue to be a problem for Third World countries, which does not leave any other choice rather than they should contract for the air service.

The international air transport system benefits from a unique world-wide integration, and as indicated earlier, regional cooperation between developing countries and between their airlines is an important development towards seeking common solutions to their common problems. However, acting alone the airlines of the developing countries will be adversely affected by almost all of the current changes in the aviation system. Their future prospects will depend upon cooperation actions by which they can gain some of the advantages which derive from large scale marketing and operations.

These problems were clearly recognized at the Aviation Seminar which IATA organised in Aqaba, Jordan, in September, 1987. The report of that meeting concluded that the airlines in developing states "not only have to find ways of competing more effectively with large airlines which have a growing strength conferred by the sophisticated automation of their marketing activities, but they also have to overcome internal problems brought about by shortages of trained manpower and limitations on capital investments".

Amongst the specific conclusions of the Aqaba Seminar, the following are particularly important for the airlines of the developing countries:

(i) Cooperative arrangements are necessary between small regional airlines to achieve the advantages of large scale marketing;

(ii) Action should be taken at a regional level to develop cooperative and neutral CRS services;

(iii) Industry lobbying activities should be increased to ensure that adequate funds are made available for essential airport and air traffic control developments;

(iv) Smaller airlines in developing countries should be assisted to find new ways to finance future aircraft requirements;

(v) Third-world airlines continue to need the protection afforded by economic regulation and action is needed to strengthen multilateral traffic coordination in regions like Africa and Latin America; and

(vi) Programmes for training assistance to airlines of developing counties need increased support and funds.

Moreover, airline industry contributes to the social and economic development of the regions, a region's socio-economic conditions, laws and policies in turn affect the financing, and the development of its airlines industry. The future of the airline industry in any region of the Third World will depend on such facts as: the political economy; the will to modify old and adopt new policies; the effectiveness of the regional institutions; and better international co-operation.

Airlines can accomplish greater economies by combining sales and operational organizations. (Pooling, interchange, globalization arrangement and privatization) "Togetherness" could be the major long-term solution for the Arab carriers as well the rest of the Third World carriers, therefore, there are two priorities for Arab Governments to consider seriously: first, the governments should privatize their airlines and eliminate the slack which tends to creep into government institutions by being responsible to private shareholders; the objectives and incentives for management would be crystallized and the immediate rationalization steps would improve cost-effectiveness. Second, governments should encourage airlines to merge and create carriers which can

compete with the American and European mega-airlines.

However, the airlines and governments ought to consider an alternative idea: creating consortia in order to safeguard national pride and to protect domestic services. Under the consortium option, the existing Arab carriers would become holding companies These holding companies would form a consortium to jointly operate the intra-state, regional and intercontinental routes, whilst leaving the domestic services as the responsibility for the holding company. The idea of consortia may be a most difficult concept for the present airline owners to accept initially, but there is no visible alternative. If the Arab carriers are going to stay in the race there is no practical solution other than the creation of consortia, or at the very least the pooling and sharing of dividends.

Part of the past problem resulted from an enormous expansion of operations, leading to equally enormous investment requirements and heightened financial leverage. Unfortunately, significant financial investments will still be required to replace the older airplanes, unless the financial performance improves significantly. The burden will have to be borne by the governments, either directly or indirectly through guarantees. Governments, however, having experienced downturns in their economies as a result of reductions in oil revenues, are placing more pressure on their airlines to improve their financial performance. Operating subsidies are being reduced and airlines are being pressured to become more efficient. The airlines will not be able to boost revenues by raising their fares, which are already high relative to the normal economy world averages. Therefore, it seems that the airlines based in this region will be forced either to reduce their costs or to increase revenue in ways other than by increasing fares or to do both.

As to the African countries, they are facing increasingly harsh economic and financial realities. The financial performance of carriers based in Africa has been dismal relative to the world average. The African airline industry as a whole has trouble achieving break-even status on an operating basis, let alone

on a net basis. The African airline industry's financial performance on a net basis is even worse, since non-operating costs tend to be high compared to those in other regions of the world. Although the airline industry in Africa will still be influenced by many external factors such as the growth in the regional economy, international trade, tourism, and balance of payments, radical changes can be brought about only through the development of multinational, or at least transnational, airlines with strong hubs at strategic locations in each of the sub-regions. Such a solution can not be implemented, however, without the will and actions of governments. Unfortunately, strong nationalistic attitudes, political considerations, ideological and cultural differences, and the fear that benefits will not be shared fairly and equitably will effectively counter efforts to increase cooperation for the foreseeable future. In summary, if they are to accommodate their growing demands for air service they must choose economically sound options. To improve and extend air service in a time of general African economic and financial crisis the various participants in aircraft financing need to work together on a national regional and inter-regional basis.

The future of the airline industry in the Latin American region is tied very closely to the economic and financial conditions of the nations within the region. In the past, neither natural nor financial resources were enough to prevent crisis without a coherent and well-structured national economic policy. This means for the Latin American airlines that the medium-term future will be little different from the recent past. This future will be characterised by low profits and very limited ability to generate foreign exchange. As airlines will still not be able to acquire new aircraft, leasing will continue to represent the most attractive fleet acquisitions solution. Historically, the continent's airlines have been major purchasers and lessees of used aircraft; given present circumstances,this is likely to continue, unless there are dramatic changes in the region.

In conclusion, it is becoming increasingly common for airlines not to buy aircraft, but to operate aircraft owned by someone else. The stronger carriers

have been hesitant to take on long-term obligations for aircraft that impact their capital structures and hurt their financial flexibility in the event of an economic downturn. Airlines with weak balance sheets as Third World airlines, must operate more efficient aircraft than they have in the past to compete and survive. Since the balance sheet lacks sufficient strength to permit the purchase of new aircraft by the airline itself, then other intermedianes must be found to fill the ownership role.

Even if an airline has the financial strength to buy its own aircraft, it may elect to enter into an operating lease which permits the airline to return the aircraft after a relatively short leasing period. This flexibility is beneficial in the light of the proliferations of new aircraft types which are being developed.

However, Third World countries, particularly Latin America, Africa, and the Middle East, will remain behind the rest of the world in aviation development but clearly, with the changes in the political climate particularly in Latin America, this should change.

Consequently, aircraft financing requires newer and more innovative techniques, providing for better security than in the present and the past. It is false security to rely on an asset's value if, pursuant to default, the security holder cannot repossess the equipment because the security interest in the asset has not been perfected.

I do believe strongly that the future of security rights in aircraft is to be found in the uniformization and internationalization of the legal principles of security law involved, which will have a positive impact on the aviation industry as a whole.

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