

# **Legal aspects of aircraft financing and new challenges for China**

by

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# **Abstract**

After over 50 years of development, aircraft financing has made significant achievements in expanding the domestic and global air transport system. An aircraft financing transaction is a complicated process which may involve not only the final users of the aircraft but also the manufacturers, banks or other private investors, trustees, lessors, and institutional lenders, concerning many areas of various subjects. This paper focuses on legal aspects of aircraft financing, especially on China's current legal system of aircraft financing.

Chapter One examines the history of aircraft financing in the United States, Japan and China. Chapter Two discusses different types of financing, and analyzes the classification of Leasing, the most frequently used type of aircraft financing. Chapter Three outlines main international conventions which have built the legal framework of international aircraft financing. Chapter Four turns to China's current legal framework of aircraft financing. Chapter Five studies new challenges posed to China's leasing industry in recent years. A few short paragraphs concludes the large gap between China's domestic aircraft financing industry and the foreign ones, and the efforts that China is making to explore a new way of aircraft financing to harmonise Chinese ideals with international practices.

## Résumé

Après plus de 50 ans de développement, le financement aéronautique a fait des pas importants dans l'expansion du transport aérien, chez nous et sur la scène internationale. Le financement d'un avion est un processus compliqué qui concerne non seulement les utilisateurs d'avions, mais aussi les fabricants, les banques ou autres investisseurs privés, les fiduciaires, les locateurs, les prêteurs institutionnels, en ce qui a trait à plusieurs aspects d'une variété de sujets. Le présent document se concentre sur les aspects juridiques du financement d'aéronefs, en particulier sur le courant système juridique de financement aéronautique de la Chine.

Le premier chapitre examine l'histoire du financement aéronautique aux États-Unis, au Japon et en Chine. Le deuxième chapitre traite de différents types de financement, et analyse le crédit-bail, le type de financement aéronautique le plus souvent utilisé. Chapitre trois décrit les principales conventions internationales qui ont servi à construire le cadre juridique international de financement aéronautique. Chapitre quatre se tourne vers le courant cadre juridique de financement aéronautique de la Chine. Chapitre cinq étudie les nouveaux défis auxquels l'industrie de location a fait face en Chine au cours des dernières années. Quelques courts paragraphes démontrent un écart important entre l'industrie du financement aéronautique en Chine et celle d'autres pays, et démontrent aussi les efforts que la Chine fait pour explorer un nouveau mode de financement aéronautique pour harmoniser les aspirations des chinois avec les pratiques internationales.

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# Introduction

The civil aviation industry emerged in the 1920s, but the real growth began after World War II.<sup>1</sup> In the 1950s, the civil aviation industry began to be used much more for leisure travel as well as for business uses. By the expansion of the domestic and global air transport system, aviation has made the domestic and global economies and cultures cross-fertilise and caused markets to proliferate in number and to grow in size and wealth.<sup>2</sup> Today, the civil aviation industry is an integral part of the infrastructure of the world economy and is too critical to the world economy to be allowed to fail.

In order to develop the civil aviation industry, a considerable amount of capital was required to support the growth of airlines' fleet size. Traditionally, airlines acquired their aircraft through straight purchase transactions. Following the traffic growth and demands to replace used aircraft, airlines were forced to find other sources of finance for their aircraft acquisitions. Therefore, various types of lease financing became attractive and financially advantageous to airlines. Aircraft financing emerged rapidly and developed all over the world.

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<sup>1</sup> D.H. Bunker, *International Aircraft Financing*, (Montreal, Quebec: International Air Transport Association, 2006) at xxv.

<sup>2</sup> P.S. Dempsey & L.E. Gesell, *Airline Management: Strategies for the 21<sup>st</sup> Century*, 2<sup>nd</sup> ed. (Chandler, Ariz.: Coast Aire Publications, 2006) at xxiii.

However, Aircraft financing is a complicated process which involves not only the final users of the aircraft but also the manufacturers, banks or other private investors, trustees, lessors, institutional lenders and so on. Moreover, aircraft are moveable and expensive. Even if the capital is available, risk may still be one of the key factors that affect the result of an aircraft acquiring transaction. Since the transaction process is complicated, a number of instruments have been introduced to secure aircraft financing. It is even more difficult in cases of international aircraft financing where parties from different jurisdictions are involved and with complicated conflicts of law. In international aircraft financing, difficulties may arise because every right or interest in aircraft is based on a national legal system which often has conflicts with foreign legal systems where the rights or interests may have to be experienced. Many efforts have been made to introduce globally accepted principles and regulations in aircraft financing. Although the process of formulating international conventions or treaties is full of thorns, some conventions and treaties respecting international aircraft financing have been adopted during the past decades.

As one of the largest aircraft importing countries, China is becoming more and more important in civil aviation industry. China's unique legal environment gives it a special nature. Following the implementation of the Reform and Open-up policy<sup>3</sup>, the

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<sup>3</sup> "Reform and Open-up policy" was introduced in 1978 by Deng Xiaoping, the core of the second generation of the Communist Party leadership, at the Third Plenary Session of the Eleventh the Communist Party of China Central Committee. The goal of this policy was to generate sufficient surplus value to finance the Four Modernization, those of agriculture, industry, science and technology and the military. The strategy for achieving these aims of becoming a modern, industrial nation was the socialist market economy. Deng Xiaoping emphasized that China was in the primary stage of socialism and the duty of the Communist Party of China was to perfect "socialism with Chinese

current legal system was gradually established in the last 30 years to regulate numerous new problems that arose from China's rapid economic growth. The basic legal framework of aircraft financing has evolved to meet the needs of the fast development of China's aircraft financing.

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characteristics". The Reform and Open-up policy significantly reduced the role of central planning by encouraging off-plan production by State-owned units and by promoting the growth of collective and individual enterprises that did not fall under the planning system. Meanwhile, foreign trade and foreign direct investment are promoted. The government endeavored to replace direct plan control with indirect guidance of the economy through economic levers, such as taxes and investment support. Despite these changes, overall direction of the economy was still carried out by the central plan, as was allocation of key goods, such as energy and steel. See *The Communiqué of the Third Plenary Session of the Eleventh the Communist Party of China Central Committee*, online: <<http://news.xinhuanet.com> > (accessed on September 1, 2008).

# **Chapter 1 Aircraft Financing: A General Historical Review**

Aircraft financing has developed for over 50 years. It has made significant achievements in expanding the domestic and global air transport system. Although aircraft financing has shown certain common features all over the world, every country has demonstrated some unique development in their own history.

Below are some particular reviews of cases in the United States, Japan and China.

## **1.1 The United States**

After World War II, the U.S. carriers began to be financed through short term bank loans, equity offering and internal financing.<sup>4</sup> Because of various factors, particularly traffic growth, increasing fleet size demands and the switch to large jet-engine aircraft, new patterns of demand for longer term financing arose, and the carriers turned to public and institutional investors to seek capital.

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<sup>4</sup>J.D. Lambert, "Survey of Domestic and International Aspects of Aircraft Equipment Financing , (April 1963)" 18 Bus. Lawyer 627.

In the 1960s, the growing potential of airline stocks allowed the carriers to obtain 10-20 year long term debentures to purchase new equipment.<sup>5</sup> For the carriers, which were not able to finance on an unsecured basis, conditional sales contracts or transactions secured by chattel mortgages were widely adopted.<sup>6</sup> In 1962, the U.S. government passed legislation to stimulate purchases of aircraft and other expensive equipment by introducing an investment tax credit for aircraft and increasing deductions for tax depreciation.<sup>7</sup> However, the revenues of the U.S. airlines were insufficient to absorb the tax deductions and they did not receive great benefit from the new legislation.<sup>8</sup> This fact was an important reason for the subsequent increase of leasing structures under which the owner-lessor could take advantage of credit and increase depreciation to offset tax liabilities by acquiring and holding title to aircraft. At the same time, the owner could pass on a portion of the benefit to the lessee by granting a lower implicit lease rate.<sup>9</sup>

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<sup>5</sup> D.I. Johnston, "Legal Aspects of Aircraft Finance" (LL.M thesis, McGill university, 1962) [unpublished] at 23.

<sup>6</sup> Lambert, *supra* note 4 at 226.

<sup>7</sup> P. L. 87-834, Oct. 16, 1962, 76 Stat. 966. See, P.K. Nevitt & F.J. Fabozzi, *Equipment Leasing*, 2nd ed., (Homewood, Illinois: Dow Jones-Irwin, 1985) at 28; Kenneth Rosales, "Legal Aspects of Asset Based Aircraft Financing" (LL.M thesis, McGill University, 1990) [unpublished] at 37.

<sup>8</sup> N.B. Stiles & M.A. Walker, "Leverage Lease Financing of Capital Equipment", (1972-73) 28 Bus. Lawyer 161 at 162; Kenneth Rosales, "Legal Aspects of Asset Based Aircraft Financing" (LL.M thesis, McGill University, 1990) [unpublished] at 37.

<sup>9</sup> Rosales, *supra* note 7.

In the 1970s, the U.S. economy experienced an inflationary period. Moreover, nearly 80% of the scheduled passenger traffic was already competitively served.<sup>10</sup> The soaring costs brought the reduction of satisfactory revenues in the U.S. airlines. Capital investment requirements outpaced internally generated funds and the airlines had to seek external sources of financing.<sup>11</sup> Although there were some choices of aircraft financing, new structures of leveraged leases that allowed the lessor to keep his risky investment at a minimum permitted him to claim maximum tax deductions.<sup>12</sup> In this structure, the owner had become a passive investor who did not assume any of the burdens normally associated with ownership by using non-recourse loans. The lessee had to bear all costs connected with the aircraft, such as maintenance, insurance and taxes.<sup>13</sup>

In the 1990s, leases became the most attractive method of financing new and used aircraft acquisitions in the U.S.. Although many types of leasing structures were available to airlines, leveraged leasing has been the preferred method of financing new aircraft over a long term because a leveraged lease provides superior economics and

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<sup>10</sup> P.S. Dempsey, "The State of the Airline, Airport & Aviation Industries" (1992) 21 Transp. L. J. 129.

<sup>11</sup> D.H. Bunker, *The Law of Aerospace Finance in Canada* (Montreal: ICASL, McGill University, 1988) at 6-8.

<sup>12</sup> W.W. Eyre, "The Sale, Leasing and Financing of Aircraft", (1979-80) 45 J.A.L.C. 217 at 234.

<sup>13</sup> J.M. Fortier, "Real Rights in Aircraft- An International Comparative Study" (LL.M thesis, McGill University, 1980) [unpublished] at 136.

allows airlines to have greater control over the residual value of aircraft.<sup>14</sup> Compared with other financial instruments, the U.S. leveraged lease is unique in offering the win-win opportunity to both the lessee and the lessor. Moreover, the guidelines and practices of the U.S. leveraged lease are well-defined and accepted by governmental departments, such as tax authorities and other policy makers.<sup>15</sup> Consequently, the U.S. leveraged lease has been an important type in aircraft financing structure and has been adopted in aircraft acquisition transactions all over the world.

In the history of aircraft financing in the U.S., airline deregulation had also played an important role by partially removing governmental control over the airline industry in order to allow the market to act as the principle regulator. After the Great Depression and World War II, most Americans' confidence in laissez faire economics was shattered. The U.S. government focused on achieving greater social good and protecting the country from threats posed by the economic crisis.<sup>16</sup> Conversely, the new generation which grew up in the 1960s and 1970s grew cynical and opposed the Great Society and high taxes. They viewed government with some hostility.<sup>17</sup> In the 1960s and 1970s, some economists also criticised, commenting that government regulation had made air transport more expensive than it need be. Their main point

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<sup>14</sup> J.V. Babcock & John Graves, "US Aircraft Leasing ", edited by Simon A. D. Hall, *Aircraft financing* (London, England: Euromoney Publications, 1993) at 73.

<sup>15</sup> *Ibid.*

<sup>16</sup> P.S. Dempsey, "The State of the Airline, Airport & Aviation Industries", (1992) 21 Transp. L. J. 129.

<sup>17</sup> *Ibid.*

was that pricing and entry restrictions gave consumers excessive service, but the pricing competition was insufficient. These restrictions also inflated airline costs, and thereby made the aviation industry's profits unsatisfactory.<sup>18</sup> It was believed that the deregulation would make the airline industry more competitive, particularly giving consumers the range of price and service options they preferred.<sup>19</sup> In such a trend, President Jimmy Carter signed the Air Cargo Deregulation Act of 1977, the Airline Deregulation Act of 1978, the Staggers Rail Act of 1980, and the Motor Carrier Act of 1980. The deregulation movement resulted in a squeeze on airlines' profits, which was encouraged by competition and stimulated innovations on aviation technologies and management. Thus, airline productivity reached a high level and resulted in massive economic wealth.<sup>20</sup> This provided the foundation for an expansion of fleet size and an opportunity for the development of aircraft financing in the U.S. in the past 30 years.

## 1.2 Japan

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<sup>18</sup> As the CAB's John Robson observed, "Only three times in the past 26 years, and never in the past decade, has the industry earned the... allowable return on investment." *Traffic World* (July 18, 1977) at 14; John W. Snow, "The Problem of Airline Regulation and the Ford Administration Proposal for Reform, Regulation of Passenger Fares and Competition among Airlines" (P. MacAvoy & John W. Snow eds., 1977); S.G. Breyer, *Regulation and the Reform* 200 (1982) [citing from *supra* note 16].

<sup>19</sup> P.S. Dempsey & L.E. Gesell, *Air Commerce and the Law*, (Chandler, Ariz: Coast Aire Publications, 2004) at 58.

<sup>20</sup> *Ibid.*

In the late 1970s, the substantial Japanese trade surplus caused many complaints from its trading partners. To cope with strong international pressure, the Japanese government tried to find methods to increase imports.<sup>21</sup> One result was that Japanese leasing companies became much more actively involved in aircraft leasing in the early 1980s. Japanese leveraged leases became a standardised product in aviation finance. Japan created one of the most consistently reliable markets for aircraft financing in the world.<sup>22</sup>

The first Japanese lease package that influenced international aircraft financing was called the Samurai lease. The Samurai lease was a foreign-currency loan program for emergency imports which Japanese leasing companies used to obtain low interest fixed-rate loans in U.S. dollars from the Export-Import Bank of Japan, the executor of the programs.<sup>23</sup> The Samurai lease did not offer U.S. airlines benefits because the purchase of aircraft did not qualify as exports from the U.S. under the circumstances where the aircraft remained in the U.S..<sup>24</sup> As a result, the program did not succeed in reducing the trade surplus substantially. The U.S. government complained that they expected more fundamental measures from Japan to promote imports, not just minor adjustments to financing agreements. Moreover, the U.S. government considered that low-cost financing by the Japanese to international competitors of U.S. airlines to be

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<sup>21</sup> Osamu Nagano, “The Japanese Leasing Market”, edited by Simon A. D. Hall, *Aircraft financing* (London, England: Euromoney Publications, 1993) at 117.

<sup>22</sup> Bunker, *supra* note 1 at 216.

<sup>23</sup> Lambert, *supra* note 4 at 117.

<sup>24</sup> Bunker, *supra* note 1 at 217.

unfair.<sup>25</sup> Finally, the Samurai leasing program was terminated in May 1979.<sup>26</sup> Although the Samurai lease was short-lived program, it provided valuable experience to Japanese leasing companies in the aircraft leasing business.

In 1980, Japanese Foreign Exchange and Foreign Trade Control Law was liberalised. The main purpose of this law, which was issued after World War II, had been to use Japan's limited foreign currency reserves more effectively by promoting exports and limiting imports.<sup>27</sup> This 1980 liberalisation allowed Japanese leasing companies to purchase overseas assets in cash and to sell these same assets by instalments to the former owner or to another party in the same jurisdiction.<sup>28</sup> The new lease, which was called the Shogun lease, was designed to succeed the Samurai lease. It was different from the Samurai lease in that: first, the Shogun lease was not subsidised by the Japanese government and, second, the Shogun lease was denominated in Yen.<sup>29</sup> From a purely commercial perspective, this Yen determination played an important role in the Shogun program because foreign airlines, which had service routes to Japan and earned revenue in Yen, showed interest in Yen-denominated instalment sales. These airlines could insulate themselves from the foreign exchange risk of Yen appreciation against the dollar because they had Yen

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<sup>25</sup> Air Transport Association of America, Memorandum No. 79-41, Apr. 17, 1979; *Airfinance Journal*, Sep., 1981, p.7 [citing from *supra* note 1 at 217].

<sup>26</sup> Rosales, *supra* note 7.

<sup>27</sup> Lambert, *supra* note 4.

<sup>28</sup> *Ibid.*

<sup>29</sup> Bunker, *supra* note 1 at 217.

receivables to service their payment. Meanwhile, Shogun leases could offer more flexible interest rates and loan terms than banks could.<sup>30</sup> In 1982, the U.S. prime rate varied between 11.5% to 17%, while the long term Japanese equivalent averaged just 8.6%.<sup>31</sup> The different rates provided good opportunities for the Yen-based Shogun lease to expand. Japanese leasing companies were able to lease or make conditional sale agreements with the benefit of low interest rate Yen funds available from Japanese financial institutions.<sup>32</sup> However, under the Shogun leases, the Japanese investors took the risk because the exchange of the Yen tended to fluctuate too much and it was too strong a currency to use for debt.

Along with the decreasing differential between the Yen and dollar funding costs and the deteriorating financial condition of the world's major airlines, Shogun leases declined and eventually disappeared, replaced by a new type of lease, called the Japanese Leveraged Lease (JLL).<sup>33</sup> JLL allowed Japanese investors to defer their tax bills by depreciating 100% of the asset cost for tax purpose.<sup>34</sup> From 1985 to 1987, over 10 aircraft were obtained by Japanese airlines through leveraged leases. Transactions were arranged by Japanese leasing companies. Each investor made a cash contribution to a company that became the lessor of the aircraft and shared in the profits and losses

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<sup>30</sup> Lambert, *supra* note 4.

<sup>31</sup> Bunker, *supra* note 1 at 217, footnote 422.

<sup>32</sup> Lambert, *supra* note 4.

<sup>33</sup> Bunker, *supra* note 1 at 217.

<sup>34</sup> *Ibid.*

generated by the lease transaction in proportion to the contribution made. Normally, the investor was a small to medium-sized private company which was held to defer corporation tax.

JLL became a relatively mature and stable product which helped it become one of the most popular cross-border leasing products. However, low Yen interest rates in Japan, competition from other markets and tax changes in Japan have effectively eliminated the JLL as a viable cross-border structure. In August 1996, Japan's Tax Advisory Council announced plans for sweeping changes in taxation policy. From the perspective of the leasing industry, the plan focuses on replacing the declining-balance depreciation method by straight line depreciation. This plan had an immediate effect on the JLL market. Although the reforms were not implemented immediately, the continuing uncertainty regarding tax changes affected investors' confidence and resulted in a business reduction in 1997.<sup>35</sup>

Japanese leasing companies have been dominant in the international aircraft financing market for 30 years, leading up to 2000. Their active involvement in the aircraft leasing industry made the Japanese aircraft leasing market mature and vigorous. Aircraft financing structures that were designed by the Japanese have affected many countries in aircraft financing practices. The Japanese government played an important role in the process, for example, in a long-term financing, Japanese commercial banks

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<sup>35</sup> Paul Ibbotson, "The Japanese Leasing Market", edited by Andrew Littlejohn and Stephen McGairl, *Aircraft financing* (London, England: Euromoney Publications, 1998) at 182.

could fund overseas projects in the light of government-backed insurance, which was operated by the Export Insurance Division (EID) of the Ministry of International Trade and Industry.<sup>36</sup> EID insures repayment of export credits. This cooperation ensures the availability of capital for exporting financing from Japan.<sup>37</sup>

### 1.3 China:

In 1949, The People's Republic of China was established. The political relationships between China and western countries were not agreeable, due to their different political ideologies. Meanwhile, because their political ideologies were similar, China and the Soviet Union maintained a friendly relationship at that time. Throughout the 1950s, all of China's aircraft were purchased from the Soviet Union.<sup>38</sup> The Il 14, which has the capacity of 30 to 40 people, was the first purchased and used by the leaders of the Chinese government.<sup>39</sup> Since the purchase of the Il 48 in 1959, with a capacity of 80 passengers, China has owned medium size aircraft. In the 1960s, the relationships between China and Europe began to change positively. A significant sign that the tension between Europe and China began to wear off was the entrance of

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<sup>36</sup> Bunker, *supra* note 1 at 325.

<sup>37</sup> *Ibid.*

<sup>38</sup> Honglian Wang & Yiping Wei, "Da Fei Ji Yu Qiang Guo Zhi Lu" (2007) 13 San Lian Sheng Huo Zhou Kan [in Chinese].

<sup>39</sup> *Ibid.*

the British aircraft “Intuition”, though most of the aircraft at the time were still coming from the Soviet Union.<sup>40</sup> In 1972, President Richard Nixon visited China and the Joint Communiqué between the People's Republic of China and the United States of America was issued in Shanghai on February 28, 1972. This marked the beginning of the normalisation of relations between China and the United States. In 1973, China purchased five Boeing 707s, and five additional Boeing 707s in the years that followed.<sup>41</sup> The introduction of Boeing 707s to China was a milestone in China's civil aviation history. Until this time, political advantage was the most important reason for China to purchase aircraft.

In the 1980s, China began to implement its Reform and Opening Up policy. The result was rapid economic development. The civil aviation market required more and more aircraft to keep up with the needs of the rapidly growing economy. More than ten aircraft manufacturers from the U.S., Europe, Canada and Brazil came to the Chinese aircraft market and lobbied Chinese airlines to purchase their aircraft and other aviation equipment. All of the manufacturers faced heavy competition in China. This period is called the Warring States Period in China's civil aviation history.<sup>42</sup> Large

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<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*

<sup>42</sup> The Warring States, also known as the Era of Warring States, covers the period from some time in the 5th century BC to the unification of China by the Qin Dynasty in 221 BC. It is considered to be the second part of the Eastern Zhou Dynasty, following the Spring and Autumn Period. The name Warring States Period was derived from the Record of the Warring States, a work historically compiled early in the Han Dynasty. In this period, regional warlords annexed smaller States around them and consolidated their rule, resulting in seven major States rising to power. The king of Zhou dynasty acted merely as a figurehead among The Seven Warring States, which were the Qi, the

numbers of new types of aircraft which included Boeing series, Airbus series, and McDonnell-Douglas (MD) series increased rapidly in Chinese airlines at that time. At the same time, the Soviet Union operated under a planned economic system and the efficiency of aircraft manufacture was very low. Aircraft which had been purchased from the Soviet Union encountered large problems in aircraft maintenance. Sometimes, replacement parts for Soviet Union aircraft were difficult to purchase.<sup>43</sup> This gave Boeing aircraft a good opportunity to enter China en masse and interrupt the Soviet Union's monopoly.

Before 1990, aircraft purchases were made by the Chinese government, and then allocated to airlines. Before 1995, China Aviation Supplies Import & Export Corporation (CASC) had the power to import aircraft. In 1995, the final decision-making power returned to the State Council from CASC and CASC became involved in aircraft acquisition.<sup>44</sup> The benefit of unified procurement by the Government was that the price of each aircraft was lower by 4% to 5%.<sup>45</sup> Moreover, large numbers of aircraft orders became an important bargaining chip in the negotiation of China's

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Chu, the Yan, the Han, the Zhao, the Wei and the Qin. Another sign of this shift in power was a change in title: before, warlords still considered themselves dukes of the Zhou dynasty king; but now the warlords began to call themselves kings, implying that they were equal to the Zhou king. The Warring States in Chinese is used to describe a situation of serious competition among various forces.

<sup>43</sup> Wang & Wei, *supra* note 38.

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*

accession to the World Trade Organisation (WTO).<sup>46</sup> In fact, specific decisions about how many aircraft and which type of aircraft to purchase were made by airlines. From 2001, airlines gained more autonomy to choose aircraft to serve their own routes and they began to focus more on long-term strategic considerations and the increasing market demands.<sup>47</sup> China began to focus more and more on acquiring aircraft for market economy consideration.

Aircraft leasing in China emerged in the early 1980s. Under a U.S. leveraged leasing contract, China leased its first Boeing 747.<sup>48</sup> In the following 20 years, China's aircraft financing had been obtained in different countries and regions, which included the U.S., Germany, France, Hong Kong, Japan, Sweden, Norway, and the Netherlands. Aircraft financing structures were also varied. These included Investment Tax Credit Leveraged Leases, Non-investment Tax Credit Leveraged Leases, Double Dipping Leveraged Leases, Tax Oriented Leveraged Leases, Sub-leases, Sale-Leaseback, Foreign Sales Corporations (FSCs), Debt Financial Leases and Operating Leases.<sup>49</sup> Both the number of countries concerned and the methods adopted in China's aircraft financing market were massive. It is worth mentioning that some new aircraft leasing structures have been adopted in China's aircraft financing history to deal with some

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<sup>46</sup> *Ibid.*

<sup>47</sup> *Ibid.*

<sup>48</sup> Jianduan Wu, "A Milestone of Air Legislation in China - Some Thoughts on the Civil Aviation Law of the People's Republic of China", (February 1997) 62 J. Air L. & Com. 823.

<sup>49</sup> Lianbiao Zhang, *Civil Aircraft Leasing*, (Beijing: China Civil Aviation Press, 2005) at 15 [in Chinese].

special circumstances in China; for example, the Residual Value Leasing, which was designed to deal with aircraft residuals after the leasing expiration in the Chinese national aircraft financing market.<sup>50</sup> Up until now, Chinese commercial banks and leasing companies have not been massively involved in aircraft financing of imported aircraft. Although most Chinese aircraft were leased, the leasing structures were normally designed and operated by foreign companies.

Compared with the U.S. and Japan, the history of aircraft financing in China is not long, but its growth is rapid. This is due to the massive aviation market needs and the economic reform policy. As mentioned above, political advantage had always been the key consideration in the early period of aircraft purchases in China. Fleet decisions were usually made by the government with little reference to airlines' management.<sup>51</sup> With the implementation of the Reform and Open- up policy, commercialisation increased quickly. As a result, commercial interests became increasingly important factors in the civil aviation market. Massive capital was required in aircraft acquisitions, resulting in aircraft financing developing quickly in China.

Chinese leasing companies, unlike Japanese leasing companies, have never played important roles or gained substantial profits in international aircraft financing. This can be attributed to a lack of funds and professionals, coupled with the lagging legal environment of China.

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<sup>50</sup> *Ibid* at 110.

<sup>51</sup> Bunker, *supra* note 1 at 4.

## Chapter 2 Types of Financing

There are many financing methods for airlines to choose in airline finance. Generally, the major types of financing which airlines have used include: equity financing, debt financing, countertrade and leasing.<sup>52</sup>

### 2.1 Equity Financing

Equity financing is the act of raising money for company activities by selling common or preferred shares to individual or institutional investors in order to get the money paid. In this scenario, shareholders are considered to be the “owners” in the corporation.<sup>53</sup> Equity may be raised either as a primary transaction in which the new funds are raised by the airline itself, or as a secondary transaction in which existing shareholders sell shares and receive the proceeds.<sup>54</sup> Secondary offerings facilitate the objectives of the initial owner, though they are not sources of funds for the airline. These owners may be either the government or entrepreneurs who wish to receive

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<sup>52</sup> Bunker, *supra* note 1 at 169-264.

<sup>53</sup> Online: <<http://dictionary.reference.com>> (accessed on January 17, 2008).

<sup>54</sup> Van Du Bose, “Sources of Finance”, by Andrew Littlejohn and Stephen McGairl, *Aircraft financing* (London, England: Euromoney Publications, 1998) at 17.

some capital appreciation. Sometimes, primary transactions and Secondary offerings are combined.<sup>55</sup> New equity may be raised when proposed future cash requirements cannot be financed entirely in the debt market. Thus, airlines may seek equity opportunities when this source of financing is cheap.<sup>56</sup>

### **2.1.1 Common Shares**

Common shares are the ultimate equity shares of a corporation and common share holders are considered to be the “owners” of the corporation.<sup>57</sup> The common shareholders may get profit from the growth of the corporation without limitation.<sup>58</sup> The more assets the company has left after it has paid all its debts, the more the shareholders of the corporation will be worth, therefore, the more income or assets the shareholders may be paid.

### **2.1.2 Preferred and Special Shares**

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<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> Bunker, *supra* note 1 at 169.

<sup>58</sup> *Ibid.*

Preferred and special shares generally used to refer to a group of shares to which preferential rights are attached over certain rights of the common shares.<sup>59</sup> In other words, if shares of a corporation were not common shares, they were preferred or special shares.<sup>60</sup> Normally, the investors of preferred or special shares were put in a middle position between that of full equity shareholders and that of a creditor who are entitled to repayment of any fund before any shareholders of any group.<sup>61</sup>

### **2.1.3 Privatisation**

Privatisation is the process of transferring the ownership of a publicly-operated entity to a privately-owned-and-operated enterprise.<sup>62</sup> In recent years, the global airline business has become more and more competitive. Some countries have to explore new methods to finance their airlines. They became more and more interested in privatisation of their national airlines, with the prospect of reducing financial dependency and enhancing efficiency. The pioneering privatisation was British

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<sup>59</sup> Bunker, *supra* note 11 at 10.

<sup>60</sup> Bunker, *supra* note 1 at 170.

<sup>61</sup> Bunker, *supra* note 11 at 11; Eduardu J. Iglesias-Badillo, “International Recognition of Property Interests in Leased Aircraft: the New UNIDROIT Convention on Mobile Equipment”, (LL.M thesis, McGill University, 2000) [unpublished] at 7-8.

<sup>62</sup> Bunker, *supra* note 1 at 170.

Airways in the early 1980s. Many airline privatisations have emerged or been announced in the following years in many countries<sup>63</sup>

According to Dr. Donald Bunker, the main reasons for considerations of privatisation included:

- (a) “a company in the private sector runs more efficiently without political interference”;<sup>64</sup>
- (b) huge capital needs of domestic airlines and national debt consideration;<sup>65</sup>
- (c) obtaining global funds and enabling carriers to be financed in a flexible method;<sup>66</sup>  
and
- (d) the trend towards global consolidation.<sup>67</sup>

The main methods of privatization include:

- “(a) flotation;
- (b) private sale; and
- (c) sale by public tender.”<sup>68</sup>

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<sup>63</sup> Anthony Saunders *et al.*, “The Economic Implications of International Secured Transactions Law Reform: a Case Study”, (1999) 20 U. Pa. J. Int'l Econ. L. 309.

<sup>64</sup> Bunker, *supra* note 1 at 171.

<sup>65</sup> *Ibid.*

<sup>66</sup> *Ibid.*

<sup>67</sup> *Ibid.*

A number of governments have complained that the financing or expanding their airlines is difficult. Most also believe that their airlines will run more efficiently and will be able to adapt to change more quickly under private ownership.<sup>69</sup> However, governments are not in favour of allowing their national airlines to totally fall into foreign shareholders' hands.<sup>70</sup> If foreign ownership has reached a certain percent, traffic rights may be at risk.<sup>71</sup> In the negotiation of a bilateral air service agreement (ASA), eliminating restrictions on foreign ownership is always one of the most sensitive issues. Some developed countries that have strong domestic airlines advocate liberalisation and "Open Skies" policies, while others in disadvantaged positions worry about consequences. The pressures for unleashing deregulation have affected airlines virtually irrespective of their own governments' attitudes. Airlines have little choice but to seek structural adjustments in order to survive in the seriously competitive market.<sup>72</sup>

In some cases, new investors are not interested in purchasing shares in some airlines because the government continued effective control restrictions or controlled the veto power in airlines. It has been well recognised that businesses and governments

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<sup>68</sup> *Ibid* at 172.

<sup>69</sup> Yu-Chun Chang & George Williams, "Prospect for Changing Airline Ownership Rules", (2002) 67 J. Air L. & Com. 233.

<sup>70</sup> Bunker, *supra* note 1 at 175.

<sup>71</sup> *Ibid*.

<sup>72</sup> Chang & Williams, *supra* note 69.

seriously lack of compatibility as commercial partners.<sup>73</sup> Actually, no matter what conditions have been attached to a privatisation, airline operations are generally controlled by the government and the control of an airline by a private institution is almost always restricted. Ways that a government controls airlines are usually through its territory, which include:

- “(a) the naming of designated carriers pursuant to ASAs with other countries;
- (b) the regulation of domestic traffic rights;
- (c) airport slots and gates;
- (d) legislative support of unions; and
- (e) taxation.”<sup>74</sup>

## 2.2 Debt Financing

If equity financing is unavailable or undesirable, airlines have to borrow by selling bonds, debentures or notes to individual or institutional investors who become creditors. These creditors receive a promise that the principal and interest on the debt will be repaid by the end of a specific period. Normally, the willing lenders are financial institutions.<sup>75</sup>

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<sup>73</sup> Bunker, *supra* note 1 at 174.

<sup>74</sup> *Ibid* at 175.

<sup>75</sup> D.H. Bunker, “Aircraft Financing in the Future”, *Annals of Air and Space Law*, (Montreal: Institute of Air and Space Law, 2002) at 144.

### **2.2.1. Bonds**

A bond is a debt instrument in which the authorised issuer owes the holders a debt and is obliged to repay the principal and interest at a later date. This date is termed maturity. Other stipulations may also be attached to the bond issue, such as the obligation for the issuer to provide certain information to the bond holder, or limitations on the behaviour of the issuer. Bonds are generally issued for a fixed term longer than ten years.<sup>76</sup>

### **2.2.2 Debentures**

A debenture is similar to a bond except that the securitisation conditions are different. A debenture is usually unsecured in the sense that there are no liens or pledges on specific assets or secured by a negative pledge or negative covenant.<sup>77</sup> In the case of bankruptcy, debenture holders are considered general creditors.

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<sup>76</sup> Online: Wikipedia <<http://en.wikipedia.org>>; Bunker, *supra* note 1 at 176.

<sup>77</sup> Bunker, *supra* note 1 at 177.

### 2.2.3 Notes

A note, also called a promissory note, is a kind of negotiable instrument. A note contains an express and absolute promise of the signor to pay to a specified person or order or bearer a definite sum of money at a specified time.<sup>78</sup>

## 2.3 Countertrade

Countertrade is an international trade method, which involves payment, partially or in full, with goods rather than with money.<sup>79</sup> In the sale of an aircraft or other high-value equipment, countertrade may be adopted because the country which needs the import is short of cash or credit.<sup>80</sup> This method is clearly growing and becoming an increasingly important part of the international business environment. Although some countries are not willing to do business through countertrade, world economic conditions have made countertrade a necessary financing mechanism for countries that cannot pay cash for their imports.<sup>81</sup>

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<sup>78</sup> *Ibid.*

<sup>79</sup> Polly Coe, "Transactions Useful in Cases of Foreign Exchange Shortages, But Caution Advised", 9 U.S. Import Weekly (BNA) NO. 20 at 679 (Feb. 22, 1984); M.J. Oh "The Need for a United States Countertrade Policy", (1985) 7 NW. J. INT'L L. & BUS. 113.

<sup>80</sup> Bunker, *supra* note 1 at 260.

<sup>81</sup> Oh, *supra* note 79.

The forms of countertrade are “barter”, “counterpurchase”, and “offset programs”.

Barter is the direct exchange of goods or services without any transfer of cash. In a barter transaction, the values of goods from two parties are approximate.<sup>82</sup> In barter transactions, after the parties decide the quantity and quality of the goods or services to be exchanged, each party must discharge his obligations under the transaction.<sup>83</sup>

Counterpurchase is where one party sells goods or services to the other and contractually agrees to make a reciprocal purchase of products. It links the value of exports and the value of imports of unrelated products.<sup>84</sup> There is no international legal regime for counterpurchase transactions and parties determine the requirements by themselves.<sup>85</sup>

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<sup>82</sup> *Ibid.*

<sup>83</sup> *Ibid.*

<sup>84</sup> *Ibid.*

<sup>85</sup> Bunker, *supra* note 1 at 262.

Offset is another type of countertrade. Offset arrangements involve technology transfer in return for buying products from the supplier.<sup>86</sup> The purchaser of an offset program is usually a foreign government and the goods sold are generally sophisticated and expensive,<sup>87</sup> such as aircraft and military-related productions.<sup>88</sup> A typical offset arrangement may involve subcontracting, licensing production in the purchaser country, or purchasing goods and services in return.<sup>89</sup>

## 2.4 Leasing

Over the past decades, leases have become one of the most attractive and widely used type of aircraft financing acquisitions in the world. From 1998 to 2002, the number of international scheduled airlines which used leased aircraft has increased by 20%. In 2001, 84% of the international scheduled airlines in operation worldwide used leased aircraft, and over 45% of all transport category aircraft in service with such airlines were leased. Regarding the sources of leased aircraft for international scheduled service airlines, between 1996 and 2001 the number of aircraft leased from other airlines increased by 33%, from leasing companies by 43%, and from others (a

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<sup>86</sup> Oh, *supra* note 79.

<sup>87</sup> Bunker, *supra* note 1 at 262.

<sup>88</sup> Oh, *supra* note 79.

<sup>89</sup> *Ibid.*

category including, for example, banks) by 44%. Thus, the trend towards the increasing use of leased aircraft has continued, reflecting in particular the economics and flexibility of leasing over purchasing.<sup>90</sup>

### **2.4.1 Reasons for Leasing**

There are a lot of reasons stimulating airlines to acquire aircraft by leasing. The most important factors are accounting and taxation purposes. Traditionally, leasing has been a method of achieving “off-balance sheet financing” and “tax benefit transfers”. This enabled lessees (borrowers) to finance equipment essential to the development of an optimum scale of plant, at financing costs below those of conventional borrowers.<sup>91</sup> In addition to these two reasons there are some other reasons for aircraft leasing:

- (a) It enables airlines to avoid the investment of funds required in aircraft purchase and releases capital which would otherwise be tied to the ownership of an aircraft;<sup>92</sup>

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<sup>90</sup> ICAO: *Aircraft Leasing in International Air Transport*, ATConf/5-WP/9, 27/9/02.

<sup>91</sup> Bunker, *supra* note 11 at 57.

<sup>92</sup> Jerome Cohen, “The Challenge of Aircraft Financing and Its Legal Implications” (LL.M thesis, McGill University, 1996) [unpublished] at 11.

- (b) It provides the lessor with a security device. In dealing with an insolvent debtor, a creditor who can establish his ownership of an asset generally fares better than a creditor with only a security interest;<sup>93</sup>
- (c) Compared with traditional methods, it may produce a lower cost for the use of equipment because of tax considerations;<sup>94</sup>
- (d) Leasing can be designed for accounting purposes as off-balance sheet and preserve the lessee's debt-equity ratio.<sup>95</sup>
- (e) From a lessee's perspective, operating leasing may shift the burden of equipment obsolescence to the lessor. The lessee does not get involved in the difficulties of reselling used aircraft.<sup>96</sup>
- (f) The flexibility of leasing makes leasing companies more adaptable than banks and financial institutions with respect to contract structure.<sup>97</sup>
- (g) Leasing provides for the use of the benefits of low-cost foreign currencies or baskets of foreign currencies.<sup>98</sup>

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<sup>93</sup> Bunker, *supra* note 1 at 250.

<sup>94</sup> *Ibid* at 252 .

<sup>95</sup> *Ibid* .

<sup>96</sup> Fortier, *supra* note 13 at 117.

<sup>97</sup> Bunker, *supra* note 1 at 251.

<sup>98</sup> *Ibid*.

## 2.4.2 Classification of Leasing

Depending on different standpoints and purposes, aircraft leasing can be classified in multiple ways. The principle influences on the classification of aircraft leasing are accounting, taxation, securities legislation, bank regulations, usury statutes, contractual relationships and political jurisdictions.<sup>99</sup>

The basic categories of aircraft leases are financial leases and operating leases and all other types derive therefrom.<sup>100</sup>

### 2.4.2.1 Financial Leases

A financial lease, also called a capital lease, is a lease that transfers substantially all of the risks and rewards of ownership of an aircraft to the lessee.<sup>101</sup> Generally, a capital lease is a long-term full payout lease pursuant to which the lessee acquires use of an aircraft for a substantial part of its useful life. Rent payments are structured so

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<sup>99</sup> Bunker, *supra* note 11 at 24.

<sup>100</sup> Bunker, *supra* note 1 at 183.

<sup>101</sup> *Ibid* at 183.

that the lessor recovers the cost of the aircraft, plus a return on investment, over the life of the lease.<sup>102</sup> In a finance lease, the obligation on a lessor is to finance the purchase of the equipment.<sup>103</sup> The title of the equipment remains with the lessor throughout the lease term; thus, there is no ownership risk on the lessor.

#### **2.4.2.2 Operating Leases**

A lease which does not meet the standard of a capital lease is called an operating lease. An operating lease provides for the lessee to receive the right to use an aircraft for a portion of its useful life.<sup>104</sup> The term of an operating lease will typically vary between three to five years, after which the aircraft will be returned to the lessor and either leased again or sold. Usually, aircraft that are the subject of operating leases are acquired by the lessor with no specific lessee in mind.<sup>105</sup>

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<sup>102</sup> R.D. Margo, “Aspects of Insurance in Aviation Finance” (1996) 62 J. Air L. & Com. 423.

<sup>103</sup> Bunker, *supra* note 1 at 183.

<sup>104</sup> Margo, *supra* note 102.

<sup>105</sup> *Ibid*; Simon Hall, *Aircraft financing* (London, England: Euromoney Publications, 1993) at 481; Margo, *supra* note 102.

In addition to the above classification, numerous types of leasing have arisen in aircraft leasing practice, such as wet leases and dry leases, single investor leases and leveraged leases, and true leases and leases which are disguised security interests.<sup>106</sup>

### **2.4.3 Types of Aircraft Leasing in China**

As mentioned in the first chapter, aircraft leasing in China emerged in the early 1980s. In the following years, leasing became the most important method in aircraft acquisition transactions in China. Most of China's aircraft leasing were designed and operated by foreign companies and institutions in different countries and regions. Thus, types of aircraft leasing in China were also varied.<sup>107</sup> The following are the main types that have been frequently used in Chinese aircraft leasing transactions.

#### **2.4.3.1 Japanese Leveraged Leases (JLLs)**

The JLL was a frequently used type of aircraft leasing structure in China. JLL required the establishment of a special purpose company to acquire the aircraft and at

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<sup>106</sup> Margo, *supra* note 102.

<sup>107</sup> See section 1.3.

least 20% of the equity in the company had to be held by Japanese nationals. Wide-body aircraft were leased for 12 years, while narrow-body aircraft were leased for 10 years.<sup>108</sup> Under a Japanese Leveraged Lease, the airline received tax deductions in its home country, and the Japanese investors were exempt from taxation on their investment.

The rules of the JLL were set out by the Japanese National Tax Administration (NTA). The general principles of the JLL are as follows:

- “(a) a residual payment not exceeding the lesser of 45% of the original equipment cost or fair market value at the end of the lease term;
- (b) the lease had to be cash positive for at least one half of the lease term;
- (c) the equity investment had to be at least 20% of the original equipment cost;
- (d) the equity had to be sold completely prior to delivery of the equipment;
- (e) the financial year-end of the investors in the TK<sup>109</sup> all had to be the same;

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<sup>108</sup> P.S. Morrell, *Airline Finance* (Aldershot, Hants, England; Burlington, VT, USA: Ashgate, 1997) at 171-172.

<sup>109</sup> The abbreviation of “Tokumei Kumiai”. Tokumei Kumiai was a lessor group through which the Japanese investors were allowed to differ their tax bills by depreciating 100% of the asset cost for tax purpose. See Bunker, *supra* note 1 at 217.

- (f) the aggregate amount of taxable income less tax losses to the lessor could not have been less than 1 % of the original equipment cost; and
- (g) the depreciation expense in excess of rental income was limited to 160% of excess depreciation that would normally be found in a regular lease.”<sup>110</sup>

The JLL was a historically important structure in international aircraft leasing market which first appeared in the 1980s and 1990s. It was a very stable and popular cross-border leasing product at that time; however, low Yen interest rate, combined with tax changes, finally eliminated Japanese leveraged leases as an instrument in the global leveraged lease market.

#### **2.4.3.2 U.S. Leveraged Leases**

U.S. leveraged leases were often used by foreign airlines for importing aircraft from the United States. In a U.S. leveraged lease structure, the lessor put up some of the money required to purchase the asset and borrowed the rest from a lender. The lender was given a senior secured interest on the asset and an assignment of the lease and lease payments. The lessee made payments to the lessor, who made payments to

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<sup>110</sup> Bunker, *supra* note 1 at 218.

the lender. In this type of lease, the lessor provided an equity portion (a minimum 20%) of the equipment cost and lenders provided the balance on a non-recourse debt basis. The lessor received the tax benefits of ownership.<sup>111</sup> Although the lessor might only provide 20% of the investment in the equipment, he was able to claim 100% of the depreciation as well as any investment tax credits available.<sup>112</sup>

Cross-border U.S. leveraged leases were of great advantage to foreign airlines who enjoyed large reductions in lease rate, but were a great drain in the aggregate on the U.S. Treasury.<sup>113</sup> In 1984, the U.S. tax law was changed to restrict depreciation for property used for exempt entities, including foreign entities not subject to the U.S. federal income taxation, and assets leased to a tax exempt entity had to be depreciated over a period equal to the longer of the statutory class life and 125% of the lease term.<sup>114</sup> Since rapid depreciation was one of a main features in achieving significant benefits from a U.S. leveraged lease structure, the reduction of the benefits have effectively eliminated it as a viable cross-border structure. Consequently, U.S. leveraged leases have become a domestically used leasing structure.

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<sup>111</sup> Morrell, *supra* note 108 at 173.

<sup>112</sup> Bunker, *supra* note 1 at 200.

<sup>113</sup> *Ibid.*

<sup>114</sup> *Ibid.*

The first aircraft leasing agreement in China was made in 1980, in which China acquired its first Boeing 747 by an Investment Tax Credit Lease.<sup>115</sup> In this structure, the lender only has access to the collateral assigned to it to satisfy the loan and the lessor only remains liable to the lender to the extent of its equity in the aircraft.<sup>116</sup> The lessor's return on the investment is provided by:

- the tax benefit associated with the ownership of the aircraft;<sup>117</sup>
- the residual value of the equipment at the end of the lease;<sup>118</sup> and
- a spread paid by the lessee over the debt service.<sup>119</sup>

Since the whole transaction was designed and operated by the U.S. company, it was regarded to be the first step of the U.S. companies occupying the Chinese aircraft leasing market.

The Foreign Sales Corporation Lease (FSC) has also been used in China. A FSC was a special purpose corporation formed in a foreign jurisdiction with which the U.S. maintained a tax treaty or information-sharing agreement. Bermuda and the U.S.

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<sup>115</sup> Zhang, *supra* note 49 at 82.

<sup>116</sup> *Ibid* at 177-178.

<sup>117</sup> *Ibid* at 201.

<sup>118</sup> *Ibid*.

<sup>119</sup> *Ibid*.

Virgin Islands were two of the most commonly used jurisdictions for FSCs. FSCs provided a U.S. government-sanctioned form of tax subsidy for the export of property from the U.S.. Income to the equity investor from 'qualified export property' generated by or through an FSC was effectively taxed at a low rate.<sup>120</sup> In 2000, the Europeans put pressure on the U.S. through the WTO, regarding to the State subsidies of FSCs.<sup>121</sup> As a result, FSCs have been prohibited to be used internationally by the WTO and have been replaced by other structures.

In May, 1991, the China Eastern Airlines leased a MD11 by the Bridge Lease, and then transferred it to the FSC in December 1991. This is the first FSC in Chinese aircraft leasing market.<sup>122</sup>

#### **2.4.3.3 German Leveraged Leases (GLLs)**

In a GLL structure, a German lessor (structured as a partnership) purchases the aircraft from the airline (or takes an assignment of the airline's right to purchase the

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<sup>120</sup> J.V. Babcock & Mark Bewsher, "US Aircraft Leasing", edited by Andrew Littlejohn and Stephen McGairl, *Aircraft financing* (London, England: Euromoney Publications, 1998) at 124.

<sup>121</sup> Bunker, *supra* note 1 at 209.

<sup>122</sup> Zhang, *supra* note 49 at 87.

aircraft from the manufacturer) and the parties make equity contributions of between 20% and 50% of the acquisition cost (in order to reduce the impact of German tax restrictions on the amount of tax depreciation claimed and on the application of corresponding tax losses).<sup>123</sup> The balance of the acquisition cost may be raised by a non-recourse sale of the lease receivables by the German lessor (a loan for more than 12 months would subject the German lessor to the 50% restriction on the deductibility of interest for trade tax purposes). In principle, the place of use of a leased asset and place of residence or incorporation of the lessee are irrelevant to the tax treatment of a German lessor, although the German leasing market tends to be limited to equipment largely manufactured in Germany or with a significant German content.<sup>124</sup> For the German lessor to be able to claim depreciation on an aircraft as the economic owner of that aircraft, the lease should have a term of not less than 40% nor more than 90% of the tax useful life of the aircraft.<sup>125</sup>

In the late 1990s, the number of leased aircraft by GLLs increased in China and the GLL became an important approach of aircraft leasing during this period; for example, the China Eastern Airline leased three A340s by the GLL in 1996, as well as the China Southern Airline leased five A320s by the GLL in 1998.<sup>126</sup>

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<sup>123</sup> Simon Hall, “Leasing in Other European Countries”, edited by Andrew Littlejohn and Stephen McGairl, *Aircraft financing* (London, England: Euromoney Publications, 1998), at 171.

<sup>124</sup> *Ibid.*

<sup>125</sup> *Ibid.*

<sup>126</sup> Zhang, *supra* note 49 at 87.

#### 2.4.3.4 Hong Kong Leveraged Leases

A typical structure of Hong Kong leveraged lease was almost the same as that of a German lease. In a Hong Kong leveraged lease transaction, a locally-incorporated lessor acquired an aircraft through a combination of non-recourse debt, recourse debt and equity (generally in a 49-16-35 proportion) and thus be able to claim depreciation allowances, despite only being liable for half of the purchase price. Its high tax losses could then be set off against profits from leasing the aircraft to a local carrier. Due to local tax laws, these investments were set up as general partnerships in which the investors' liability was mainly limited by insurance and by contract with the operator.<sup>127</sup>

In the November of 1990, the Hong Kong government authority changed its taxation policy on leveraged leases. According to the amendment, the lessee of a Hong Kong leveraged lease (ultimate end user) who enjoys benefits of the tax rate must be a Hong Kong operator.<sup>128</sup> Therefore, Hong Kong leveraged leases became unviable as a cross-border structure for foreign airlines and airlines of Mainland China.

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<sup>127</sup> Online: Wikipedia <<http://en.wikipedia.org>> (assessed on 20 February 2008).

<sup>128</sup> Hong Kong Inland Revenue Department issued Departmental Interpretation and Practice Notes NO. 15 (Revised) in January 2006. The Notes replaced those issued on 1 May 1986, on 15 November 1990 and in September 1992. According to the Notes, the lessee of a Hong Kong leveraged lease/ ultimate end user “must be a Hong Kong operator”. Article 20 provided that “where the asset is a leased ship or aircraft the law prescribes a different test for deciding whether initial or annual allowances shall be granted to the taxpayer (lessor).” “In such cases the question is not whether the ship or aircraft is used wholly or principally outside Hong Kong but whether the person holding rights as lessee (the end-user) is an operator of a Hong Kong ship or

In Chinese aircraft leasing history, transactions through Hong Kong leveraged leases gathered in the period of 1985 to 1990 and twenty-one B737-200s were leased through this structure.<sup>129</sup>

#### **2.4.3.5 Swedish Leveraged Leases**

The Swedish Leveraged Leases that emerged at the beginning of the 1990s were used for small equipment because the Swedish treasury was not wealthy enough to afford deals of large aircraft. The main characteristic of the Swedish Leveraged Lease is the lessor's entitlement to benefit from tax depreciation. Moreover, the following should be considered:<sup>130</sup>

- The lessor must acquire and retain ownership in accordance with Swedish tax law;
- The fact that a foreign lessee obtains depreciation tax benefits in relation to the asset according to the domestic laws of its own jurisdiction does not have any impact on the Swedish lessor's right to deduct depreciation allowances in respect of the asset.

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aircraft. An operator of a Hong Kong ship or aircraft is a person who carries on business as an operator of ships or aircraft being a business controlled and managed in Hong Kong.”

<sup>129</sup> Zhang, *supra* note 49 at 106.

<sup>130</sup> Hall, *supra* note 123 at 179.

- The leased asset must be recorded as an asset in the lessor's balance sheet; and
- The lessee may have an option to purchase the aircraft. The option should not be for a purely nominal price but must reflect the market value of aircraft.

On April 3, 1992, four SAAB-340s were leased by the China Southern Airlines through the Swedish Leveraged Lease.<sup>131</sup> It is the only transaction that uses the Swedish Leveraged Lease in the Chinese market.

#### **2.4.3.6 Residual Value Leases**

The structure of a Residual Value Lease is similar to that of a Sale-Leaseback. This kind of transaction involves the sale of the used aircraft and equipment to a Chinese leasing company who enters into a lease agreement with the seller for the lease of the aircraft and equipment. In this scenario, the purchaser (the leasing company) acts as lessor and the seller acts as lessee. In a Residual Value Lease, the involved aircraft are always used aircraft rather than new ones and the lease is always denominated in Yuan.

The Residual Value Lease was designed to meet the needs of Chinese airlines for paying for the residual value of leased aircraft after the leasing expiration. The first Residual Value Lease emerged in 2000 when China Northern Airlines cooperated with

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<sup>131</sup> *Ibid* at 109.

the Xin Shi Ji Financial Leasing Company and the Xinjiang Financial Leasing Co., Ltd. The involved aircraft are four MD82s, involving 44.16 million US dollars.<sup>132</sup>

#### **2.4.3.7 Operating Leases<sup>133</sup>**

Before 1990, the Financial Lease is the only approach that was used in the Chinese aircraft leasing market. In 1990, the Guangzhou Civil Aviation Authority<sup>134</sup> and GPA<sup>135</sup> signed a package of agreements concerning Operating Leases of five B737-300s, five B737-500s and 8 engines. This is the first time that China used the Operating Lease to acquire aircraft and equipment. As a result, many other Chinese airlines began following this approach to acquire aircraft. Thus, the Operating Lease gradually became an important method in aircraft leasing practices in China. Up until now, about 25% of aircraft in China are obtained by Operating Leases.<sup>136</sup> For some airlines, over 50% are obtained by Operating Leases.

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<sup>132</sup> Zhang, *supra* note 49 at 110.

<sup>133</sup> The definition of the operating lease has been discussed in section 2.4.2.2.

<sup>134</sup> The Guangzhou Civil Aviation Authority is the predecessor of the China Southern Airlines Corporation.

<sup>135</sup> GPA is the predecessor of the General Electric Capital Aviation Services, Inc. (GECAS)

<sup>136</sup> Zhang, *supra* note 49 at 112.

Wet Leases have also been used in Aircraft financing in China. The first Wet Lease transaction was used by Xinjiang Airlines to acquire two Il 86s from the Tashkent Airlines of Uzbekistan.<sup>137</sup>

In a Wet Lease structure, one airline (lessor) provides an aircraft, complete crew, maintenance, and insurance, (known as ACMI) to another airline (lessee). The lessee provides fuel, covers airport fees, and any other duties and taxes. The flight uses the flight number of the lessee. A Wet Lease generally lasts in a very short term and is best suited for some specific circumstances,<sup>138</sup> such as introducing a new route during peaking period or seasonal demands.

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<sup>137</sup> Zhang, *supra* note 49 at 112.

<sup>138</sup> Bunker, *supra* note 1 at 229.

## **Chapter 3 The International Legal Framework of Aircraft Financing**

The operation of aviation is complex. It has relations with aircraft and other equipment, infrastructure and other air transportation services. Although the history of aircraft financing is not long, the development is quick. Various types of financing have been designed to fulfill different objectives in aircraft financing practices.

Aircraft financing involves not only the final users of the aircraft but also the manufacturers, banks or other private investors, trustees, lessors, institution lenders and so on. Because aircraft can be moved easily from one country to another, regardless of territories and jurisdictional boundaries, the law applicable to security rights over them also changes.<sup>139</sup> Moreover, the value of aircraft is high and the rights or interests are subjected to private property law. Certain difficulties arise because every right or interest in aircraft is based on a national legal system which may have conflicts with those of a foreign legal system where the right or interest has to take

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<sup>139</sup> See International Regulation of Aspects of Security Interests in Mobile Equipment: Study, prepared by Professor R.C.C. Cuming, UNIDROIT 1989 Study LXXII - Doc.1 [*Cuming Report*].

effect.<sup>140</sup> Not only public international air law but also domestic law had an intense impact on international civil aviation.

The *lex situs* rule applies the law of the jurisdiction in which mobile equipment is situated to determine a range of basic questions. It often includes conflict of laws rules such as the validity of security-type rights and interests. These conflicts of laws rules reduce the level of predictability in a transaction, thereby increasing its risk. “If this was the principal legal problem to be addressed in the context of international secured financing and leasing, the appropriate means to do so would have been an international conflict of laws instrument.”<sup>141</sup> The different treatment of security interests in aircraft across national boundaries is the most powerful motivation for harmonisation of the law in this area. In most jurisdictions, the *lex situs* conflict of laws rule would be applied to determine the law governing the constitution and effects of proprietary interests in movable equipments. In a practical sense, however, aircraft do not have a specific *situs*. Therefore, the *lex situs* rule is considered to be completely inadequate when apply to objects that are continuously moving from State to State in the ordinary course of business.<sup>142</sup> As the movable has now acquired a new *situs*, the question arises as to whether the security interest created in the first country has any effect in the

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<sup>140</sup> J.A. Krupski, “Laws in Aircraft Securitisation” (LL.M thesis, McGill University, 1999) [unpublished] at 31.

<sup>141</sup> Jeffrey Wool, “The Next Generation of International Aviation Finance Law: An Overview of the Proposed Unidroit Convention on International Interests in Mobile Equipment as Applied to Aircraft Equipment” (1999) 20 U. Pa. J. Int'l Econ. L. 499.

<sup>142</sup> B.P. Honnebier, “The Fully-Computerized International Registry for Security Interest in Aircraft and Aircraft Protocol That Will Become Effective Toward the Beginning of 2006” (2005) 70 J. Air L. & Com. 63.

second.<sup>143</sup> “This question is particularly problematic if the security interest in the second country would have been invalid.”<sup>144</sup> “If the first security interest is recognised as valid under the law of the second nation, a further question remains as to whether, despite its existence, the first security interest is displaced by the *in rem* rights acquired in the property under the law of the second State.”<sup>145</sup> At common law, the foreign security interest was treated as valid in the new *situs* unless and until it was displaced by a new title acquired in accordance with the law of the new *situs*.<sup>146</sup> In contrast, in some continental legal systems “the continued existence of rights in the form of a security interest created under the original *situs* is dependant upon whether or not the foreign security interest can be accommodated to the municipal law of the new *situs*.”<sup>147</sup> Common law courts are more willing to look to “the original *lex situs*” to determine the nature of a foreign security interest before deciding how it is to be treated.<sup>148</sup> Common law courts also have less difficulty in accommodating most foreign security interests because of the flexible approach taken by equity regarding

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<sup>143</sup> See UNIDROIT Congress to Celebrate the 75th Anniversary of the Foundation of UNIDROIT: Worldwide Harmonization of Private Law and Regional Economic Integration, online: UNIDROIT <<http://www.unidroit.org>>.

<sup>144</sup> Honnebier, *supra* note 142.

<sup>145</sup> *Ibid.*

<sup>146</sup> Ronald C.C. Cuming, “International Regulation of Aspects of Security Interests in Mobile Equipment” (1990) 1 Unif. L. Rev. 63.

<sup>147</sup> *Ibid.*

<sup>148</sup> *Ibid.*

the requirements for a valid security interest.<sup>149</sup> The continental European approach however, may result in the non-recognition of a security interest in a country deemed to be a second *situs*, especially when the second *situs* jurisdiction has no analogous law.<sup>150</sup> Therefore, the *lex situs* rule is considered to be inadequate when applied to aircraft that are continuously moving from State to State in the ordinary course of business.

In providing aircraft finance, a key concern of a lender, investor, or lessor is the risk-adjusted return. An interest payment plus return of principal are the positive result of a financing contract. However, the lender or investor may lose all promised interest if a borrower becomes insolvent. Because of this risk and the general limitations on extending unsecured credit, many lenders require some form of security backing to a loan or debt contract. The prevalence of secured financing in the aviation industry is attributable to a number of factors including:

- “(1) the strong projected residual values and lengthy useful lives of aircraft equipment;
- (2) the cyclical nature of the aviation industry combined with the requirements for long-term financing of aircraft equipment; and

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<sup>149</sup> *Ibid.*

<sup>150</sup> *Ibid.*

(3) the magnitude of the financings and thus the risks involved.”<sup>151</sup>

Because some legal systems do not embody asset-based financing principles, the ability of creditors to establish and enforce claims against debtors is very weak. The priority of claims in domestic registries of security interests “are non-transparent”.<sup>152</sup> Aircraft, a kind of mobile property, “is often viewed as bad collateral”.<sup>153</sup> Its value as collateral will depend in large part on the speed and legal certainty with which a creditor can repossess the equipment and sell or lease it on debtor default. The longer the time between default or bankruptcy and repossession and between repossession and sale or redeployment, the lower the expected recapture-value of the asset, and the greater the opportunity cost and risk exposure of the creditor.<sup>154</sup>

There have been many attempts to introduce globally accepted principles and regulations in high value equipment financing. In general, the framework of related laws in international aircraft financing includes the Convention on International Civil Aviation,<sup>155</sup> the Convention for the International Recognition of Rights in Aircraft,<sup>156</sup>

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<sup>151</sup> Saunders, *supra* note 63.

<sup>152</sup> *Ibid.*

<sup>153</sup> *Ibid.*

<sup>154</sup> *Ibid.*

<sup>155</sup> *Convention on International Civil Aviation*, signed at Chicago on 7 December 1944 (entered into force on 4 April 1947) [*Chicago Convention*].

the UNIDROIT<sup>157</sup> Convention on International Financial Leasing,<sup>158</sup> and the Convention on International Interests in Mobile Equipment Convention<sup>159</sup>.

### 3.1 The Chicago Convention

After World War II, aircraft demonstrated the overwhelming significance of flight for civilian travel. As a consequence, in 1944 an international conference on the regulation of aviation was held in Chicago, Illinois. The achievement of the conference is the Convention on International Civil Aviation, commonly known as the "Chicago Convention."<sup>160</sup> The basic regulations that the Chicago Convention established in civil aviation are as following:

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<sup>156</sup> *Convention for the International Recognition of Rights in Aircraft*, signed at Geneva on 19 June 1948 (entered into force on September 17, 1953) [*Geneva Convention*].

<sup>157</sup> UNIDROIT is the abbreviation of the International Institute for the Unification of Private Law.

<sup>158</sup> *UNIDROIT Convention on International Financial Leasing*, Signed at Ottawa on 28 May 1988, Online UNIDROIT <<http://www.unidroit.org>> (entered into force on May 1, 1995) [*Ottawa Convention*].

<sup>159</sup> *Convention on International Interests in Mobile Equipment*, 16 November 2001, online: UNIDROIT <<http://www.unidroit.org>> (entered into force on April 1, 2004) [*Cape Town Convention*].

<sup>160</sup> B.E. Foont, "Shooting Down Civilian Aircraft: Is There an International Law?", (2007) 72 J. Air L. & Com. 695.

- (a) The Chicago Convention specifically provides that "the contracting States recognise that every State has complete and exclusive sovereignty over the airspace above its territory."<sup>161</sup>
- (b) The first two of the "Freedoms of the Air" were established, which are the right of overflight and the right to land for technical purposes without letting off or taking on passengers, such as for refueling.<sup>162</sup>
- (c) The establishment of the International Civil Aviation Organization (ICAO), which evolved into a specialised agency of the United Nations. The purpose of the ICAO was to facilitate discussions and negotiations involving legal and technical issues of international aviation. Actually, the most important task assigned to ICAO was to "promote safety of flight in international air navigation."<sup>163</sup>
- (d) Article 90 of the Chicago Convention provides that new Annexes can be adopted by a two-thirds vote of ICAO council unless the majority of Contract States have registered their disapproval within certain delays.<sup>164</sup>

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<sup>161</sup> Article 1.

<sup>162</sup> Article 5 provides that "each contracting State agrees that all aircraft of the other contracting States, being aircraft not engaged in scheduled international air services shall have the right, subject to the observance of the terms of this Convention, to make flights into or in transit non-stop across its territory and to make stops for non-traffic purposes without the necessity of obtaining prior permission, and subject to the right of the State flown over to require landing. Each contracting State nevertheless reserves the right, for reasons of safety of flight, to require aircraft desiring to proceed over regions which are inaccessible or without adequate air navigation facilities to follow prescribed routes, or to obtain special permission for such flights."

<sup>163</sup> Article 44.

<sup>164</sup> Bunker, *supra* note 1 at 608.

The followings are the adopted Annexes to the Chicago Convention:

Annex 1	Personnel Licensing
Annex 2	Rules of the Air
Annex 3	Meteorological Service for International Air Navigation
Annex 4	Aeronautical Charts
Annex 5	Units of Measurement to be Used in Air and Ground Operations
Annex 6	Operation of Aircraft
Annex 7	Aircraft Nationality and Registration Marks
Annex 8	Airworthiness of Aircraft
Annex 9	Facilitation
Annex 10	Aeronautical Telecommunication
Annex 11	Air Traffic Services
Annex 12	Search and Rescue
Annex 13	Aircraft Accident Investigation
Annex 14	Aerodromes

Annex 15	Aeronautical Information Services
Annex 16	Environmental Protection
Annex 17	Security – Safeguarding International Civil Aviation Against Acts of Unlawful Interference
Annex 18	The Safe Transport of Dangerous Goods by Air

## 3.2 The Geneva Convention

In 1948, delegates to the Convention on the International Recognition of Rights in Aircraft established and signed the Geneva Convention which concerns the international recognition of rights in aircraft. It was drafted under the auspices of the ICAO and strengthened the Chicago Convention's mandates by reaffirming participating nations' dedication to the protection of ownership rights in aircraft and by avowing the supremacy of these international mandates.<sup>165</sup>

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<sup>165</sup> D.L. Dick, “The Case of the Little Yellow Cuban Biplane: Can Interest Analysis Reconcile Conflicting Provisions in Federal Statutes and International Treaties?”, (2005) 57 Fla. L. Rev. 91.

The U.S. was the most ardent advocate for international order covering aircraft. The fast growth of American air industry encouraged American interests to pursue some degree of certainty on the international recognition of rights in aircraft. Moreover, airlines were paying more and more attention to finding solutions to the conflicts problems facing financiers advancing loans against mobile equipment which involved different jurisdictions.<sup>166</sup> The themes of the Geneva Convention focused on the international recognition of rights created under domestic law, rather than the creation of any new supranational rights.<sup>167</sup> The themes could be concluded as:

- “(a) a general recognition of rights in aircraft;
- (b) central registries established;
- (c) an overriding international preference or priority order with respect to certain claims; and
- (d) establishment of international conditions with respect to the execution of judgments and sale of aircraft.”<sup>168</sup>

The most controversial provisions might be the enumeration of the types of claim that the Geneva Convention addressed in Article 1.<sup>169</sup> It was found difficult to agree a

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<sup>166</sup> Andrew Tetley, “Security Interests in Ships and Aircraft”, (2006) NZ Law Review 689.

<sup>167</sup> *Ibid.*

<sup>168</sup> Bunker, *supra* note 1 at 613.

<sup>169</sup> Article 1 of the Geneva Convention provided that the Contracting States undertake to recognise:(a) rights of property in aircraft;(b) rights to acquire aircraft by purchase coupled with possession of the aircraft; (c) rights to possession of aircraft under leases

single phrase to cover the types of security interest and addressed the differences in financing techniques and legal interests recognised in civil and common law countries.<sup>170</sup> The Geneva Convention adopted a system that would merely recognise the national laws.<sup>171</sup> Where an aircraft is registered in its original country and the original security interest is registered in the same country, any other contracting State is required to recognise the foreign security interest if the aircraft is in any contracting State.<sup>172</sup> Recognition of any claim of rights on aircraft requires a formal record of the interest in a register kept by the State party. For those States that did not have any form of registration, it was therefore in their interest to create one. Once recognised, a valid charge is given priority over all other rights in the aircraft, including State fiscal or regulatory claims.<sup>173</sup>

Twenty countries signed up to the Geneva Convention in 1948 which came into force on 17 September 1953. There has been a steady stream of adherents since then.

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of six months or more; (d) mortgages, hypothèques and similar rights in aircraft which are contractually created as security for payment of an indebtedness: Provided that such rights (i) have been constituted in accordance with the law of the Contracting State in which the aircraft was registered as to nationality at the time of their constitution, and (ii) are regularly recorded in a public record of the Contracting State in which the aircraft is registered as to nationality. The regularity of successive recordings in different Contracting States shall be determined in accordance with the law of the State where the aircraft was registered as to nationality at the time of each recording.

<sup>170</sup> Tetley, *supra* note 166.

<sup>171</sup> Bunker, *supra* note 1 at 613.

<sup>172</sup> Article 1; P.B. Larsen & J.A. Heilbock, "Unidroit Project on Security Interests: How the Project Affects Space Objects", (1999) 64 J. Air L. & Com. 703.

<sup>173</sup> Tetley, *supra* note 166.

The most recent coming was Qatar in 2007.<sup>174</sup> There are currently 89 State parties to the Geneva Convention.<sup>175</sup> However, some active countries in the aviation sector have not ratified it because they can get the aircraft financed without having to sacrifice their rights of detention and attachments.<sup>176</sup> The notable absentees are the United Kingdom and Japan. China ratified the Geneva Convention on April 28, 2000 with two statements.<sup>177</sup>

### 3.3 The Ottawa Convention

In 1974, the governing Council of the UNIDROIT started to work on a draft convention setting up uniform rules with respect to international leasing. Initially, the tax issue in leasing agreements was controversial and the delegates found it difficult to achieve uniformity in the draft convention.<sup>178</sup> They tried to create a legal device that

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<sup>174</sup> Online: <<http://www.icao.int>> (accessed on 27 July 2008).

<sup>175</sup> *Ibid.*

<sup>176</sup> Stephen McGairl, “International Conventions Affecting Aircraft Transactions”, edited by Andrew Littlejohn and Stephen McGairl, *Aircraft financing* (London, England: Euromoney Publications, 1998) at 373.

<sup>177</sup> The Government of the People’s Republic of China made the Notification on 28 April 2000, which included two statements: “1. The Government of the People’s Republic of China does not recognize the signing of the Convention ... by the old Chinese Government; 2. The Convention ... does not apply ex tempore in the Hong Kong Special Administrative Region of the People’s Republic of China until notified otherwise by the Government of the People’s Republic of China.” Online: <<http://www.icao.int>> (accessed on 27 July 2008).

<sup>178</sup> Anda Djojonegoro, “The Unidroit International Aviation Finance Law Reform

was not encrusted with impending fragments of local law respecting bailments, mortgages and sales.<sup>179</sup> Thus, they created a new concept called the *sui generis* financial lease.<sup>180</sup>

The Ottawa Convention was adopted in 1988. The main objectives of the Convention being to:

- (a) remove certain legal impediments to the international financial leasing of equipment, while maintaining a fair balance of interests between the different parties to the transaction;
- (b) make international financial leasing more available;
- (c) adapt the rules of law governing the traditional contract of hire to the distinctive triangular relationship created by the financial leasing transaction; and
- (d) formulate certain uniform rules relating primarily to the civil and commercial law aspects of international financial leasing.

The main principles of the Ottawa Convention are as follows.<sup>181</sup>

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Project” (LL.M thesis, McGill University, 2000) [unpublished] at 73.

<sup>179</sup> Bunker, *supra* note 1 at 624.

<sup>180</sup> *Ibid.*

<sup>181</sup> Franco Ferrari, “General Principles and International Uniform Commercial Law Conventions: A Study of the 1980 Vienna Sales Convention and the 1988 UNIDROIT Convention on International Factoring and Leasing”, (1998) 10 Pace Int’l L. Rev. 157.

(a) Party autonomy

Article 5 provided that “the application of this Convention may be excluded only if each of the parties to the supply agreement and each of the parties to the leasing agreement agree to exclude it.”<sup>182</sup> Article 5 of the Ottawa Convention also permits the parties to derogate from or modify the effect of any provision, except for some specific ones protecting the lessee.

(b) The protection of the lessee's interests

Article 8(2) introduces the lessee's interests. “Where the lessee's default is substantial”, then the lessor may also require accelerated payment of the value of the future rentals, where the leasing agreement so provides, or may terminate the leasing agreement and after such termination:

- i. recover possession of the equipment; and
- ii. recover such damages as will place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms.

(c) The Lessor's Real Rights

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<sup>182</sup> Article 5.

Article 7 (1) indicates that “the lessor's real rights in the equipment shall be valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution”. The following Article 7 (2) provides that the "trustee in bankruptcy" includes a liquidator, administrator or other person appointed to administer the lessee's estate for the benefit of the general body of creditors.<sup>183</sup>

(d) The mitigation principle

Article 13(6) States that "the lessor shall not be entitled to recover damages to the extent that it has failed to take all reasonable steps to mitigate its loss."<sup>184</sup>

Although the Ottawa Convention entered into force on 1 May 1995, it has been ratified by only 10 countries.<sup>185</sup>

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<sup>183</sup> Article 7.

<sup>184</sup> Article 13.

<sup>185</sup> Online: UNIDROIT < <http://www.unidroit.org> > (accessed on January 27, 2008).

### 3.4 The Cape Town Convention

From 1996 to 2001, some nations participated in negotiations under the UNIDROIT to draft a convention that would set up an international legal regime to provide a mechanism for recognising and recording international security interests created in high value mobile equipment, usually overriding local title interests or claims. In November 2001, the Cape Town Convention was signed by fifty-three countries at Cape Town, South Africa. The Convention was designed to address three types of equipment: aircraft equipment, railway rolling stock, and space assets. While the convention contains provisions that apply generally to such equipment, more specific provisions concerning each of the three types of equipment are included in protocols to the convention. The first protocol, the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment,<sup>186</sup> which is on aircraft equipment (including airframes, aircraft engines, and helicopters), was completed at the same time as the Cape Town Convention. The second protocol, the Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Railway Rolling Stock,<sup>187</sup> was adopted on

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<sup>186</sup> *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*, 16 November 2001, online: UNIDROIT <<http://www.unidroit.org>> (entered into force on March 1, 2006) [*Cape Town Protocol*].

<sup>187</sup> *Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Railway Rolling Stock*, 23 February 2007, online: UNIDROIT <<http://www.unidroit.org>> [*Luxembourg Protocol*].

February 23, 2007 at Luxembourg. The space asset protocol remains under negotiation. Technically speaking, the Cape Town Convention contains two types of documents: the Cape Town Convention and the Protocols. In this paper, “the Convention” will simply refer to the Convention and the Protocols collectively.

The Cape Town Convention entered into force on April 1, 2004. The Cape Town Protocol came into force March 1, 2006. To the present day, twenty nations have ratified or acceded to the convention, the most recent being Saudi Arabia and Luxembourg on June 27, 2008.<sup>188</sup> Four nations have signed the Luxembourg Protocol which has not yet entered into force.<sup>189</sup> The Cape Town Convention supersedes the Geneva Convention with regards to aircraft and aircraft objects, and the Rome Convention for the Unification of Certain Rules Relating to the Precautionary Attachment of Aircraft 1933 with regards to aircraft. The Cape Town Convention also replaces the Ottawa Convention with regards to aircraft objects.

The goal of the Cape Town Convention is to set up a regime to recognise law in various Member States to facilitate the extension of mobile equipment credit to reduce its cost.<sup>190</sup> There is a strong demand for more effective ways to ensure the international protection of interests in aircraft equipment, and the Cape Town Convention have been

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<sup>188</sup> Online: UNIDROIT <<http://www.unidroit.org>> (accessed on July 27, 2008).

<sup>189</sup> Online: UNIDROIT <<http://www.unidroit.org>> (accessed on July 27, 2008).

<sup>190</sup> Bunker, *supra* note 1 at 616.

designed to solve the problems that presently interfere with the financing of aircraft equipment. They particularly address the secured transaction issues that currently exist in relation to international asset-based financing and leasing of aircraft objects.

A significant achievement of the Cape Town Convention is the establishment of the International Registry, which plays an important role in the convention.<sup>191</sup> Article 17 provides different categories of objects which are suitable for different registries. The Cape Town Convention regulates the privileges, immunities, and liability of these institutions. The Registrar will be strictly liable for compensatory damages for any loss suffered due to errors, omissions or system malfunctions.<sup>192</sup> The International Registry was designed to be operated by the Registrar under ICAO. The Irish company Aviareto, a joint venture between the Irish government and a Swiss-based aviation information technology firm, with oversight by ICAO, has been selected to manage the International Registry. The electronic, internet-based register service is available online twenty-four hours a day, seven days a week. The system is designed to prevent the recording of interests without the required prior electronic consent. The checking of the registration applications, the registrations themselves, and the responses to searches is processed automatically by the computer.<sup>193</sup> This process does not require human involvement. The international interests and other registrable rights may be entered in

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<sup>191</sup> Article 16.

<sup>192</sup> Article 17.

<sup>193</sup> Article 16.

the International Registry. The registration of an interest has effect from the moment that the registration is searchable.<sup>194</sup>

Provisions under the Cape Town Convention and Protocols are either core or optional.<sup>195</sup> Core provisions are compulsory for each Member State; optional provisions are elective and allow each Member State to decide what extent it desires to facilitate asset-based financing during the adoption process.<sup>196</sup> Options include opt-in and opt-out, which are affected by filing declarations to certain provisions at the time adoption of the Convention. If a Member State declares remedies for mortgages and lessors and its domestic law does not include laws with respect to concepts such as security, retention of title, equipment leases and bankruptcy, it will be difficult to achieve the desired purpose of facilitating repossession of aviation objects. Thus, the International Registry serves only to provide public notice rather than a perfect title.<sup>197</sup>

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<sup>194</sup> Article 18.

<sup>195</sup> Article 39; Bunker, *supra* note 1 at 619.

<sup>196</sup> Bunker, *supra* note 1 at 619.

<sup>197</sup> Bunker, *supra* note 1 at 622.

# **Chapter 4 Legal Framework of Aircraft Financing in China**

## **4.1 Historical background of China's Legal environment**

Generally, China is regarded as a civil law jurisdiction and China's legal system has some common features with other statutory law jurisdictions. However, the unique legal environment causes China's legal system to have a special nature.

In the history of the development of Chinese legal ideals, there are two philosophies that have tremendously influenced the traditional Chinese legal basis: Confucianism and Legalism.

Confucius (551- 479 BC) is considered to be a sage of ancient China. His speeches were collected in the "Analects of Confucius". Confucianism focused on the fields of ethics and politics, emphasising personal and governmental morality, correctness of social relationships, justice, traditionalism, and sincerity. Confucius

believed that desirable behaviour and social harmony can be obtained through the rule of good men and strict regulation or severe punishment is not considered effective. Moreover, Confucius stated that individuals are less important than the group. In *Analects*, Confucius stated: "lead the people with administrative injunctions and put them in their place with penal law, and they will avoid punishments but will be without a sense of shame. Lead them with excellence and put them in their place through roles and ritual practices, and in addition to developing a sense of shame, they will order themselves harmoniously."<sup>198</sup>

Legalism is a pragmatic political philosophy synthesised by a theoretician Han Fei (280-233 BC).<sup>199</sup> Han Fei's philosophy centered on the ruler and he believed that a ruler should govern his subjects by three principles: (a) law; (b) tactic or statecraft; and (c) power. He emphasised that "when the epoch changed, the ways changed".<sup>200</sup> Legalism was the chosen philosophy of the Qin Dynasty, which has been well recognised as a strong but tyrannous dynasty in Chinese history. Thus, Legalism is now considered to be one of the theoretical foundations of a totalitarian society.

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<sup>198</sup> *Analects II*, 3, online: <<http://chinese.dsturgeon.net>> (accessed on September 1, 2008).

<sup>199</sup> Han Fei's works were collected in "Han Fei Zi" by some scholars who were directed by the King of Han. In ancient China, "Zi" is an honorific suffix that was often added to the names of philosophers, meaning "Master".

<sup>200</sup> *Han Fei Zi*, online: <<http://chinese.dsturgeon.net>> (accessed on September 1, 2008).

These two philosophies have existed side by side throughout Chinese history and lead China's legal system developing in different directions from that in western countries. It is worth mentioning that Confucianism has a stronger influence in Chinese society than Legalism.

In 1911, the outbreak of the May Fourth Movement<sup>201</sup> completely abolished the old imperial institutions and practices of China, such as the Confucianism, and western philosophies began to enter China. There were many attempts to incorporate democracy, republicanism, and industrialism into Chinese philosophy in this period. The New Culture Movement<sup>202</sup> which came out of the May Fourth Movement resulted in not only a challenge to traditional Chinese values but also a drastic change in society that fuelled the birth of the Communist Party of China. At the beginning of 20th century, the Communist Party of China brought Marxism, Stalinism, and other communist ideals to China.

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<sup>201</sup> The May Fourth Movement of 1919 was an anti-imperialist, cultural, and political movement in early modern China. It was caused by dissatisfaction with the Treaty of Versailles, in which The Western Allies paid little attention to China for its contribution to the Allies' victory and the treaty awarded Shandong Province to Japan. Chinese diplomatic failure at the Paris Peace Conference became the fuse that touched off the outbreak of the May Fourth Movement. On May 4<sup>th</sup>, 1919, more than 3000 students of Beijing University and other schools gathered together in front of the Tiananmen Square to condemn both the West Allied betray of China and the "spineless" Chinese government for its inability in the Paris Peace Conference. Nationalism had been strongly stimulated in China since the May Fourth Movement.

<sup>202</sup> The New Culture Movement was ignited by the *New Youth* journal, established in 1915 by Beijing University professor Chen Duxiu. The New Culture Movement was a movement of intellectuals blaming the cultural heritage of China for its many wrongs. This would also be the basis for the more widespread and politically-focused May Fourth Movement.

In 1949, the Communist Party of China took over the control of Mainland China and announced the establishment of the People's Republic of China (PRC). Traditional Chinese philosophies, excepting Legalism, were denounced as immoral. Later, a more radical movement, the Cultural Revolution in 1966, advocated breaking with all Chinese traditional thoughts. It lasted 10 years and brought the ideological chaos to China. Even today, the confusion still influences Chinese society.

Since the end of the Cultural Revolution, the Chinese government realised that a State-run economy could not lead China to economic prosperity. The current government became more patient with the practice of western philosophies and traditional Chinese beliefs, trying to find out a new way to build a stronger China. They pursued the Reform and Open-up policy<sup>203</sup> and tried to find a form of socialism with Chinese characteristics in market economy. At the beginning of the Reform and Open-up policy, light industry operated via collectives and small private enterprises in manufacturing and services were encouraged by the State. Under this policy, the economy grew rapidly and large privately-run companies emerged. Additionally, foreign investors also engaged in the Chinese market and gained substantial profits from China. In fact, the current Chinese economic system, namely socialism with Chinese characteristics in market economy, looks very much like capitalism. In this

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<sup>203</sup> See *supra* note 3.

transformation process, many new laws have been issued to satisfy the demands of the rapid economic growth.

## **4.2 The Current Legal Framework of Aircraft Financing in China**

All the above factors have strongly influenced China's current legal system. In the aircraft financing field, there are many related laws, regulations and rules that have been issued. Under these laws, regulations and rules, numerous aircraft acquiring transactions were performed, particularly in the recent 30 years. These laws, regulations and rules can be divided into three parts:

### **4.2.1 Laws**

In China, the legislative power of the State is exercised by the National People's Congress and its Standing Committee. The National People's Congress enacts and amends basic laws governing criminal offences, civil affairs, the State organs and other

matters. The Standing Committee of the National People's Congress enacts and amends laws other than the ones to be enacted by the National People's Congress.<sup>204</sup>

Laws related to aircraft financing include:

- Constitution of the People's Republic of China<sup>205</sup>
- General Principles of the Civil Law of the People's Republic of China<sup>206</sup>
- Real Rights Law of the People's Republic of China<sup>207</sup>
- Company Law of the People's Republic of China<sup>208</sup>

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<sup>204</sup> Article 7 of the *Legislation Law of the People's Republic of China* (adopted at the third Session of the Ninth National People's Congress on March 15, 2000 and promulgated by Order No. 31 of the President of the People's Republic of China on March 15, 2000) [*Legislation Law*].

<sup>205</sup> *Constitution of the People's Republic of China* (adopted at the Fifth Session of the Fifth National People's Congress on December 4, 1982 and adopted at the First Session of the Eighth National People's Congress on March 29, 1993) [*Constitution*].

<sup>206</sup> *General Principles of the Civil Law of the People's Republic of China* (adopted at the Fourth Session of the Sixth National People's Congress, and promulgated by Order No. 37 of the president of the People's Republic of China on April 12, 1986, and effective as of January 1, 1987) [*General Principles of the Civil Law*].

<sup>207</sup> *Real Rights Law of the People's Republic of China* (adopted at the 5th session of the Tenth National People's Congress on March 16, 2007, and entered into force on October 1, 2007) [*Real Rights Law*].

<sup>208</sup> *Company Law of the People's Republic of China* (adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993, and entered into force on July 1, 1994) [*Company Law*].

- The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures<sup>209</sup>
- Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures<sup>210</sup>
- Law of the People's Republic of China on Foreign-funded Enterprises<sup>211</sup>
- Civil Aviation Law of the People's Republic of China<sup>212</sup>
- Contract Law of the People's Republic of China<sup>213</sup>

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<sup>209</sup> *The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures* (adopted by the Second Session of the Fifth National People's Congress on July 1, 1979 and revised in accordance with "Resolution on Revision of the Law of the People's Republic of China on Chinese-Foreign Joint Venture" of the Third Session of the Seventh National People's Congress on April 4, 1990, revised for the second time in accordance with "Resolution on Revision of the Law of the People's Republic of China on Chinese-Foreign Joint Venture" of the Fourth Session of the Ninth National People's Congress on March 15, 2001).

<sup>210</sup> *Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures* (adopted at the First Session of the Seventh National People's Congress, revised according to the Decision on Modifying the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures adopted at the 18th Session of the Standing Committee of the Ninth National People's Congress on October 31, 2000, and promulgated by Order No.40 of the President of the People's Republic of China on October 31, 2000).

<sup>211</sup> *Law of the People's Republic of China on Foreign-funded Enterprises* (adopted at the 4th Meeting of the Sixth National People's Congress on April 12, 1986, amended in accordance with the Decision on Modifying the Law of the People's Republic of China on Foreign-funded Enterprises adopted at 18th Meeting of the Standing Committee of the Ninth National People's Congress on October 31, 2000, and promulgated by Order No. 41 of the President of the People's Republic of China on October 31, 2000).

<sup>212</sup> *Civil Aviation Law of the People's Republic of China* (adopted at the Sixteenth Session of the Standing Committee of the Eighth National People's Congress on October 30, 1995, and entered into force on March 1, 1996) [*Civil Aviation Law*].

<sup>213</sup> *Contract Law of the People's Republic of China* (adopted at the Second Session of the Ninth National People's Congress on March 15, 1999, and entered into force on October 1, 1999) [*Contract Law (1999)*].

- The Guarantee Law of the People's Republic of China<sup>214</sup>
- Customs Law of the People's Republic of China<sup>215</sup>
- Enterprise Income Tax Law of the People's Republic of China<sup>216</sup>

#### 4.2.2 Regulations and Rules

According to the Legislation Law of the People's Republic of China, administrative regulations should be formulated by the State Council to implement the provisions of law.<sup>217</sup> Moreover, the ministries and commissions of the State Council, the People's Bank of China, the State Audit Administration as well as the other organs endowed with administrative functions directly under the State Council may formulate rules. These rules should comply with the laws as well as the administrative regulations, decisions and orders of the State Council. Matters governed by the rules of

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<sup>214</sup> *The Guarantee Law of the People's Republic of China* (adopted by the Standing Committee of the Eighth National People's Congress at the Fourteenth Session on June 30, 1995, and entered into force on October 1, 1995) [*Guarantee Law*].

<sup>215</sup> *Customs Law of the People's Republic of China* (adopted at the 19th Meeting of the Standing Committee of the Sixth National People's Congress on January 22, 1987, promulgated by Order No. 51 of the President of the People's Republic of China on January 22, 1987, and entered into force on July 1, 1987).

<sup>216</sup> *Enterprise Income Tax Law of the People's Republic of China* (adopted at the Fifth Session of the Tenth National People's Congress on March 16, 2007, and entered into force on January 22, 2008).

<sup>217</sup> Article 56 of the Legislation Law.

departments shall be those for the enforcement of the laws or the administrative regulations, decisions and orders of the State Council.<sup>218</sup>

Regulations and Rules related to aircraft financing include:

- The Provisions on Guiding the Orientation of Foreign Investment<sup>219</sup>
- The Regulation of the People's Republic of China on the Administration of Foreign-funded Banks<sup>220</sup>
- Regulations of the People's Republic of China on the Nationality Registration of Civil Aircraft<sup>221</sup>
- Regulations of the People's Republic of China on Civil Aircraft Rights Registration<sup>222</sup>
- Provisional Regulations of the People's Republic of China on Turnover Tax<sup>223</sup>

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<sup>218</sup> Article 71 of the Legislation Law.

<sup>219</sup> *The Provisions on Guiding the Orientation of Foreign Investment* (promulgated on February 11, 2002, and entered into force on April 1, 2002).

<sup>220</sup> *The Regulation of the People's Republic of China on the Administration of Foreign-funded Banks* (adopted at the 155th executive meeting of the State Council on November 8, 2006, and entered into force on December 11, 2006).

<sup>221</sup> *Regulations of the People's Republic of China on the Nationality Registration of Civil Aircraft* (promulgated on October 21, 1997, and entered into force on October 21, 1997).

<sup>222</sup> *Regulations of the People's Republic of China on Civil Aircraft Rights Registration* (promulgated on October 21, 1997, and entered into force on October 21, 1997).

- Provisional Regulations of the People's Republic of China on Value Added Tax<sup>224</sup>
- Provisional Rules of the People's Republic of China on Stamp Duty<sup>225</sup>
- Import & Export Tariff Regulations of the People's Republic of China<sup>226</sup>
- Provisions on Foreign Investment in the Civil Aviation Industry<sup>227</sup>
- The Supplementary Provisions to the Provisions on Foreign Investment in the Civil Aviation Industry<sup>228</sup>
- The Supplementary Provisions to the Provisions on Foreign Investment in the Civil Aviation Industry (II)<sup>229</sup>
- The Supplementary Provisions to the Provisions on Foreign Investment in the Civil Aviation Industry (III)<sup>230</sup>

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<sup>223</sup> *Provisional Regulations of the People's Republic of China on Turnover Tax* (promulgated on December 13, 1993, and entered into force on January 1, 1994).

<sup>224</sup> *Provisional Regulations of the People's Republic of China on Value Added Tax* (promulgated on December 13, 1993, and entered into force on January 1, 1994).

<sup>225</sup> *Provisional Rules of the People's Republic of China on Stamp Duty* (promulgated on August 6, 1988, and entered into force on October 1, 1988).

<sup>226</sup> *Import & Export Tariff Regulations of the People's Republic of China* (promulgated on November 23, 2003, and entered into force on January 1, 2004).

<sup>227</sup> *Provisions on Foreign Investment in the Civil Aviation Industry* (promulgated on June 21, 2002, and entered into force on August 1, 2002).

<sup>228</sup> *The Supplementary Provisions to the Provisions on Foreign Investment in the Civil Aviation Industry* (promulgated on January 24, 2005, and entered into force on February 24, 2005).

<sup>229</sup> *The Supplementary Provisions to the Provisions on Foreign Investment in the Civil Aviation Industry (II)* (promulgated on January 4, 2007, and entered into force on January 4, 2007).

<sup>230</sup> *The Supplementary Provisions to the Provisions on Foreign Investment in the Civil Aviation Industry (III)* (promulgated on October 12, 2007, and entered into force on

- Measures for the Administration of Finance Leasing Companies<sup>231</sup>
- Measures for the Administration of Foreign-funded Lease Industry<sup>232</sup>
- Regulations on the Foreign Exchange System of the People's Republic of China.<sup>233</sup>

### 4.2.3 Judicial Interpretation

In China's legal system, the power of legal interpretation belongs to the Standing Committee of the National People's Congress if a specific meaning of a provision need to be further defined.<sup>234</sup> In the Judicial system, the Supreme Court has the power of judicial interpretation.<sup>235</sup> Some interpretations which are related to aircraft financing have been issued to deal with some special circumstances in China, for example, the "Provisions of a Number of Issues Hearing on the Financial Leasing Contract Dispute Cases" was issued by the Supreme Court on May 27, 1996,<sup>236</sup> as well as the

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January 1, 2008).

<sup>231</sup> *Measures for the Administration of Finance Leasing Companies* (promulgated on January 23, 2007, and entered into force on March 1, 2007).

<sup>232</sup> *Measures for the Administration of Foreign-funded Lease Industry* (promulgated on February 3, 2005, and entered into force on March 5, 2005).

<sup>233</sup> *Regulations on the Foreign Exchange System of the People's Republic of China* (entered into force on April 1, 1996).

<sup>234</sup> Article 42 of the Legislation Law.

<sup>235</sup> Article 32 of the Law on the Organization of People's Court.

<sup>236</sup> The "Provisions of a Number of Issues Hearing on the Financial Leasing Contract Dispute Cases" entered into force on May 27, 1996.

“Interpretation of Several Issues on the Application of The Guarantee Law of the People's Republic of China” was issued on December 8, 2000.<sup>237</sup> These interpretations have the same force as law, providing some further explanations on specific issues about aircraft financing in China.

### 4.3 Basic Protections for Property Rights

Theoretically, the socialist system is the basic system of the People's Republic of China. Thus, the basis of the socialist economic system of the People's Republic of China is socialist public ownership.<sup>238</sup> As a complement to the socialist public economy, the private sector of the economy is permitted to exist and the lawful rights and interests of the private sector and other non-public sectors are encouraged and supported by the State.<sup>239</sup> Foreign enterprises, other foreign economic organisations and individual foreigners are permitted to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic

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<sup>237</sup> The “*Interpretation of Several Issues on the Application of the Guarantee Law of the People's Republic of China*” entered into force on December 13, 2000.

<sup>238</sup> Article 1 of the Constitution. The PRC has had five constitutions: the 1949 (Common Program), the 1954 Constitution, the 1975 Constitution, the 1978 Constitution and the 1982 Constitution. The 1949 Common Program served as a provisional constitution until the 1954 Constitution could be enacted. The 1982 Constitution has been followed by 4 Amendments in 1988, 1993, 1999 and 2004.

<sup>239</sup> Article 11 of the current Constitution. This article is an amendment of Article 11 of the 1982 Constitution.

organisations. Lawful rights and interests of foreign enterprises, other foreign economic organisations as well as Chinese-foreign joint ventures are protected by the constitution.<sup>240</sup>

The General Principles of the Civil Law was issued in 1987. The purpose of the Principles is to protect the lawful civil rights and interests of citizens and legal persons and correctly adjusting civil relations.<sup>241</sup> Article 5 provided that the lawful civil rights and interests of citizens and legal persons shall be protected by law and no organisation or individual may infringe upon them. A Chinese-foreign equity joint venture, Chinese-foreign contractual joint ventures or foreign-capital enterprise established within the People's Republic of China shall be qualified as a legal person in China, if it has the qualifications of a legal person and has been approved and registered by the administrative agency for industry and commerce in accordance with the law.<sup>242</sup>

After a period of constant fierce debate about whether China should have a whole single law to protect real rights, which had been regarded as a challenge to socialist public ownership, the Real Rights Law was finally issued on March 16, 2007. The

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<sup>240</sup> Article 18 of the Constitution.

<sup>241</sup> Article 1 of the General Principles of the Civil Law.

<sup>242</sup> Article 41 of the General Principles of the Civil Law

term "res" mentioned in the Real Rights Law is defined as realties and chattels, as well as the term "real right" is defined as the exclusive right of direct control over a specific res enjoyed by the holder in accordance with law, including ownership, usufructuary rights and real rights for security.<sup>243</sup> Article 3 and Article 4 confirm, again, that the development of the non-public economy is encouraged and the non-public economy has the equal legal status and development rights with other markets.

## **4.4 Principles on Financing and Leasing**

### **4.4.1 China's financial institutions**

#### **4.4.1.1 The People's Bank of China (PBC)**

The PBC was established on December 1, 1948, based on the consolidation of the former Huabei Bank, Beihai Bank and Xibei Farmer Bank. In September 1983, the State Council decided to have the PBC function as a central bank. The Law of the People's Republic of China on the People's Bank of China legally confirmed the PBC's

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<sup>243</sup> Article 2 of the *Real Rights Law*.

central bank status.<sup>244</sup> In March 2003, the First Plenum of the Tenth National People's Congress approved the Decision on Reform of the Organisational Structure of the State Council, separating the supervisory responsibilities of the PBC for the banking institutions, asset management companies, trust and investment companies and other depository financial institutions. Instead, the China Banking Regulatory Commission was established to supervise the financial industry. Today, the major functions of the PBC are summarised by the Law of the People's Republic of China on the People's Bank of China as follows:<sup>245</sup>

- (a) issuing and enforcing relevant orders and regulations;
- (b) formulating and implementing monetary policy;
- (c) issuing Renminbi (RMB)<sup>246</sup> and administering its circulation;
- (d) regulating inter-bank lending market and inter-bank bond market;
- (e) administering foreign exchange and regulating the inter-bank foreign exchange market;
- (f) regulating the gold market; holding and managing official foreign exchange and gold reserves;
- (g) managing the State treasury; maintaining normal operation of the payment and settlement system;

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<sup>244</sup> Article 2 of the Law of the People's Republic of China on the People's Bank.

<sup>245</sup> Article 4.

<sup>246</sup> For purposes of this paper the conversion rate of the RMB on October 31, 2008 was approximately 1 US dollar = 6.84 China Yuan RMB.

- (h) guiding and organizing the anti-money laundering work of the financial sector and monitoring relevant fund flows;
- (i) conducting financial statistics, surveys, analysis and forecasts;
- (j) participating in international financial activities in the capacity of the central bank;  
and
- (k) performing other functions specified by the State Council.

#### **4.4.1.2 The China Banking Regulatory Commission (CBRC)**

The CBRC was established in April 28, 2003. Before the establishment of the CBRC, both monetary policy and banking supervision were the responsibility by the People's Bank. The CBRC's main function is banking supervision which was excluded from that of the PBC, for the purpose of improving banking supervision and thereby allowing the PBC to better carry out its macro-control functions and implementation of monetary policy.

#### **4.4.1.3 The China Securities Regulatory Commission (CSRC)**

The CSRC was established in October 1992. It is the State authority responsible for exercising centralised market regulation. In November 1993, the State Council decided to charge the State Council Securities Commission (SCSC) with the

responsibility of the test operation of the futures market to be carried out by the CSRC. In March 1995, the State Council formally approved the Organisational Plan of the China Securities Regulatory Commission, thereby confirming the CSRC to be a deputy-ministry rank unit directly under the State Council and the executive branch of the SCSC.<sup>247</sup> The CSRC was authorised to conduct supervision and regulation of the securities and futures markets. In August 1997, The State Council decided to put the securities markets in Shanghai and Shenzhen under the supervision of the CSRC. Today, the CSRC is one of the enterprise units directly under the State Council and the authorised department governing the securities and futures markets of China.

#### **4.4.1.4 The China Insurance Regulatory Commission (CIRC)**

The CIRC was established on November 18, 1998. It is authorised by the State Council to conduct administration, supervision and regulation of the Chinese insurance market, and to ensure that the insurance industry operates stably in compliance with the law. In 2003, the CIRC was upgraded by the State Council from a semi-ministerial institution to a ministerial institution directly under the State Council.

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<sup>247</sup> Online: China Securities Regulatory Commission <[http:// www.csrc.gov.cn](http://www.csrc.gov.cn)> (accessed on June 15, 2008).

#### **4.4.1.5 Commercial Banks**

In China's commercial bank system, the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China, the China Construction Bank and the Bank of China are the four largest commercial banks, making up more than 60% of the total market share.<sup>248</sup> In addition, numerous other commercial banks and foreign banks are components in China's commercial banking system. Today, the ICBC, the China Construction Bank and the Bank of China have completed joint-stock reform from wholly State-owned commercial banks.

It is worth mentioning that Chinese airlines were always required to provide Letters of Guarantee issued by Chinese financial institutes in aircraft acquiring transactions, in order to protect foreign investors' interests from the "China risk". Before 1994, Letters of Guarantee for Chinese airlines were always issued by the Bank of China because it was the State-designated specialised foreign exchange bank and substantially contributed to development of foreign trade at that time. Following the entrenchment of the reform of the financial sector, the Bank of China was converted into a wholly State-owned commercial bank in 1994 and then converted into a joint-stock commercial bank in 2004. It now has the same status with the other commercial

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<sup>248</sup> See "Review and Outlook of China's Financial System Reform", by the China Centre for Economic Research [in Chinese], online: <<http://www.ccer.edu.cn>> (accessed on September 1, 2008).

banks. Afterwards, the ICBC also engaged in issuing Letters of Guarantee in aircraft acquiring transactions.

Today, foreign-capital banks are becoming more and more active in China. In 2001, China joined the WTO, promising that the China's banking industry will be fully open to foreign-capital institutions in five years. The Regulation of the People's Republic of China on the Administration of Foreign-capital Banks, which was issued in 2006, legally confirmed the national treatment for foreign-capital banks.<sup>249</sup> Subsequently, China opened the banking industry to foreign investors and therefore the Chinese government has theoretically fulfilled the commitments it made when joining the WTO.

In addition, non-banking institutions, including insurance companies, trust and investment companies, securities institutions, finance and leasing companies, financial companies of enterprise groups, and rural credit cooperatives are also components of China's financial institutions.

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<sup>249</sup> *The Regulation of the People's Republic of China on the Administration of Foreign-funded Banks* (adopted at the 155th executive meeting of the State Council on November 8, 2006, and entered into force on December 11, 2006).

#### 4.4.2 Rules on Leasing in China

Up until now, there is no specialised law on leasing in China. The Contract Law of the People's Republic of China that was issued in 1993 did not even have any chapters about the contract for lease.<sup>250</sup> However, more and more leases have arisen from the rapidly growing market. In 1996, the Supreme Court had to issue the "Provisions of a Number of Issues Hearing on the Financial Leasing Contract Dispute Cases" to provide principles for financial leasing activities. Afterwards, the Contract Law (1999) presented two chapters specialised on financing and leasing.<sup>251</sup>

Chapter 13 "Contracts for Lease" of the Contract Law (1999) define a lease contract as "a contract whereby the lessor shall deliver the leased property to the lessee for the latter's use or obtaining proceeds through the use, while the lessee pays the rent".<sup>252</sup> The rules and main obligations of the lessor and the lessee in a lease contract are stipulated as follows:

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<sup>250</sup> The Contract Law (1993) has been abolished and replaced by the Contract Law (1999).

<sup>251</sup> The Chapter 13 of the Contract Law (1999) is "Contracts for Lease", as well as the Chapter 14 "Contracts for Financial Lease".

<sup>252</sup> Article 212.

- (a) The term of a lease may not exceed 20 years. At the expiry of the term of the lease, the parties may extend the lease contract.<sup>253</sup> However, the extended term of each lease agreed upon shall not exceed 20 years;<sup>254</sup>
- (b) The lessor shall deliver the leased property to the lessee and keep it being fit for the use;<sup>255</sup>
- (c) The lessee shall pay the rent according to the time limit agreed upon in the contract;<sup>256</sup>
- (d) The lessee shall return the leased property at the expiry of the lease term. The property returned shall be in conformity with the conditions after use according to the terms of the contract or the nature of the leased property;<sup>257</sup>
- (e) The lessor shall perform the obligation of maintenance of the leased property, unless otherwise agreed upon by the parties;<sup>258</sup>
- (f) With the consent of the lessor, the lessee may sublet the leased property to a third party. In case of subletting by the lessee, the lease contract between the lessee and lessor shall continue to be effective, and the lessee shall compensate for the losses if the third party causes losses to the leased property;<sup>259</sup>

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<sup>253</sup> There is no limitation on times of extended leases stipulated in the Contract Law (1999).

<sup>254</sup> Article 214.

<sup>255</sup> Article 216.

<sup>256</sup> Article 217.

<sup>257</sup> Article 235.

<sup>258</sup> Article 220.

<sup>259</sup> Article 224.

- (g) Where a third party claims rights and makes it impossible for the lessee to use or obtain proceeds from the leased property, the lessee may request a reduction of rent or not to pay the rent;<sup>260</sup>

Chapter 14 “Contracts for Financial Lease” of the Contract Law (1999) defined a financial lease contract as “a contract whereby the lessor buys the leased property from the seller based on the lessee's choice of the seller and the leased property, and supplies it to the lessee for the latter's use, while the lessee pays the rent”.<sup>261</sup> The rules and main obligations of the lessor and the lessee in a financial lease contract are stipulated as follows:

- (a) The seller shall deliver the object to the lessee according to the terms of the contract, and the lessee shall enjoy the rights of a buyer relating to the received object;<sup>262</sup>
- (b) The lessor, seller and lessee may agree that, where the seller fails to perform the sales contract, the lessee shall exercise the right to claims. Where the lessee exercises the right, the lessor shall provide assistance;<sup>263</sup>

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<sup>260</sup> Article 228.

<sup>261</sup> Article 237.

<sup>262</sup> Article 239.

<sup>263</sup> Article 240.

- (c) The lessor shall be entitled to the ownership of the leased property. In case of the bankruptcy of the lessee, the leased property does not belong to the bankrupt property;<sup>264</sup>
- (d) The lessor shall insure the lessee's possession and use of the leased property;<sup>265</sup>
- (e) The lessee shall pay the rent according to the terms of the contract;<sup>266</sup>
- (f) Where the parties agree in the contract that the leased property shall belong to the lessee at the expiry of the lease term, the lessee has paid the majority of the rent but is unable to pay the remaining rent, and the lessor rescinds the contract for this reason and takes back the leased property, the lessee may request the lessor to return a certain part of the value of the leased property taken back if the value exceeds the rent and other expenses which the lessee owes to the lessor;<sup>267</sup>
- (g) The lessor and lessee may agree upon the attribution of the leased property at the expiry of the lease term. Where there is no agreement in the contract as to the attribution of the leased property or such agreement is unclear, the ownership of the leased property shall belong to the lessor.<sup>268</sup>

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<sup>264</sup> Article 242.

<sup>265</sup> Article 245.

<sup>266</sup> Article 248.

<sup>267</sup> Article 249.

<sup>268</sup> Article 250.

The Civil Aviation Law of the People's Republic of China classifies aircraft lease contracts to two parts: financial leasing and other lease contracts. As the main form of aircraft leasing in China, aircraft financial leasing is defined as the purchase by the lessor of the aircraft from the supplier designated by lessee and the lease of the aircraft from the lessor to the lessee for use with payment of rentals at regular intervals.<sup>269</sup> The specific rules can be found as follows:

- (a) During the term of financial lease, the lessor has the ownership over the civil aircraft according to law and the lessee has the right to hold, use and derive income from the aircraft according to law;<sup>270</sup>
- (b) The lessor shall not interfere with the lessee's possession and use of the aircraft according to law. The lessee should take due care of the aircraft so as to keep it in the original condition at the time of delivery, excepting reasonable wear and tear and modifications of the aircraft with the lessor's consent;<sup>271</sup>
- (c) At the expiry of a financial lease, the lessee should return the aircraft to the lessor, except that the lessee may exercise any right to purchase the aircraft according to the contract, or to extend the lease of the aircraft.<sup>272</sup>

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<sup>269</sup> Article 27.

<sup>270</sup> Article 28.

<sup>271</sup> Article 29.

<sup>272</sup> Article 30.

- (d) During the term of a financial leasing, with the consent of the lessor, the lessee can transfer to others the right for the possessing of the aircraft or other rights as agreed upon in the lease contract on the condition that the transference would not damage the interest of a third party;<sup>273</sup>
- (e) A supplier of the civil aircraft may not be liable repeatedly to the lessor and lessee for same damages of the air aircraft supplied;<sup>274</sup>
- (f) If a term of a lease is over six months, the lessee should register the right for possessing the aircraft with the Civil Aviation Administration of China (CAAC).<sup>275</sup>

Although these laws have provided some rules to govern leasing practices, the general provisions are still far from sufficient to meet the needs arising from the rapid growing market. Besides CAAC, other regulatory authorities have also developed some specialised rules, such as the taxation rules on the financial lease depreciation and investment deductions that were issued by the Tax Authority and tariff rules on leased objects that were issued by the Customs.

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<sup>273</sup> Article 32.

<sup>274</sup> Article 31.

<sup>275</sup> Article 33.

## 4.5 Security Laws on Aircraft Financing in China

### 4.5.1 General Principles

According to the Real Rights Law, where the obligor fails to pay its due debts or any circumstance for realising real rights for security as stipulated by the parties concerned happens, the holder of real rights for security shall enjoy preferred payments from the secured property.<sup>276</sup> The security range shall cover principal obligee's rights and their interests, default fines, damages as well as expenses for keeping the secured property and for realising the real rights for security.<sup>277</sup> For establishing real rights for security, a security contract shall be entered into as a subordinate one to the principal contract. Unless it is otherwise prescribed by any law, the security contract shall be invalid when the principal contract is nullified. After a security contract is confirmed to be nullified, the obligor, the security provider and the obligee who has faults shall, in light of their respective faults, undertake corresponding civil liabilities.<sup>278</sup> If a secured credit happens, involving both physical and personal security, where the obligor fails to pay its due debts or any circumstance as stipulated by the parties concerned for realising the property for security, the obligee shall realise

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<sup>276</sup> Article 170.

<sup>277</sup> Article 173.

<sup>278</sup> Article 172.

the obligee's rights as stipulated. In the case there is no such stipulation, or where it is unclear, and where the obligor provides his/its own property for the security, the obligee's rights shall be realised firstly by the secured property. If the secured property is provided by a third party, the obligee may realise the obligee's rights by the physical security or through requiring the guarantor to assume the guarantee liability. After undertaking the security liability, the third party has the right to recover payments from the obligor.<sup>279</sup>

#### **4.5.2 Chattel Mortgage**

Although there is no clear concept on “chattel mortgage” in the provisions of the Guarantee Law and the Real Rights Law, the Guarantee Law provides that “machines, transport devices” are eligible to be used as subjects of mortgages.<sup>280</sup> Additionally, the Real Rights Law also presents that “vessels and aircraft under construction” and “devices of communications and transportation” are eligible properties to establish mortgages.<sup>281</sup> In other words, realty mortgage rights and chattel mortgage rights share the same general rules; thus, principles on general mortgages are also shared by the

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<sup>279</sup> Article 176.

<sup>280</sup> Article 34.

<sup>281</sup> Article 180.

chattel mortgages in China. The rules governing mortgages in China can be summarised as follows:

- (a) In order to ensure the payment of debts, an obligor or a third party mortgages his/her/its properties to the obligee without transferring the possession of such properties, and when the obligor fails to pay due debts or any circumstance as stipulated by the parties concerned for realising the mortgage right happens, the obligee has the right to seek preferred payments from such properties;<sup>282</sup>

The mortgage right may not be alienated alone or be used as a security for other obligee's rights by departing from the obligee's rights unless it is otherwise prescribed by any law or is otherwise stipulated by the parties concerned. When the obligee's rights are alienated, the mortgage right thereof shall be alienated concurrently;<sup>283</sup>

- (b) When the obligor fails to pay his/her/its due debts or any circumstance occurs as stipulated by the parties concerned for realizing under mortgage, the mortgagee may negotiate with the mortgagor, convert the mortgaged property into money or

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<sup>282</sup> Article 179 of the Real Rights Law.

<sup>283</sup> Article 192 of the Real Rights Law.

seek preferred payments from the money generated from the auction or sale of the mortgaged property;<sup>284</sup>

- (c) The mortgage right of aircraft which is under construction shall be established on the date the mortgage contract comes into effect; without the registration, the mortgage may not challenge any bona fide third party.<sup>285</sup>

### **4.5.3 Registration of Secured Right on Aircraft**

Both the Real Rights Law and the Guarantee Law have provided some basic principles of registration of mortgage rights. More specific rules of the registration of mortgage rights on aircraft are stipulated by the Civil Aviation Law and the Regulations of the People's Republic of China on Civil Aircraft Rights Registration, which can be summarised as follows:

- (a) Formally instituted mortgage rights over civil aircraft should be registered together by the mortgagee and mortgagor<sup>286</sup> and entered into the register book;<sup>287</sup>

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<sup>284</sup> Article 195 of the Real Rights Law.

<sup>285</sup> Article 188 of the Real Rights Law.

- (b) If aircraft are mortgaged, the registration shall be handled by the aircraft registering authority (CAAC),<sup>288</sup>
- (c) With the exception of compulsory auction in accordance with the law, the transfer abroad of nationality registration or of the rights of registration is prohibited until the rights of civil aircraft have been compensated or the creditors of the civil aircraft have consented,<sup>289</sup>
- (d) The lessee of a lease of civil aircraft for a term of over six months should register the right for possessing the aircraft with CAAC. Without such registration, the lessee may not prevail over the rights of a third party.<sup>290</sup>

## 4.6 Taxation

Tax is always a crucial factor in a business transaction. A low tax policy has played an important role in attracting foreign investment to China's rapidly developing economy. However, tax policy on aircraft financing in China has been criticised

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<sup>286</sup> Article 16 of the Civil Aviation Law.

<sup>287</sup> Article 11 and Article 12 of the Civil Aviation Law provided that aircraft on mortgage should be presented on the register book and this item is open to the public for consultation, duplication or extraction.

<sup>288</sup> Article 42 of the Guarantee Law; see also at Article 11 of the Civil Aviation Law.

<sup>289</sup> Article 13 of the Civil Aviation Law.

<sup>290</sup> Article 33 of the Civil Aviation Law.

severely by the professionals for its unreasonableness. The following are types of major taxes which are related to aircraft financing in China's legal system:

#### **4.6.1 Income Taxes**

The new Enterprise Income Tax Law was issued on March 16, 2007 and entered into force on January 1, 2008. Meanwhile, the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises<sup>291</sup> and the Provisional Regulations on Enterprise Income Tax of the People's Republic of China<sup>292</sup> were annulled from January 1, 2008. The 2007 new Enterprise Income Tax Law abolished preferential treatments for enterprises with foreign Investment and foreign enterprises, and provided for the same income tax rate as those on Chinese domestic enterprises.

The Enterprise Income Tax Law divides enterprises into two categories: resident enterprises and non-resident enterprises.

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<sup>291</sup> *The Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* was issued in 1991.

<sup>292</sup> *The Provisional Regulations on Enterprise Income Tax of the People's Republic of China* was issued in 1991.

Resident enterprises refer to enterprises that are set up in China in accordance with Chinese law, or that are set up in accordance with the law of a foreign country (region) whose principal place of business is in China.<sup>293</sup> Resident enterprises shall pay enterprise income tax originating both within and outside China, at the rate of 25%.<sup>294</sup>

Non-resident enterprises refer to enterprises that are set up in accordance with the law of a foreign country (region) whose principal place of business is outside China, but they have set up places of business in China or they have income originating from China without setting up places of business in China.<sup>295</sup> Non-resident enterprises that have set up places of business in China shall pay enterprise income tax in relation to the income originating from China, as well as income derived outside China. The income tax rate for non-resident enterprises shall be 20%.<sup>296</sup> Where non-resident enterprises that have not set up places of business in China, or where places of business are set up but there is no actual relationship with the income obtained by

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<sup>293</sup> Article 2.

<sup>294</sup> Article 3.

<sup>295</sup> Article 2.

<sup>296</sup> Article 4.

places of business set up by such enterprises, they shall pay enterprise income tax in relation to the income originating from China at the rate of 10%.<sup>297</sup>

The payable income tax from income obtained by non-resident enterprises is subject to tax withheld at source, with the payer as the withholding agent. The tax payment is withheld from the amount paid or the payable amount due from each tax payment and payable amount of the withholding agent.<sup>298</sup> If the withholding agent has not withheld or fails to perform the withholding obligation, the taxpayer shall pay in the place where the tax is incurred. If the taxpayer does not pay, the tax authority may pursue the payable tax amount of such taxpayer from the amount payable by the payer of other income projects in China of such taxpayer.<sup>299</sup>

#### **4.6.2 Turnover Taxes**

The Provisional Regulations of the People's Republic of China on Turnover Tax provides the general principles for levying turnover taxes. More specific rules were

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<sup>297</sup> Article 3 of The Law of the People's Republic of China on Enterprise Income Tax; Article 91 of the Implementation of The Law of the People's Republic of China on Enterprise Income Tax.

<sup>298</sup> Article 37 of The Law of the People's Republic of China on Enterprise Income Tax.

<sup>299</sup> Article 39 of The Law of the People's Republic of China on Enterprise Income Tax.

issued by the State Administration of Taxation and the Ministry of Finance in the Notification on Several Issues about Turnover Taxes.<sup>300</sup>

Under a financial leasing contract, turnover is the revenue respecting the full price the lessee has paid to the lessor less the actual costs of the lessor. The full price includes residuals. The actual cost the lessor bears comprises of the price of the goods purchased, customs duties, value added taxes, consumption taxes, transportation fees, installation fees, insurance premiums and interest on loans (including foreign exchange and RMB).<sup>301</sup> The payable turnover tax of financial leasing should be at the rate of 5% of the turnover.<sup>302</sup>

#### **4.6.3 Value Added Taxes**

According to the Provisional Regulations of the People's Republic of China on Value-Added Tax, the value-added tax rate for taxpayers selling or importing goods

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<sup>300</sup> *The State Administration of Taxation and the Ministry of Finance in the Notification on Several Issues about Turnover Taxes* was issued on January 15, 2003.

<sup>301</sup> Article 3 (11) of the State Administration of Taxation and the Ministry of Finance in the Notification on Several Issues about Turnover Taxes.

<sup>302</sup> Article 3 of the Turnover Taxable Items and Tax Rate Table which is the attachment of the Provisional Regulations of the People's Republic of China on Turnover Tax.

shall be 17%.<sup>303</sup> On October 18, 2004, the General Administration of Customs issued the Notice of the General Administration of Customs on Adjusting the Policies concerning the Value-Added Tax on Aircraft Imported by Domestic Airline Companies. The Notice adjusted the policies concerning the value-added tax on aircraft imported by domestic airlines and decided that the import-link value-added tax on passenger and cargo aircraft with their load weight over 25 tons imported by domestic airline companies should be levied at the rate of 4% from October 1, 2004.

#### **4.6.4 Stamp Taxes**

The Provisional Rules of the People's Republic of China on Stamp Duty provides that "all organisations and individuals which conclude or receive any of the documents listed in these Rules shall be regarded as obligatory payers of stamp duty and shall pay stamp duty".<sup>304</sup> Documents of "property leasing" and "loans" are regarded as taxable.<sup>305</sup>

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<sup>303</sup> Article 2.

<sup>304</sup> Article 1.

<sup>305</sup> Article 2.

Stamp duties on operating leasing and on financial leasing are different. Aircraft operating leasing contracts shall be subject to stamp duty of 0.1% of the leasing fee;<sup>306</sup> aircraft financial leasing contracts shall be subject to stamp duty of 0.005% of the leasing fee.<sup>307</sup>

Loan contracts signed between banks or other financial institutions and borrowers (not including inter-bank short-term loans, on which interest is calculated daily) shall be subject to stamp duty of 0.005% of the amount borrowed, to be paid by the parties to the contract. Receipts shall be used as a contract and stamp duty shall be paid as for a contract.<sup>308</sup>

#### **4.6.5 Customs Tariffs**

The Customs Tariff Commission of the State Council is the government authority that is responsible for readjusting and interpreting tariff items, tariff nomenclature

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<sup>306</sup> Article 5 of the Appendix: Stamp Duty Tariff Table- Item Scope Tax Rate Taxpayer Explanation.

<sup>307</sup> *Written Reply about Stamp Duty on Aircraft Leasing Contracts* (issued by the State Administration of Taxation, 1992)

<sup>308</sup> Article 8 of the Appendix: Stamp Duty Tariff Table- Item Scope Tax Rate Taxpayer Explanation.

heading numbers and tariff rates.<sup>309</sup> It also makes decisions on the goods subject to temporary tariff rates, the tariff rates and time limit, the rate of tariff quota, the imposition of antidumping duties, countervailing duties, duty under safeguard measures, retaliatory duties and the application of tariff rates under special circumstances.<sup>310</sup> Obligatory customs duty payers are the consignees of imported goods, the consignors of exported goods and the owners of entry articles.<sup>311</sup> The dutiable value for import goods is examined and determined by the customs on the basis of the transaction value, the freight, the associated expenses and the insurance premiums incurred prior to the arrival and unloading of the goods at the destination within China.<sup>312</sup> The dutiable value for the goods imported by means of leasing should be the rent of the goods.<sup>313</sup>

## 4.7 Foreign Exchange Policy

The current foreign exchange policy is that the foreign exchange for current account transactions is convertible, but the foreign exchange for capital account

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<sup>309</sup> Article 4 of Import & Export Tariff Regulations of the People's Republic of China.

<sup>310</sup> *Ibid.*

<sup>311</sup> Article 5 of Import & Export Tariff Regulations of the People's Republic of China.

<sup>312</sup> Article 18 of Import & Export Tariff Regulations of the People's Republic of China.

<sup>313</sup> Article 23 of Import & Export Tariff Regulations of the People's Republic of China.

transactions is restricted to a certain extent. Under this policy, all foreign exchange receipts for capital account transactions shall be repatriated and placed in the foreign exchange account at the designated foreign exchange banks. Such receipts can be also sold to the designated foreign exchange banks upon the approval of the exchange administration agencies.<sup>314</sup> Moreover, external guarantees shall only be offered by qualified financial institutions and enterprises meeting the government requirements and subject to the approval by the exchange administration agencies.<sup>315</sup> Without external security registration and approval, external security contracts will be invalid.

## **4.8 Supervision on Financial Leasing Companies**

In China's current legal system, both the CBRC and the Ministry of Commerce are supervising authorities for financial leasing companies. The Measures for the Administration of Finance Leasing Companies, which was issued by CBRC in 2007, and the Measures for the Administration of Foreign-capital Lease Industry, which was issued by the Ministry of Commerce in 2000, are currently effective regulations for governing financial Leasing Companies.

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<sup>314</sup> Article 19 and Article 20 of the Regulations on the Foreign Exchange System of the People's Republic of China.

<sup>315</sup> Article 19 and Article 20 of the Regulations on the Foreign Exchange System of the People's Republic of China.

The main purpose of the Measures for the Administration of Financial Leasing Companies is to promote the healthy development of the financial leasing industry and strengthen the supervision over financial leasing companies.<sup>316</sup> According to the Measures, no entity or individual may engage in the finance leasing business or use the words “finance leasing” in its name without approval of the CBRC.<sup>317</sup> Other principles include:

- (a) Definitions of the term “financial leasing companies”, “financial leasing”, “sales-leaseback” and “connected party relationship and connected transactions”;<sup>318</sup>
- (b) Establishment, modification and termination of financial companies;<sup>319</sup>
- (c) Qualification of directors and senior managers of finance leasing companies;<sup>320</sup>
- (d) Changes, dissolution and bankruptcy of finance leasing companies;<sup>321</sup>
- (e) The scope of business and operating rules of finance leasing companies; and<sup>322</sup>
- (f) Regulations that apply to finance leasing companies.<sup>323</sup>

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<sup>316</sup> Article 1.

<sup>317</sup> Article 2.

<sup>318</sup> Article 2 to Article 5.

<sup>319</sup> Article 7.

<sup>320</sup> Article 16.

<sup>321</sup> Article 17 to 19.

<sup>322</sup> Article 22.

The Measures for the Administration of Foreign-funded Lease Industry focuses on regulations respecting foreign-capital lease companies, and its principles can be summarised as follows:

- (a) Requirements for applying to establish a foreign-capital financial leasing company;<sup>324</sup>
- (b) The scope of business of a foreign-capital financial leasing company;<sup>325</sup> and
- (c) Risk prevention.<sup>326</sup>

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<sup>323</sup> Article 35.

<sup>324</sup> Article 9.

<sup>325</sup> Article 14.

<sup>326</sup> Article 16.

# **Chapter 5 New Challenges for China in Aircraft Financing**

## **5.1 Challenges for Chinese Financial Leasing Industry**

### **5.1.1 Background**

China's finance leasing industry emerged in the 1980s. At that time, the Chinese government wanted to attract foreign capital to China without sharing the Chinese financial market with foreign banks. At the same time, foreign banks and financial institutions wanted to develop business in China without being bound by the laws of China and the financial supervision from the Chinese government. Before March 1, 2007, China forbade banks to invest in the financial leasing industry. Thus, domestic Chinese financial leasing companies, which were in small scale and their registered capital was only several ten million Yuan to several hundred million Yuan, could not afford high value equipment transactions. These domestic companies not only lacked funds, but they did not have adequate experience in the business. Moreover, taxation

on domestic financial leasing transactions was very heavy.<sup>327</sup> Thus, many high value equipment financing transactions were operated by foreign financial institutions and were completed outside of China. For a long period of time therefore, these domestic companies could only be involved in certain small businesses in which foreign banks and financial institutions were not interested. Foreign banks and financial institutions monopolised the high value equipment financing market in China. In fact, a number of Chinese banks and financial institutions had made exploratory attempts to set foot in the operations for aircraft financing in the 1990s, but these attempts all failed. In most of China's aircraft acquiring transactions, the only business that Chinese commercial banks could still involve themselves in was to issue Letters of Guarantee for Chinese airlines.

Following the rapid economic growth, China's civil aviation industry has been growing quickly in recent years. At the end of August 2006, Chinese airlines have held 940 aircraft, of which over 60% were acquired through leasing.<sup>328</sup> According to Boeing's recent forecast, China will demand many more aircraft over the next 20 years than Boeing had initially expected in 2006. Boeing predicts that between 2007 and

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<sup>327</sup> Before 2004, taxation policy on domestic financial leasing contracts is severely criticised for its unreasonableness. For example, turnover taxes levy were based on the full price the lessee has paid to the lessor at the rate of 5%. The actual cost that the lessor has bared could not be deducted.

<sup>328</sup> Jinbo Liu, "Maximising the Function of Leasing to Enhance Aircraft Financing Channels" (Presented on The China Aeroleasing Summit, September 2006).

2026, China will purchase 3,400 new aircraft worth US\$340 billion,<sup>329</sup> while Rolls-Royce foresees a demand for 3,100 aircraft over the same period.<sup>330</sup> In addition to a new aircraft leasing market, the used aircraft leasing market in China is also substantial. In China, most aircraft were leased in the term of 12 years. At the end of the term, the residual may reach 30% of the real total value of an aircraft. There is a huge profit margin and market space in residuals of these leased aircraft. China's aircraft leasing business has attracted not only foreign financial institutions but also China's domestic ones.

### **5.1.2 The Current Status of Chinese Leasing Companies**

China is now allowing both domestic and foreign commercial banks to establish financial leasing companies in China and the Chinese government has now taken the position that it has fulfilled the commitment to open the banking industry to foreign investors in five years, which they made in the accession to the WTO in 2001.

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<sup>329</sup> Online: Boeing < <http://www.boeing.com> > (accessed on March 19, 2008).

<sup>330</sup> Online: *China Economic Review* <<http://www.chinaeconomicreview.com>> (accessed on March 19, 2008).

In China's current legal system, both the CBRC and the Ministry of Commerce are the supervising authorities for the leasing industry.<sup>331</sup> They are jointly conducting examination and approval rights over the sector. Leasing companies set up by financial institutions are under the administration of the CBRC, while the Ministry of Commerce covers those run by non-financial institutions. From the point of the procedure of approval and the establishment, current Chinese leasing companies can be divided into four main types:

- (a) China-funded financial leasing companies that are approved by the People's Bank of China;
- (b) Financial Leasing Companies that are approved by the CBRC;
- (c) Foreign leasing companies that are approved by the Ministry of Commerce; and
- (d) Other leasing companies, mainly refers to the original approved by the State Economic and Trade Commission<sup>332</sup> and general leasing companies, which was established in accordance with the general procedures for registration without the approval by the Ministry of Commerce or the CBRC.

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<sup>331</sup> Before the establishment of CBRC on April 28, 2003, its function was exercised by the People's Bank of China. See section 4.8.

<sup>332</sup> The State Economic and Trade Commission is the predecessor of the Ministry of Commerce.

The Measures for the Administration of Finance Leasing Companies (issued by the CBRC in 2007) and the Measures for the Administration of Foreign-capital Lease Industry (issued by the Ministry of Commerce in 2000) are currently effective regulations for governing financial leasing companies.<sup>333</sup> According to rules stipulated in these laws, with respect to the market entry, the registered capital of a leasing company shall not be lower than RMB100 million and there must be a principal contributor in the shareholder structure.<sup>334</sup> Only qualified commercial banks, large equipment manufacturers, leasing companies and financial institutions can act as the principal contributor. Moreover, their capital adequacy ratio is required to stand at over 8%, they are required to have total assets of over 80 billion Yuan per annum, and have been registering profits for two consecutive fiscal years.<sup>335</sup> The ICBC, China Construction Bank, Bank of Communications, China Merchants Bank, and China Minsheng Banking Corp have been approved to set up financial leasing companies by the CBRC. A number of leasing companies with an aviation enterprise background have also been set up, attempting to gain an advantage in China's aircraft leasing market by utilising their background in the aviation area. Some of these companies have already started entering the aircraft leasing market with good performance. For example, China Development Bank has signed a primary agreement in February 2008 to purchase about 90% stake in Shenzhen Financial Leasing Co., Ltd.. According to the agreement, China Development Bank will inject over 7 billion Yuan into the target

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<sup>333</sup> See section 4.8.

<sup>334</sup> Article 8 and Article 10 of the Measures for the Administration of Finance Leasing Companies.

<sup>335</sup> Article 9 of the Measures for the Administration of Finance Leasing Companies.

company, replenishing its registered capital to 8 billion Yuan. Upon the completion of the capital injection, Shenzhen Financial Leasing will become the largest financial leasing company in China and is expected to be a major profit contributor to the bank. On the other hand, Chinese financial institutions are trying to expand overseas business in aircraft financing. In December 2006, the Bank of China acquired the Singapore Aircraft Leasing Enterprise, the largest aircraft leasing company in Asia, marking an unprecedented expansion overseas. In this transaction, the Bank of China has paid 965 million U.S. dollars in cash to wholly own the Singapore Aircraft Leasing Enterprise and renamed it as BOC Aviation. Not only does BOC Aviation focus on the Asia-Pacific aircraft financing market, but it is expanding its business in the North American market also.<sup>336</sup>

China has been the fastest-growing major nation for the past quarter of a century with the high average annual GDP growth rate. It is forecasted that China's GDP will keep growing in 6.6% per year in the next 20 years, which is the highest in the world and is more than double the world GDP forecast of 3.1%.<sup>337</sup> However, there is still a large gap between the Chinese leasing market and the matured market with respect to penetration and proportion of leasing volume in the GDP. Being a useful financing tool,

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<sup>336</sup> On March 18, 2008, BOC Aviation announced that it had finalised agreements with Air Canada for the purchase and leaseback of two new Boeing 777-300ER aircraft. Scheduled for delivery to Air Canada from the U.S. manufacturer in March and April this year, the aircraft will be leased to the airline for a period of 12 years each. These aircraft are part of Air Canada's current order with Boeing. Online: BOC Aviation <[http:// www.bocaviation.com](http://www.bocaviation.com)> (accessed on March 20, 2008).

<sup>337</sup> Online: Boeing <<http://www.boeing.com>> (accessed on March 19, 2008).

financial leasing in China has not yet been brought into full play to facilitate aircraft financing. In the context of worldwide aircraft financing market, China still occupies a relatively low position. The scope of China's financial leasing industry is smaller not only than the developed countries, but also smaller than some developing countries. This is not consistent with their economic level in the world. Until 2006, only 2% of companies in China chose to use the lease method to acquire equipment. The total financial leasing volume does not reach 1% of the U.S.', 2% of Japan's – it does not even reach 1/10 of South Korean's leasing volume.<sup>338</sup> Although the numbers cannot be compared directly, it is a fact that the China's financial leasing market is lagging behind the market in the developed countries. Among various reasons, the lagging legal system has been criticised most severely. The sluggish legislative arrangement and the unreasonable taxation policies have affected the development of leasing industry. In the current legal system, multiple government authorities are making approval rules and supervising the financial leasing industry. This complicates the financial leasing management and causes confusion in the financial leasing market. Moreover, financial leasing companies lack professionals and effective management, which makes them unable to provide customer-tailored services or simple credit products very similar to, or even the same as, those provided by banks. In this scenario, the companies are struggling along on their tiny capital in the competition with banks.<sup>339</sup>

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<sup>338</sup> Shuyan Guo, "Impact of the Financial Leasing Legislation on the Development of the Aircraft & Engine Leasing" (Presented on The China Aeroleasing Summit September 2006).

<sup>339</sup> Ersheng Cai "Speech at the International Symposium on Bank Leasing" (June 2007).

## **5.2 The Proposed China Financial Leasing Law**

### **5.2.1 Background**

China's financial leasing industry originated in the early 1980s. It was introduced from the developed countries for the purpose of enlarging the international economic cooperation and technical communication as well as developing the foreign-investment channel. However, the financial leasing industry of China did not develop well in the following years. Many reasons have been indicated by professionals and the public. The absence of a specific financial leasing law is regarded as one of the main reasons that caused the financial leasing industry to grow slowly in China. In the Contract Law (1993), there are no references to leases.<sup>340</sup> In 1996, the Supreme Court issued the “Provisions of a Number of Issues Hearing on the Financial Leasing Contract Dispute Cases” to deal with numerous new financial leasing activities. Afterwards, the Contract Law (1999) presented two chapters respecting leasing,<sup>341</sup> however, these chapters and articles are normal provisions. There is no specified regulation respecting

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<sup>340</sup> The Contract Law (1993) has been abolished and replaced by the Contract Law (1999).

<sup>341</sup> The Chapter 13 of the Contract Law (1999) is “Contracts for Lease”, as well as the Chapter 14 “Contracts for Financial Lease”.

the special issues of financial leasing, such as the types of leasing, registration of leases, compensation for breaking the leasing contract, repossession, risk responsibilities. Although State departments have set up some regulations, these department principles lack uniformity and integrity. Thus, they cannot play the same role as a specific financial leasing law.

### **5.2.2 The Process of the Legislation**

By the end of 2003, the 10th National People's Congress included the Financial Leasing Law into the legislation planning. The aim of the proposed Financial Leasing Law was to regulate the financial leasing business, maintain the order of the financial leasing market, protect the legal rights of the leasing parties and promote the healthy development of the leasing industry through legislation. The Financial & Economic Committee of the National People's Congress set up the working group in March 2004 to draft the legislation. In October 2004, the draft group proposed the design of the Financial Leasing Law. By the end of April 2005, the draft group proposed the Financial Leasing Law Draft (under consultation) and asked for suggestions nationally. In the late April 2006, the draft group improved the Draft (Under Consultation) and formed the Financial Leasing Law Draft (for 2nd consultation).<sup>342</sup> After several

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<sup>342</sup> Guo, *supra* note 338.

months consultation, the new Financial Leasing Law Draft (for 3rd consultation) was formed in November 2006.<sup>343</sup>

### **5.2.3 Main Factors Taken into Consideration**

#### **5.2.3.1 The Scope of the Proposed Financial Leasing Law**

The draft of the proposed Financial Leasing Law focuses only on financial leasing. One opinion is that all kinds of leasing deals should be included in the adjusted scope of the Financial Leasing Law; however, the working group indicated that it is very difficult to put all kinds of leasing businesses into one law. Moreover, only the Financial Leasing Law was included in the legislation plan by the 10th National People's Congress. As a result, the Scope of the Proposed Financial Leasing Law will be limited to financial leasing.

#### **5.2.3.2 General Principles of the Proposed Financial Leasing Law**

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<sup>343</sup> Xuesong Zhang, “Brief Introduction on the Drafting Procedure and Main Content of China’s Financial Leasing Law” (Presented on the 2nd China Aeroleasing Summit September 2007).

In the Financial Leasing Law Draft (for 3rd consultation), a financial leasing is defined as a transaction in which a lessor purchases the leased property from the seller based on the lessee's choice of the seller and the leased property. The lessor supplies it to the lessee for possession and use and the lessee pays the rent. At the end of a lease term, the lessee may extend the lease, purchase or return the leased property. The first term of a lease may not be less than one year.<sup>344</sup> Moreover, lessors are required to obtain a qualification to operate financial leasing companies.<sup>345</sup> Special forms of financial leasing, such as Sale- Leaseback and Sub-Leases, are also provided by the proposed Financial Leasing Law.<sup>346</sup>

### **5.2.3.3 The Supervision on the financial leasing industry**

As China's market economy has not developed until approximately 30 years ago, and China's legal system is not yet thorough enough, many worry that China's current legal system cannot effectively protect the financial leasing industry. Moreover, the financial leasing industry is an industry with high capital concentration - the capital risks of financial leasing companies may reach several times over their own capital. Consequently, it is considered necessary to have proper government supervision on

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<sup>344</sup> Article 2 of the Financial Leasing Law Draft (for 3rd consultation).

<sup>345</sup> *Ibid.*

<sup>346</sup> Article 3 of the Financial Leasing Law Draft (for 3rd consultation).

financial leasing companies. As discussed before, in China's current legal system both the CBRC and the Ministry of Commerce are supervision authorities for financial leasing companies. The multiple supervisors caused confusion in financial leasing market.<sup>347</sup> The draft of the Financial Leasing Law suggests that the supervision function should be exercised by the State Council Commerce Department.<sup>348</sup> Only banking financial leasing institutions are supervised by the State Council Financial Department.<sup>349</sup> The main focus of the government supervision is on the establishment of financial leasing companies, such as shareholders' sources of funding and their financial situations.<sup>350</sup>

#### **5.2.3.4 Taxation**

In general, the tax preference policy played an important role in attracting investment to China throughout the development of China's market economy. However, China's current taxation for the financial leasing industry has been criticised

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<sup>347</sup> See section 4.8 and section 5.2.1.

<sup>348</sup> Article 37 of the Financial Leasing Law Draft (for 3rd consultation) provides that "the State Council's Commerce departments are in charge of the leasing industry sectors, the leasing of the comprehensive coordination, guidance, management and services".

<sup>349</sup> Article 38 of the Financial Leasing Law Draft (for 3rd consultation).

<sup>350</sup> Article 39 of the Financial Leasing Law Draft (for 3rd consultation).

severely for its unreasonableness.<sup>351</sup> The criticism is not only due to the high rates, but also due to some unclear definitions on the taxation items. Taxation is regarded as one of the obstacles for the growth of China's financial leasing industry. Therefore, taxation has always been a critical issue in the drafting process and some tax preference policies have been promoted in the draft of the Financial Leasing Law. Article 50 of the Financial Leasing Law Draft (for 3rd consultation) provided the principle of accelerated depreciation on financial leasing equipment. Financial leasing companies are allowed to withdraw bad debts expenses and deduct them before taxation.<sup>352</sup> Value-added tax on a financing transaction should be levied on the added value that results from the entire revenue deducting the actual cost.<sup>353</sup> In a cross-border financing transaction, custom tariffs may be installed on each rent payment.<sup>354</sup>

Although the Working Group of the Financial Leasing Law has completed the draft on schedule, it failed to be brought to the discussion process by the National People's Congress because its Standing Committee did not put it in its legislative mandates plan in 2007. Moreover, the debate about whether China needs a specific financial leasing law still continues. Currently, the Financial Leasing Law Draft is shelved.

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<sup>351</sup> See section 4.6.

<sup>352</sup> Article 50 of the Financial Leasing Law Draft (for 3rd consultation).

<sup>353</sup> *Ibid.*

<sup>354</sup> Article 51 of the Financial Leasing Law Draft (for 3rd consultation).

## Conclusion

From a legal point of view, an aircraft acquiring transaction is a complicated process which may involve both domestic law and international law. The resulting transaction can be a confusion of rights and obligations arising from a plethora of different regulations, under a variety of different legal systems.<sup>355</sup> Obtaining adequate security is already an arduous task, but it becomes still more complicated with the added interaction of domestic and international legislation. The biggest challenge in the whole field of aircraft financing is to secure interests as well as avoid risks in order to meet the needs of all parties involved in aircraft acquiring transactions.

Over the past 20 years, China's economy has grown rapidly. China's civil aviation keeps growing following the development of the market economy. Aircraft financing in China has huge profit margins and market space that attracts both foreign and domestic investors. However, for a long period, this business was monopolised by foreign banks and financial institutions. Many factors affect the growth of China's aircraft financing industry, for example, unreasonable taxation policies and lack of professionals. Compared with some developed countries, policies for aircraft financing

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<sup>355</sup> Bunker, *supra* note 11 at XXIV.

in China are imperfect. In the aircraft financing history of the United States and Japan, governments paid more attention to develop their financial industries. They provided more favourable taxation policies, such as allowing depreciation and investment offset, promoting the credit insurance system and providing low interest loans.<sup>356</sup>

Although there is still a large gap between China's domestic aircraft financing industry and the foreign one, China is trying its best to engage in this market. At present, the basic legal framework is formulated and some regulations are being revised to meet the need of aircraft financing in China. Moreover, government agencies are collaborating to enable financial leasing companies to enter into the bank credit system to create a favourable policy environment for aircraft financing industry. The existing status shows that China still has lots of work to do to build itself up and explore a new way of aircraft financing to harmonise Chinese ideals with international practices.

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<sup>356</sup> See section 1.1 and section 1.2.

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