A Primer on Aircraft Financing in India

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Abstract

Lately, India has emerged as one of the most promising and fastest growing aviation markets in the world. To keep pace with this growth, large orders for aircraft acquisition have been placed by almost all airlines in India. Thus, finding enough capital for their ambitious fleet expansion program is one of the key concerns of all Indian airlines.

In order for the airlines to be able to tap the more conventional and cost effective sources of aircraft financing, it is essential that the Indian legal system be able to generate sufficient confidence in bankers, financiers and aircraft lessors as being protective of their ownership rights and being clear and transparent so that there are no ambiguities regarding applicable laws.

This work, therefore, examines the Indian legal system to establish which laws, rules, regulations and jurisprudence govern aircraft financing and to discover any flaws therein, which may have an adverse impact.

Résumé

Récemment, l'Inde s'est avéré comme le marché de l'aviation le plus prometteur et à plus forte croissance au monde. Pour maintenir le rythme associé a cette croissance, plusieurs commandes d'aéronefs ont été placé par presque toutes les compagnies aériennes Indiennes. Pour ces compagnies, trouver les fonds nécessaires pour leur ambitieux programme d'expansion est un élément capital.

Dans le but recueillir le plus de financement possible, il est essentiel que banquiers, financiers et différents bailleurs de fonds aient confiance envers le système de loi Indiennes.(ou la législation indiennes), entre autre en regard de la protection des droits de propriété et en étant clair et transparent pour qu'il n'y ait ainsi aucune ambiguïté envers la loi.

Ce travail examine donc la législation Indienne pour établir quels lois, règlements et jurisprudences gouvernent le financement de l'aéronautique et cherche a découvrir s'il y a des vides légaux pouvant amenés des effets négatifs.

Introduction

In the history of aviation, India's role is quite small as the country where the first airmail in the world was delivered in 1911, when a French pilot M. Picquet flew from Allahabad to Naini. It took more than 20 years for the first Indian airline to begin operations. This was Tata Son's Ltd., which would later become India's State carrier – Air India. In 1953, the Government nationalized the airline industry and the then existing nine airlines were merged and reborn as Air India and Indian Airlines, the international and domestic State carriers respectively, which enjoyed a monopoly over air transport services for almost 40 years. It wasn't until 1991 that the deregulation of the sector began in earnest and the private players were allowed back into the field. However, the initial euphoria did not last for long as by the late 1990s one airline after another went bankrupt. The situation started improving somewhat in the earlier part of this century, so much so that India has now become one of the fastest growing aviation markets in the world with almost phenomenal growth recorded each year. India's potential in the aviation sector is fueled by a massive middle class population and a rapidly developing economy, which has been growing at the rate of around 9% for the past two years. The Centre for Asia Pacific Aviation ("CAPA") has forecasted that the domestic air traffic will grow between 25% to 30% each year, while international traffic will grow at a rate of 15% until the end of 2010.[1] By then the number of passengers is expected to reach 100 million.[2] At the end of the next decade, the figure for domestic and international passengers is expected to increase to 180 million and 50 million respectively. The forecasted annual growth rate of 25% per annum for the aviation sector has slowed down somewhat with the global crises over the price of aviation turbine fuel ("ATF") and the general slowdown in the world's economy but it still continues at a robust pace. In April 2008 as compared to the statistics for April 2007, aircraft movement increased by 12.4%, the number of passengers grew at a rate of 7.5%, while the growth rate for freight was 5.2%.[3] According to Boeing, in the next twenty years i.e. between 2008 and 2027, the demand for

1See Will Roberts, "Reaching for the Skies" (April 2008) 309 Air finance Journal 20 at 20 [Roberts].

2 See *Ibid.*

3See "Traffic Reporter for April 2008", Airport Authority of India at 1, online: AAI <http://www.aai.aero/traffic_news/TRAPR2008.pdf> (accessed on 1 July 2008).

aircraft in India is going to touch 1001, the list price of which will be more than USD 105 billion. This is an increase of 10% from the forecast for 2007 to 2026. Currently, there are 164 Boeing aircraft on order from India: 68 by Air India, 63 from Jet Airways, 30 from SpiceJet and three by the Indian Air Force.[4] In 2007, Airbus had also revised its estimate of the number of aircraft that India is likely to need in the next 20 years from 800-1000 aircraft to 1100 aircraft valued at USD 105 billion.[5] In the last three years, Airbus has received 295 aircraft orders worth USD 22 billion from Indian carriers, consisting of 64 from Kingfisher, 74 from Deccan, 10 from Jet Airways, 100 from Indigo, 43 from Indian and 10 from GoAir.[6] The Minister of Civil Aviation, Praful Patel, is even more sanguine and predicts that in the next ten years, airlines in India would need 1500 to 2000 passenger aircraft and 500 cargo aircraft.[7]

As the above-mentioned figures indicate, almost all airlines in India have massive fleet augmentation plans and have placed large orders. In 2005, at the Paris Airshow, Interglobe Enterprises, an Indian company which hadn't even begun operation at that time, placed an astounding order for 100 Airbus aircraft. These figures raise an interesting question of how the airlines are actually going to finance their fleet acquisition and expansion and have led to the examination of the Indian legal system in this paper, primarily to determine which laws govern aircraft financing in India, as there is a considerable lack of material on the subject, and also to evaluate if the system itself is robust enough to sustain this type of growth. Where possible, comparisons have also been made with the legal regimes of UK and USA. In order to familiarize the readers with the Indian airlines, a brief description of the major players in the industry is given below.

I. Airlines in India

At present, there are 16 scheduled operators in India and 86 non scheduled operators. The main airlines are:

4See "Boeing raises India sales forecast by 10%", *Business Standard* (24 July 2008), online: Business Standard <http://www.business-standard.com/india/storypage.php?autono=329502>.

5See "Airbus Upgrades India Forecast", *India Aviation [CAPA]* (6 February 2007), online: India Aviation <http://indiaaviation.aero/news/airline/2482/59/Airbus-upgrades-India-forecast>.

6See Shaheen Mansuri, "Airbus Boeing see sharp growth in India demand", *The Financial Express* (4 August 2008), online: The Financial Express < http://www.financialexpress.com/news/Airbus-Boeing-see-sharp-growth-in-Indian-demand/344252/>.

7See *Supra* note 5.

(i) Air India: a recent merger between all the State-owned airlines i.e. Air India – the international flag carrier, Indian – the domestic carrier, Air India Express – the low cost subsidiary of Air India, and Alliance Air – the low cost arm of Indian, has created a behemoth under the brand name of Air India with 136 aircraft in its fleet and planned induction of at least 100 aircraft. The ownership of the merged entity is vested in National Aviation Company of India Limited, an umbrella organization whose business divisions now include an international passenger airline, a domestic airline, a low cost carrier, cargo, ground handling operations and a maintenance, repair and overhaul facility. By the end of this financial year, the merger is expected to result in a cost saving of around INR (Indian National Rupees) 1100 crores[8] (USD 275 million) for Air India through synergies in the schedules, ticketing systems, buying of fuel in bulk for both airlines etc.[9] The combined orders of the airline include 68 Boeing aircraft valued at a list price of USD 11 billion[10], which was the largest order of civil aircraft to come out of India at that time; comprising of eight B777-200LR, 15 B777-300ER, 27 B787 and 18 B737-800W, out of which, five B777-200LRs, three B777-300ERs and 12 B737-800 have already been delivered[11] and a USD 2.2 billion order for 43 Airbus consisting of 19 A319, 20 A321 and four A320 aircraft. Air India is currently owned by the Government of India although it is likely that in the second half of 2008, the Government may divest 10-15% of its shares.[12] In order to expand its global reach, Air India is set to join the Star Alliance, whose members include Lufthansa, Air Canada, Singapore Airlines, Northwest and US Airways.[13]

8 1 crore is equal to 10 million.

9See Ashwini Phadnis, "AI hopes to save Rs. 1,100 cr thru merger by the year-end", *Business Line* (5 May 2008), Business Line <http://www.blonnet.com/2008/05/05/stories/2008050551460300.htm>.

10See "AI places $11 b order with Boeing", *The Hindu* (12 January 2006), online: The Hindu <http://www.thehindu.com/2006/01/12/stories/2006011209961900.htm>.

11See "Background Note", online: Air India <http://home.airindia.in/SBCMS/Webpages/Backgrounder-Note.aspx?MID=196> (accessed on 07/25/2008).

12See "Air India IPO likely in 2nd half of '08: Patel", *The Financial Express* (11 January 2008), online: The Financial Express < http://www.financialexpress.com/news/Air-India-IPO-likely-in-2nd-half-of-08-Patel/260357/>.

13 See "Air India to join Star Alliance", online: Air India <http://home.airindia.in/SBCMS/Webpages/2007-AI-to-join-star-alliance.aspx>.

(ii) Jet Airways – Air Sahara: With the acquisition of Air Sahara[14] (which is now known as JetLite) by Jet Airways in April 2008, Jet has become one of the biggest private airlines in India with a current market share of 29.8%[15]. At present, the fleet of Jet Airways consists of 83 aircraft including ten ATR 72-500, 35 B737 800, two B737 900, four B737 400, nine A330 200, 13 B737 700 and ten B777 300E.[16] Jet currently operates flights to 59 destinations in India and abroad including New York, Toronto, Brussels - which is its hub for international operations, London, Singapore, Kuala Lumpur, Colombo, Bangkok, Kuwait, Bahrain, Muscat, Doha etc. Last year, it introduced daily flights from Mumbai to New York and five-times-a-week flights from Delhi to Toronto through its hub in Brussels. With the induction of wide-body aircraft in its fleet and through code sharing arrangements with airlines like Brussels Airlines, American Airlines, Air Canada, etc., Jet Airways is planning to expand its international operations into other cities in North America, Europe, Africa and Asia. The shares of Jet Airways are listed on the Bombay Stock Exchange and the National Stock Exchange, although the majority of its shares are still held by Tail Winds Limited, a company based in Isle of Man whose sole shareholder is Naresh Goyal, the chairman of Jet Airways.

JetLite operates a fleet of 24 aircraft comprising of 17 B737s and 7 CRJ 200s.[17] Prior to the takeover, it had placed order with Boeing for 10 B737 800 aircraft at a list price of more than USD 700 million, delivery of which will start from mid 2009 and continue till 2011.[18]

(iii) Air Deccan – Kingfisher: Air Deccan (now rechristened simply as Deccan) was the first airline in India to usher in the era of low cost carriers and to offer low

14Air Sahara was a private airline which began operations in 1993. Prior to its take-over by Jet Airways, it was the only other privately owned airline in India apart from Jet, which was qualified under the civil aviation rules to operate internationally.

15"Domestic Passengers Carried by Indian Airlines and Private Scheduled Operators during 2008", Director General of Civil Aviation, online: DGCA <http://www.dgca.nic.in> (accessed on 07/25/2008).

16"Fleet Information", online: Jet Airways: <http://www.jetairways.com/Cultures/en-US/Other/About+Us/Fleet+Information/> (accessed on 07/25/2008).

17"About Us – Our Fleet", online: JetLite: <http://www.jetlite.com/jlv1/AboutUs/ourfleet.aspx> (accessed on 07/25/2008).

18"Air Sahara confirms order for 10 B737 800s" and "Boeing confirms Air Sahara jet sale", *India Aviation [CAPA]* (28 August 2006), online: India Aviation <http://indiaaviation.aero/news/airline/1799/Air+Sahara+confirms+order+for+ten+B737-800s> and <http://indiaaviation.aero/news/airline/1838/Boeing+confirms+Air+Sahara+jet+sale>.

fares ranging from INR 1 – 500, which brought flying within the means of an average middle class Indian. Since it started operations in 2003, its no-frills model has been successfully copied by many new entrants. Currently, Deccan flies only on domestic routes, but in August 2008, it will become eligible to operate internationally as well. This is one of the driving forces behind the merger of Kingfisher and Deccan, as otherwise Kingfisher would not be entitled to fly on international routes for another two years. Deccan started off as a privately owned airline but in May 2006, the company divested 26% of its share through an initial public offering. In June 2007, the parent company of Kingfisher Airlines – United Breweries, better known in India for its beer which bears the same kingfisher brand, acquired 26% of Deccan's shares and a further 20% through an open offer. In December 2007, the merger of the Deccan and Kingfisher was finalized. It was decided that pursuant to the merger, the airlines will continue to operate as separate brands and maintain their characteristic of a low cost carrier and a legacy carrier respectively, although they will be managed by a single holding company. Once permission is granted by the Director General of Civil Aviation ("DGCA") to fly internationally, it is expected that Deccan will operate on the South East and West Asian routes, while Kingfisher will fly to US cities like New York and San Francisco.[19] Both the airlines have posted considerable losses for 2007 – Deccan has shown a loss of INR 419 crore, while in case of Kingfisher, it is INR 577 crore.[20] The merger is expected to result in annual cost savings of over USD 70 million through synergies in ground handling, training, maintenance and schedule coordination.[21] The outlook for Deccan appears to be brighter in 2008 as despite the financial crisis, the company has reported a 34% increase in its revenues in the third quarter of this financial year.[22] The current fleet of Deccan consists of 20

19See "Kingfisher to merge with Air Deccan", *Business Standard* (20 December 2007) online: Business Standard <http://www.business-standard.com>.

20See *Ibid*.

21See "Air Deccan Profile", *India Aviation [CAPA]* (last updated on 24 August 2007) online: India Aviation <http://indiaaviation.aero/news/airlineCarrier/view/12/107/Air+Deccan>.

22See "Deccan posts 33% increase in revenue despite lean season", (22 April 2008), online: Deccan <http://www.airdeccan.net/PressReleases/2008/Press_release-Q3_FY08.pdf>.

A320s and 23 ATR turboprops.[23] At present, Kingfisher operates 43 aircraft that include 18 ATR 72 500 and the rest are a mixture of A319s, A320s and A321s. Apart from the Airbus order that also includes ten A380s (the first in India), which will join the fleet from 2011, the aircraft acquisition plans of Kingfisher include 35 ATRs, the first of which was delivered in March 2006[24].

(iv) SpiceJet: SpiceJet, formerly known as Royal Airways, is the revival of a domestic airline, which started operations in 1994 under the name of Modiluft and went through a long drawn reorganization process that ended in 2005, during which more than 30 winding up petitions were filed against it. Despite having such a colorful history, SpiceJet gained the confidence of the lenders and aircraft lessors, including GATX Corporation, which was the first to lease two B737 800 to SpiceJet upon its rebirth, followed by Babcock and Brown and ILFC. At present, it has a fleet of 17 B737 800 and two B737 900ER - SpiceJet was the first airline in India to use the B737 900ER. Since 2005, it has placed orders for 30 B737s, some of which have already been delivered.[25] SpiceJet has also branched out in cargo and is presently servicing nine cities in India.[26]

(v) Paramount Airways: Paramount started operations in 2005 and caters mainly to the southern part of India. At present, it operates a fleet of seven ERJ 170s and ERJ 175s aircraft. The airline is taking deliveries of five aircraft in 2008, 15 next year, which will increase the number to 27, and plans to have a fleet of 40 aircraft by the end of 2010. It is also in talk with Airbus and Boeing about purchase of wide bodied aircraft for starting international operations in 2011.[27]

(vi) GoAir: GoAir started operations in November 2005 with two leased A320s. In 2006, the airline placed firm orders for 10 A320s with an option to purchase

23See "About Us", online: Deccan <http://www.airdeccan.net/data/about/about.html> (accessed on 07/25/2008).

24See "Kingfisher Airlines ready to bring home its first ATR 72-500 Aircraft", (30 March 2006), online: Kingfisher <http://www.flykingfisher.com/view_archives.asp?id=19>.

25See "SpiceJet Announce Order for 10 Next-Generation 737s", (26 April 2007), online: Boeing http://www.boeing.com.

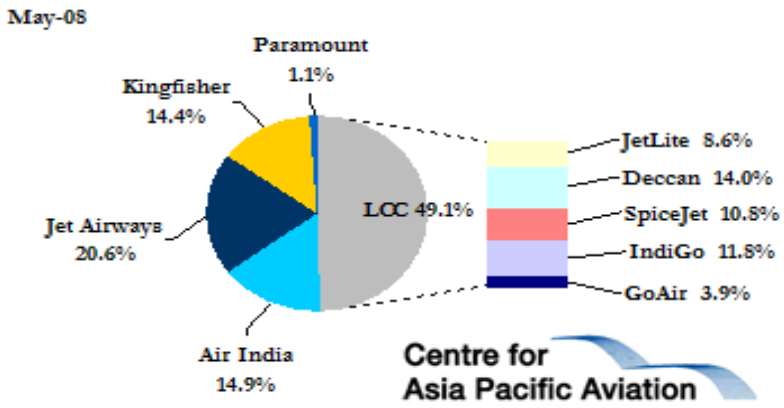
26See "SpiceJet Cargo takes off", *India Aviation [CAPA]* (31 July 2008), online: India Aviation, < http://indiaaviation.aero/news/airline/12850/59/SpiceJet-Cargo-takes-off->.

27See "Paramount Airways to acquire new aircraft", (9 February 2008), online: Paramount Airways <http://www.paramountairways.com/doc/Paramount_Airways_to_aquire_new_aircraft.doc>.

another ten, the first of which was delivered in November 2007.[28] It plans to increase the number of its aircraft to 18 by March 2009 and 34 by March 2011. GoAir claims to have a steady recording of the highest load factor in the Indian aviation scenario– its average load factor in the first half of the financial year 2007 was 81%.[29]

(vii) Indigo: Indigo, another low cost carrier, made a somewhat dramatic entrance in the aviation scene in India when Interglobe Enterprises, the company which owns the airline, placed a USD 6 billion order for 100 new A320s and A321s aircraft in 2005 to be delivered over a period of ten years.[30] The first aircraft was delivered in July 2006 and the current fleet strength of the airline is 18 A320 200s.[31]

The following chart gives the market share of the above-mentioned airlines as in May 2008:



Source: Website of Centre for Asia Pacific Aviation

Many of the airlines have been running into loss due to high operating expenses and the cut throat competition. One of the primary factors that have contributed to the soaring operating

28"GoAir signs deal with Airbus Expands its fleet with the purchase of 10 A320s", (17 July 2006), online: GoAir < http://www.goair.in/news_july06.asp>.

29"GoAir receives new A320 aircraft, flight expansion to be completed by November-end", (15 November 2007), online: GoAir <http://www.goair.in/news_nov07.asp#>.

30"Indigo Profile", *India Aviation [CAPA]* (last updated on 25 July 2007) online: India Aviation <http://indiaaviation.aero/news/airlineCarrier/view/255/107/IndiGo>.

31"Indigo Fleet", online: Indigo: < http://book.goindigo.in> (accessed on 26 July 2008).

cost is the inordinately high amount of duty on ATF, which Indian airlines are required to pay. At present, a domestic carrier pays a custom duty of 10% and an excise duty of 10%, in addition to sales tax which may reach as high as 30 % on ATF. Thus, ATF is 70% more expensive in India and on an average, accounts for 40% of the operating cost of an Indian carrier, while for its international counterparts this figure is only 20%.[32] The Government has set up a committee to study the financial crises and to provide short and long term recommendations for the continued development and robust growth of the Indian aviation industry.[33]

II. Aviation Policy

The Indian aviation policy provides for three categories of air transport services, namely – scheduled air transport service, which means flight between two destinations which is open to public and is operated according to a fixed, published schedule; non scheduled services that refers to air service which is not scheduled as for e.g. a charter service, and cargo service which may be scheduled or non scheduled. The DGCA is the authority that regulates air transport to, from and within India. The rules and regulations pertaining to civil aviation are contained in the Aircraft Act of 1934, the Aircraft Rules of 1937, as amended from time to time, the Civil Aviation Requirements ("CARs") and the Aeronautical Information Circulars ("AICs") issued by the DGCA, which also issues certain other non-binding circulars that contain advisory and guidance material.

Although the deregulation of the sector has taken place to a large extent, there are still certain restrictions concerning the routes on which the Indian airlines can fly, which are imposed by the Government in order to enhance the connectivity to remote and underdeveloped regions. These are contained in the Route Dispersal Guidelines, which divide all routes in: (i) category I, which are the routes directly connecting the metro cities in India i.e. Bangalore, Kolkata, Chennai, Delhi, Hyderabad, Mumbai and Trivandrum; (ii) category II, which are routes connecting destinations in Jammu and Kashmir, North-East Region, Andaman and Nicobar and Lakshadweep Islands to destinations outside of these areas; (iii) category IIA that are routes

32See Raja Awasthi and Dheeraj Tiwari, "Aviation Ministry writes to Finmin on rising ATF prices" The Economic Times, (10 May 2008), online: The Economic Times <http://economictimes.indiatimes.com/Features/The_Sunday_ET/Economy/Aviation_ministry_writes_to_Finmin_on_rising_ATF_prices/rssArticleicleshow/3028654.cms>.

33See "Committee set up to examine financial crises of domestic airlines in India", (9 July 2008) online: Press Information Bureau <http://pib.nic.in/release/release.asp?relid=40199>.

connecting destinations within the areas mentioned in the previous category; and (iv) category III, which are routes other than the aforementioned. The Route Dispersal Guidelines specify that all scheduled operators are required to: (i) deploy in category II at least 10% of their deployed capacity in category I routes; (ii) deploy in category IIA at least 10% of their deployed capacity in category II routes; and (iii) at least 50% of the their capacity deployed in category I route is to be deployed in category III routes.[34] On international routes, only those scheduled air carriers are allowed to operate which have serviced the domestic sector for at least five years and have a fleet of at least 20 aircraft.[35] As mentioned above, amongst the private airlines, only Jet Airways and JetLite qualify for international operations at present. The more lucrative routes to the Gulf countries like UAE, Qatar, Bahrain, Oman, Kuwait and Saudi Arabia are not available to the private carriers until a period of three years has elapsed from the date of commencement of international operations[36], although Jet Airways has recently been given permission by the Government to operate on these routes. A preference is given to Air India in route allocation. To provide more efficient services to regional areas and to enhance their connectivity, the Government recently introduced the concept of regional airlines, whereby a special operating permit is granted to airlines using smaller aircraft, which can operate flights between any airport in their designated region i.e. North, South, East/NorthEast to all airports in other regions, except for the airport of metro cities of such regions. The metro cities are Delhi, Mumbai, Chennai, Kolkata, Bangalore and Hyderabad. Since, the southern region has three metro cities i.e. Bangalore, Chennai and Hyderabad, the airline operating in this region are permitted to operate flights to these metro cities. The regional airlines are not allowed to operate on category I routes but they receive a waiver with respect to the navigation, landing and parking charges, and also get a duty concessions on ATF.[37]

In June 2008, a revised policy regarding Foreign Direct Investment ("FDI") in the civil aviation sector was notified. The policy *inter alia* provides for the following FDI limits:

34*Domestic Air Transport Policy – Annexure I*, (India), Ministry of Civil Aviation, online: Ministry of Civil Aviation <http://civilaviation.nic.in/> (accessed on 26 July 2008).

35*Guidelines for Operation of Indian Scheduled Carriers on International Routes*, (India), DGCA, AIC No. 2/2005 (21 January 2005) at 1.1, online: DGCA < http://www.dgca.nic.in/rules/car-ind.htm>.

36*Ibid* at para 2.1.

37See Vinay Kumar, "Regional airlines coming soon, says Praful Patel" *The Hindu* (11 August 2007), online: The Hindu <http://www.hindu.com/2007/08/11/stories/2007081156661600.htm>.

- Airports – in case of Greenfield airports, FDI up to 100% is permitted under the automatic route, which means that the approval of the Foreign Investment Promotion Board is not required. In case of existing projects, FDI up to 100% is allowed although prior approval of the Government is required for FDI beyond 74%;
- Scheduled Air Transport Service/Domestic Scheduled Passenger Airline – FDI up to 49% and investment by Non-resident Indians up to 100% is permitted under the automatic route;
- Non-Scheduled Air Transport Service/ Non-Scheduled airlines, Charter Services and Cargo – FDI up to 74% and investment by Non-resident Indians up to 100% is permitted under the automatic route; and
- Ground Handling Services - FDI up to 74% and investment by Non-resident Indians upto 100% is allowed under the automatic route subject to sectoral regulations and security clearance;
- Maintenance and Repair organizations/flight training institutes; and technical training institutions – FDI up to 100% is allowed under the automatic route.[38]

The minimum requirements for grant of a scheduled air operator's permit include:

- Certain restrictions as to citizenship which are discussed in detail in chapter three of this paper;
- Paid up capital – airlines, which operate or propose to operate aircraft with a take-off mass equal to or exceeding 4000 kg are required to have a paid up capital of INR 40 crores for a fleet of five aircraft, with a further INR 20 crores for each additional group of five aircraft. Airlines which operate or are going to operate, aircraft with a take-off mass of less than 4000 kg only need INR 20 crores for five aircraft and INR 10 crores thereafter for each additional group of five aircraft;
- A fleet of minimum of five aircraft;
- Not less than three set of crew per aircraft; and

38*FDI Policy for the Civil Aviation Sector* (India), Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, Press Note 4/2008 (12 March 2008) at para 3, online: DIPP, < http://siadipp.nic.in/policy/changes.htm >.

- Adequate maintenance, repair and ground handling facilities.[39]

A draft civil aviation policy has been in the pipeline for a while now. In June 2007, it was referred by the Cabinet to a Group of Ministers[40] ("GoM") to study its more controversial aspects. At the time of writing this paper, the GoM had not submitted its report. The draft policy addresses issues like further liberalization of international operations of the Indian carriers, including relaxation of the requirement of five years of prior domestic experience before being permitted to operate on international routes (new entrants like Kingfisher are aggressively lobbying for this, while it is vigorously opposed by Jet Airways to preserve its monopoly), the reorganization of the Airport Authority of India and the privatization of the traffic control services.[41] It is also envisaged that the Airport Authority of India and DGCA will be combined to form a single civil aviation regulator.

The ensuing chapters of this paper discuss certain facets of the aviation policy like the procedure for import and registration of aircraft in more detail, as also the legal aspects relating to aviation finance, such as the various methods of acquisition of aircraft, the modes of financing used by the airlines, the concept of security, a description of the insurance provisions and the taxes that may be imposed in a typical financing transaction and the impact of the Cape Town Convention [42], which came into force in India on 1 July 2008.

39*Minimum Requirements for Grant of Permit to Operate Scheduled Passenger Air Transport Services* (India), DGCA, CARs, Section 3- Air Transport, Series 'C', Part II, (1 March 1994 revised on 30 June 2007) at para 3.2, online: DGCA < http://www.dgca.nic.in/rules/car-ind.htm> [*CAR – Grant of Permit*].

40 The 12 member Group of Minister includes the Minister for Civil Aviation, the Minister for Defence, the Minister for External Affairs , the Minister for Railways and the Minister for Agriculture.

41See Shauvik Ghosh, "GoM may clear civil aviation policy", The Financial Express (3 January 2008), online: The Financial Express < http://www.financialexpress.com/news/GoM-may-clear-civil-aviation-policy-today/256941/>

42*Convention on International Interests in Mobile Equipment*, 11 November 2001, ICAO Doc 9793 (entered into force on 1 March 2006) [*Cape Town Convention*].

Chapter One

Methods of Acquisition of Aircraft

An airline's decision to acquire an aircraft is invariably accompanied by the question of whether the aircraft is to be taken on lease or purchased. The answer largely depends on the airline's requirements, cost of the aircraft, availability of capital, legal constraints and taxation issues. Whilst ownership of the aircraft does offer benefits like investment tax credit and depreciation, leasing remains the most important method of aircraft acquisition in India. Leasing, *inter alia,* offers flexibility, enables the lessee to obtain 'off balance sheet financing"[43], and, if the lessor shares the tax benefits it gains from ownership of the aircraft, the lease rentals may be significantly lower than the cost of conventional borrowing. It offers the best security to the lessor, since in case of default it is easier to regain possession of the aircraft in almost all jurisdictions, where the ownership of the aircraft continues to vest in the lessor. The global percentage for aircraft leasing is 30%, whereas in India this figure is as high as 53%.[44] Described below are some of the most important variants of lease and sale that exist in the aviation industry and the extent to which they are recognized in India.

I. Aircraft Lease

A. Types of Leases

Although there is a plethora of leases depending on the accounting standards, commercial and tax laws of different countries, the two main categories are: finance lease and operating lease. Apart from these two categories, a study of leveraged leases and sale and leaseback transactions is also relevant in the context of aircraft acquisition.

1. Finance Lease and Operating Lease

A finance lease is a contract where almost all of the risks and rewards of ownership are borne by the lessee and the lease payments made to the lessor during the lease period are

43Operating lease obligations are not included as a liability in the balance sheet of the lessee and therefore do not affect its debt/equity ratio.

44See Roberts, *supra* note 1 at 22.

sufficient to cover the lessor's costs and also present a profit.[45] The function of a finance lease is, therefore, somewhat analogous to a secured loan with the exception that the title continues to vest in the lessor.[46] Although the aircraft is purchased by the lessor, it does not usually have a hand in the selection of its model, which is done on the basis of the specifications provided by the lessee. The lessee is responsible for all repairs, maintenance and insurance costs, and also bears the risk of obsolescence. The lease period normally covers the economic life of the aircraft so that by the end of the lease, the residual value of the aircraft may be negligible. The lessor may generally give the lessee an option to purchase the aircraft either at the end of the lease period or throughout, taking into consideration bank breakage charges and the relative negotiating powers of the parties. Such options may be exercised at predetermined prices or for fair market value.

The purpose of an operating lease is to facilitate usage of the asset rather than transfer of any ownership interest and it covers most other forms of leases, where the risks and rewards of ownership remain with the lessor. An operating lessor has to place the aircraft on a number of successive leases or sell the aircraft in due course to recover its capital outlay and make a profit, whereas a finance lessor looks to a single lease to do the same. An operating lessor must, therefore, have significant expertise in the management of the asset, while a finance lessor is primarily concerned with effectiveness of the lease structure and has minimal interest in asset management.[47]

In order to understand the criteria for classification of leases, the underlying characteristics of each class, and the basis for their distinction from other modes of transfer of property, it is essential to take a look at the accounting standards and tax laws pertaining to leases in countries like USA, where leasing was first used on a large scale in equipment finance and where it has been refined to its present day form. This is followed by taking a brief look at leasing in UK and an in-depth study of the treatment of leases under Indian laws.

45See Donald H. Bunker, *International Aircraft Financing* (Montreal: International Air Transport Association, 2005), vol. 1 at 183 [Bunker].

46See Stephen Holloway, *Aircraft Acquisition Finance*, (London: Pitman Publishing, 1992) at 141 [Holloway].

47See *Ibid* .

(i) Accounting and Tax Treatment of Leases in USA.

In USA, the accounting standard FAS 13[48] distinguishes between a capital lease, which is similar to a finance lease, and an operating lease. In a nutshell, if a lease meets any of the following four criteria, it is characterized as a capital lease by the lessee:[49]

(a) by the end of the lease term, the ownership of the asset is transferred to the lessee;

(b) a bargain purchase option[50] is included;

(c) the lease term is equivalent to 75% or more of the estimated economic life of the leased asset;[51]

(d) the present value of the minimum lease payments[52], at the beginning of the lease term, after excluding executory costs, equals to or exceeds 90% of the excess of the fair value[53] of the leased asset.[54]

If the lease meets any of the above criteria, in addition to the two criteria given below, it is classified as a 'sales type lease'[55] or a 'direct financing lease'[56] by the lessor, as the case may be:[57]

(a) "collectibility of the minimum lease payments is reasonably predictable;

48*Accounting for Leases* (U.S.), Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 13, (Norwalk: FASB, 1976), online: FASB < http://www.fasb.org/pdf/fas13.pdf> [*FAS 13*]

49*Ibid* at para 7.

50A bargain purchase option is "[a] provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured." *FAS 13*, *supra* note 48 at para 5(d).

51There is an exception to this parameter. See *FAS 13*, *supra* note 48 at para 7(c).

52Minimum Lease Payments refers to "[f]rom the standpoint of the lessee: [the] payments that the lessee is obligated to make or can be required to make in connection with the leased property…." and in case of the lessor in addition to the aforementioned, it refers to "…any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee or the lessor, provided the third party is financially capable of discharging the obligations that may arise from the guarantee." See *FAS 13*, *supra* note 48 at para 5(j) for a detailed definition of Minimum Lease Payments.

53Fair value is the price for which the property could be sold in an arm's-length transaction between unrelated parties. *FAS 13*, *supra* note 48 at para 5(c).

54There are certain exceptions to this parameter. See *FAS 13*, *supra* note 48 at para 7(d).

55Sales type leases are "[l]eases that give rise to manufacturer's or dealer's profit (or loss) to the lessor…. Normally, sales-type leases will arise when manufacturers or dealers use leasing as a means of marketing their products…." *FAS 13*, *supra* note 48 at para 6(b)(i) for a complete definition of sales type leases.

56Direct financing leases are "[l]eases other than leveraged leases that do not give rise to manufacturer's or dealer's profit (or loss) to the lessor.…" See *FAS 13*, *supra* note 48 at para 6(b)(ii) for a complete definition of direct financing leases.

57*FAS 13*, *supra* note 48 at para 8.

(b) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease."

In all other cases, a lease is classified as an operating lease.

In taxation, the distinction is made between leases and conditional sale contracts. The Revenue Ruling 55-540[58] provides that whether an agreement would be characterized as a lease or a conditional sales contract depends on the intention of the parties, as evidenced by the provisions of the agreement and the facts and circumstances that existed when the agreement was executed. There is no particular test or general rule that could be applied for such characterization but if one or more of the following conditions are met, the transaction, in the absence of evidence to the contrary, would be characterized as a purchase or sale agreement rather than as a lease or rental agreement:

(i) "Portions of the periodic payments are made specifically applicable to an equity interest to be acquired by the lessee in the leased asset;

(ii) The lessee will acquire title to the leased asset upon payment of the stated amount of `rentals' which under the contract he is required to make;

(iii) The total amount which the lessee is required to pay for a relatively short period of use of the leased asset constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of title;

(iv) The agreed `rentals' payments materially exceed the current fair rental value. This may be indicative that the lease payments include an element other than compensation for the current use of property;

(v) The leased property may be acquired by the lessee under a purchase option at a price that is nominal in relation to the fair market value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or that is a relatively small amount when compared with the total payment required to be made; and/or

58*Guides to be used in determining the treatment, for Federal Income Tax purposes, of leases of equipment used in the trade or business of the lessee* (U.S.), Internal Revenue Services, Revenue Ruling. 55-540, 1955-2 C.B. 39., online: taxlink < http://www.taxlinks.com/rulings/1955/revrul55-540.htm>, [*Rev.Rul.55-540*].

(vi) Some portion of the periodic payments is specifically designated as interest or is otherwise recognizable as the equivalent of interest."[59]

Even if the contract does not contain a provision for the transfer of title or the transfer of title is specifically excluded, the contract can still be characterized as a sale of an equitable interest in the property.[60] The following are some of the characteristics of a transaction which would normally indicate an intention to lease:

(a) "…the rental payments are based on an hourly, daily or weekly rate, or are calculated on the basis of production, use, mileage or a similar measure and are not directly related to the normal purchase price, provided that in case of a purchase option, the purchase price is reasonably equivalent to the anticipated fair market value on the option date."[61];

(b) the lessor bears the costs of repairs, maintenance, taxes, insurance, etc.;

(c) provisions are included for termination of the agreement at the specified periods after proper notification by either party.

(d) where the agreement contains a purchase option, the price at which the option is exercisable is not connected to the lease rentals.[62]

In 1975, the Internal Revenue Service ("IRS") issued the Revenue Procedure 75-21, which offered certain guidelines for classifying a lease transaction as a leveraged lease. Although the guidelines were applicable specifically to leveraged leases, it was considered that IRS would also use them to determine whether a leveraged lease or a non leveraged lease i.e. a single investor lease would qualify as a true lease.[63] The Revenue Procedure 75-21 has been superseded by the Revenue Procedure 2001-28[64], according to which in a leveraged lease, a lessor will be regarded

59*Ibid* at sec. 4(1).

60*Rev.Rul.55-540, supra* note 58, s. 4(2).

61 *Rev.Rul.55-540, supra* note 58, s. 4.04

62*Rev.Rul.55-540, supra* note 58, ss. 2(a) and (b).

63 See Peter K. Nevitt & Frank J. Fabozzi, *Equipment Leasing*, 4th ed. (New Jersey: John Wiley & Sons Inc., 2000) at 79.

64U.S., Revenue Procedure 2001-28, 26 CFR 601 provided in Internal Revenue Service, Bulletin, 2001-19, (7 May 2001) at 1156-1160, online: Internal Revenue Service < http://www.irs.gov/pub/irs-irbs/irb01-19.pdf>.

as the owner of the asset and the transaction to be a valid lease if all of the conditions described below are met, unless the facts and circumstances of the case indicate otherwise:[65]

(a) The lessor is required to make at the beginning of the lease term a minimum unconditional 'at risk' equity investment of at least 20% of the cost in the asset, and to maintain it throughout the lease term;

(b) The lessor must show that it would be reasonable to expect that the fair market value of the asset at the end of the lease term would be at least 20% of the cost of the asset. Additionally, the remaining useful life of the asset at the end of the lease term must be shown to be one year or 20% of the originally estimated useful life of the asset, whichever is longer;

(c) A member of the lessee group may not have a right to purchase the asset at a price less than its fair market value (determined at the time when such right is exercised). When the asset is first placed in the service of or used by the lessee, the lessor may not have a right under the contract to cause the asset to be purchased by lessee or nominee thereof, which includes the right to abandon the asset in favor of such party;

(d) Except as provided for in the guidelines, a member of the lessee group may not provide for any part of the cost of the asset or the cost of improvements, modifications or additions to the asset;

(e) A member of the lessee group may not loan to the lessor any portion of the acquisition price of the asset or provide a guarantee for any debt incurred by the lessor for the same; and

(f) The lessor must show that it expects to derive a profit from the transaction, excluding any tax benefits.

(ii) Accounting and Tax Treatment of Leases in UK.

In UK, the accounting standard SSAP 21[66] defines a finance lease as "a lease which transfers substantially all the risks and rewards of ownership in the asset to the lessee. It should

65 See *Ibid* for the full details.

66 *Statement of standard accounting practice no. 21 – Accounting for leases and hire purchase contracts* (U.K.), Accounting Standard Board, August 1984, online: ASB <http://www.frc.org.uk/asb/technical/standards/pub0391.html> [*SSAP 21*].

be presumed that such a transfer of risks and rewards occurs when at the inception of the lease, the present value of the minimum lease payments, including any initial payment, amounts to substantially all (normally 90% or more) of the fair value of the asset."[67] An operating lease is defined as a lease which is not a finance lease.[68] Practically speaking, some portion of the risks and benefits of ownership is passed on to the lessee in each type of lease and the distinction between a finance lease and an operating lease is essentially one of degree.[69] Hire purchase contract which contain elements of financing are also accounted for in the same way as finance leases.[70]

For the purpose of taxation, the legal form of finance lease is recognized i.e. the tax system considers finance lease to be a transaction of hire like operating lease and not a loan and regards the lessor as the owner of the asset even though economic ownership may vest in the lessee.[71] The tax treatment of hire purchase transactions, which are considered to be a species of finance lease containing an option to purchase the asset at the end of the lease term after fulfillment of certain conditions, is different. Here, the hirer is treated as the owner of the asset.[72]

(iii) Accounting of Leases in India.

The Indian accounting standard AS 19[73] is similar to SSAP 21 and almost identical to International Accounting Standard 17 'Accounting for Leases'. It makes a distinction between finance leases and operating leases on the basis of the 'risks and rewards of ownership'[74] criterion. A lease is categorized as a finance lease if it transfers most of the risks and rewards associated with ownership, irrespective of whether or not the title to the asset is transferred.

67*Ibid* at para 15.

68*SSAP 21, supra* note 66 at para 17.

69 *SSAP 21 supra* note 66 at para 8.

70 *SSAP 21 supra* note 66 at para 31.

71*Finance Leasing Manual* (U.K.), HM Revenue and Custom, online: HM Revenue and Custom <http://www.hmrc.gov.uk>.

72*Capital Allowances Manual* (U.K.), HM Revenue and Custom, online: HM Revenue and Custom <http://www.hmrc.gov.uk>.

73*Accounting Standard 19 Leases* (India), Council of the Institute of Chartered Accountants of India, 2001, online: ICAI < http://www.icai.org/icairoot/resources/as_index.jsp>, [*AS 19*].

74According to section 5 of *AS 19, ibid,* "[r]isks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realization of residual value."

Otherwise, it is classified as an operating lease.[75] The determination is done on the basis of the substance of the transaction and not its form.[76] Some examples of situations, individually or in combination, which would result in the lease being characterized as a finance lease in India, are:

(i) the lease contains a provision whereby the lessee becomes the owner of the asset by the end of the lease term;

(ii) the lease contains a bargain purchase option i.e. it permits the lessee to purchase the asset at a price which is expected to be significantly lower than the fair value[77] of the asset at the time of exercise of option and at the inception of the lease[78], it can be reasonably ascertained that the lessee will choose to exercise the option;

(iii) the term of the lease covers a significant part of the economic life[79] of the asset even if there is no transfer of title;

(iv) at the inception of the lease, the present value of the minimum lease payments is almost equivalent to the fair value of the leased asset;

(v) the leased asset is of such a specific type that it can be used only by the lessee without major alterations having to be done;

(vi) if the lease can be terminated by the lessee before the end of the lease term, the lessee is liable for lessor's losses resulting from such termination;

(vii) the lessee bears the gains or losses resulting from the variation in the fair value of the residual, for e.g. the lessee may receive a reduction in rentals amounting to most of the proceeds that may have been obtained from a sale of the asset at the end of the lease; and/or

75*AS 19*, *supra* note 73 s. 6.

76*AS 19*, *supra* note 73, s. 8.

77Fair value is defined in section 3 of *AS 19*, *supra* note 73, as "the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction."

78The inception of the lease is defined in section 3 of *AS 19*, *supra* note 73, as "the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease."

79Economic life is defined in section 3 of *AS 19*, *supra* note 73, as "either: (a) the period over which an asset is expected to be economically usable by one or more users; or (b) the number of production or similar units expected to be obtained from the asset by one or more users."

(viii) the lessee can renew the lease for a subsequent period at a rent which is significantly lower than market rate.[80]

In case of a finance lease, the lessee is required to recognize it in its balance sheet as an asset and a liability to pay the lease rentals[81], while the lessor writes it down as "…a receivable at an amount equal to the net investment in the lease".[82] For operating leases, the lease payments are characterized as an expense in lessee's statement of profit and loss over the lease term[83] and as income in the statement of the lessor,[84] on a straight line basis. Hire purchase agreements also come within the ambit of the definition of a lease in As 19. Here, hire purchase agreements refer to "agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions" and include "agreements under which the property in the asset is to pass to the hirer on the payment of the last installment and the hirer has a right to terminate the agreement at any time before the property so passes".[85]

(iv) Tax Treatment of Leases in India.

Similar to the practice in UK, the distinction for tax purposes is made between a lease or *hire simpliciter* and a hire purchase transaction. The former is merely a bailment of the asset[86], while in case of the latter, in addition to the terms of hire, an option to purchase the asset is given to the hirer upon payment of a specified sum of money,[87] normally, at the end of the hiring period. Thus a hire purchase agreement has two elements: first there is an element of bailment and secondly there is an element of sale, which materializes if the purchase option is exercised by the intending purchaser, after complying with all the terms of the agreement.[88] An installment sale is distinguished from a hire purchase transaction on the basis that in case of the former, the property in the goods passes to the buyer at the moment of the sale, irrespective of when the full price is paid i.e. it may be paid in installments over a period of time but in case of latter the

80*AS 19*, *supra* note 73, ss. 8 and 9.

81*AS 19*, *supra* note 73, s. 11.

82*AS 19*, *supra* note 73, s. 26.

83*AS 19*, *supra* note 73, s. 24.

84AS 19, *supra* note 73, s. 40.

85*supra* note 73, s. 4.

86See *CIT v. Shaan Finance (P) Ltd*, [1998] 231 ITR 308 (SC); *S.B.I Home Finance Ltd. v CIT* [2005] 199 CTR 623 (Cal).

87See *Sundaram Finance Ltd v State of Kerala*, [1966] AIR 1178 (SC) [*Sundaram Finance*].

88 See *K. L. Johar & Co v Deputy CIT, Coimbatore*, (1964) [1965] AIR 1082 (SC) [*K. L. Johar*].

property passes only if the hirer purchases the goods by exercising the purchase option and not when the hire purchase agreement is executed.[89]

A further distinction is drawn between pure hire purchase and a transaction which is in guise of a hire purchase but is essentially a loan transaction. This becomes relevant in taxation of interest payments in a loan transaction which are disguised as hire charges. In this regard, a circular issued by the Central Board of Direct Taxes ("CBDT") provides that "[w]hen a hirer is the real purchaser of the asset but does not pay the full purchase price and the hire-purchase company pays the price or a substantial part thereof on behalf of such hirer, and a hire-purchase agreement is entered into merely as an arrangement, then such agreement is a security for repayment of the loan and is essentially a loan transaction."[90] The Supreme Court of India in *Sundaram Finance*[91] has elaborated on the nature of the two transactions and laid down the following test for distinguishing between the two:

> "A hire-purchase agreement is normally one under which an owner hires goods to another party called the hirer and further agrees that the hirer shall have an option to purchase the chattel when he has paid a certain sum, or when the hire-rental payments have reached the hire-purchase price stipulated in the agreement.
>
> …In such a hire-purchase agreement there is no agreement to buy goods; the hirer being under no legal obligation to buy, has an option either to return the goods or to become its owner by payment in full of the stipulated hire and the price for exercising the option. This class of hire-purchase agreements must be distinguished from transactions in which the customer is the owner of the goods and with a view to finance his purchase he enters into an arrangement which is in the form of a hire-purchase agreement with the financier, but in substance evidences a loan transaction, subject to a hiring agreement under which the lender is given the license to seize the goods.
>
> …If there is a *bona fide* and completed sale of goods, evidenced by documents, anterior to and independent of a subsequent and distinct hiring to the vendor, the transaction

89 *Ibid*.

90 *Instructions Regarding Taxability of Hire-Charge as Interest* (India), Central Board of Direct Taxes, Circular No. 760 (13 January 1998), at para 3(iii), [*Circular no.760*].

91 *Supra* note 87.

may not be regarded as a loan transaction, even though the reason for which it was entered into was to raise money. If the real transaction is a loan of money secured by a right of seizure of the goods, the property ostensibly passes under the documents embodying the transaction, but subject to the terms of the hiring agreement, which become part of the buyer's title, and confer a license to seize. When a person desiring to purchase goods and not having sufficient money on hand borrows the amount needed from a third person and pays it over to the vendor, the transaction between the customer and the lender will unquestionably be a loan transaction."

In deciding whether a transaction is a hire purchase or a financing transaction, the assessing officer is required to consider the issue on merits, taking into account, *inter alia*, the following:[92]

(i) the terms of the agreement between the parties;

(ii) the nature of arrangement between the supplier, the hire purchase company and the end user of the asset; and

(iii) the intention of the parties which manifests itself in the fixation of the initial payment, the method of determination of the hire-purchase price etc.

Although the terms 'finance lease' and 'operating lease' are not used in the Income Tax Act, they are used in several cases[93] and in some internal circulars of the CBDT. An Approach Paper issued by the CBDT[94] provides that a lease may be considered to be a finance lease if any of the following conditions are satisfied:

(i) "The lease transfers the ownership of the asset to the lessee by the end of the lease term. This is nothing but hire purchase;

(ii) The lease contains a bargain purchase option;

(iii) Had the lessee owned the asset, 75% or more of the initial value (actual cost or written down value) of the asset would have been available as depreciation; or

92*Circular no.760*, *supra* note 90.

93For e.g. see *Shree Rajasthan Syntex Ltd. v Asstt. Commissioner of Income-tax*, (2005) 93 TTJ 41 (ITAT); *Sharyans Resources Ltd.v Joint Commissioner of Income Tax* [2002] 83 ITD 340 (Mum).

94*Tax Treatment for Leasing Business* (India), CBDT, Approach Paper, (23 January 1996) cited in *The ICICI Ltd. v Dy. CIT, Special Range 36* and *Mid East Portfolio Management Ltd v Dy. CIT, Special Range 28* and *The West Coast Papers Mills Ltd. v Jt. CIT, Special Range 36* (14.8.2003) ITA No. 3300/MUM/1997 Assessment Year, 1993-94, ITA No. 5616/MUM/1999 Assessment Year, 1995-96 and ITA No. 5403/MUM/1997 Assessment Year, 1996-97 (ITAT Mumbai, Special Bench C) at para 68 [*ICICI Ltd*].

(iv) The present value of minimum lease payments (lease rentals + guaranteed residual value) at the beginning of the lease term is 90% or more of the initial value. The rate of interest taken here is the highest rate of interest at which the lessor has taken a loan from a bank or financial institution. In the absence of this information, a rate of 20% is to be taken."

The CBDT has provided guidelines for investigating the genuineness of a finance lease transaction and for establishing the ownership of the asset in another set of internal instructions issued to the assessing officers for allowance of depreciation on leased assets.[95] According to these guidelines, the assessing officer should make enquiries to verify the existence of the asset and examine the lease agreement and supporting documents like insurance papers, inspection reports, board resolutions, and books of account and in particular, look at the following:

(i) "nature of warranty given by the lessor for quality, condition, suitability, fitness etc. of the leased assets;

(ii) the liability of the lessee in respect of any damage, loss of assets during transportation, delivery, use or its failure to perform during the period of the lease;

(iii) the liability to obtain all consents /licenses/ approvals etc. for import/storage installation, use, operation etc. of the assets during the lease term;

(iv) the liability to pay taxes, penalty etc. levied either in connection with the transaction or the transfer of asset such as sales tax, goods tax, interest tax , etc;

(v) the variation in rate of the lease rent contingent upon the disallowance of depreciation on the asset in the hand of the lessor; and/or

(vi) the condition of transfer back of the asset at the end of the period of lease agreement and the option of the lessee to purchase the asset at the scrap value."

The guidelines further specify that if the finance lease is found to be fraudulent or not genuine and the basic documents like insurance papers, inspection reports etc. are found to be false, then in addition to the disallowance of claim of depreciation, launching of prosecution against the offenders may also be considered.

95*Finance Leases – Guidelines for Investigation* (India), CBDT, Instructions No. 1978 (F. No. 225/190/98/ITA II) (31 December 1999).

The Approach Paper and the guidelines are not a part of the circulars issued by the CBDT and are therefore not binding but they do have a persuasive value. However, there have been many cases where the assessing officers, following the line of investigation specified above, have disallowed depreciation to the lessor on the basis that the lease is a financing transaction but the Appellate Tribunals and the Courts have held that unless the lessor parts with any of its ownership rights, the lessor is entitled to depreciation.[96] Although in some cases, the Courts have looked at the substance of the agreement rather than its form to determine the nature of transaction, it is also a well settled aspect of Indian law, that the Courts cannot rewrite an agreement for the parties. In the absence of fraud, the Courts will generally accept the form of the agreement as long as the intention of the parties is clearly manifested.

Based on the above discussion, the conclusion which can be drawn is that the tax treatment of finance and operating leases is the same[97] unless it is a hire purchase transaction. If the transaction is treated as a lease, the lessor as owner is entitled to claim depreciation on the asset, the lease rentals are treated as its income and the lessee is allowed to write off the rentals as expenses. In case of hire purchase, it is the hirer who claims depreciation and other tax benefits. This creates a dichotomy between the accounting and tax treatment of operating and finance leases in India.[98] In the absence of clear guidelines by the Income tax authorities, there is also some confusion as to the delineation between finance lease and hire purchase, which has been entirely left at the discretion of the assessing officer.

(v) Leases in Foreign Exchange Regulations of India.

In the foreign exchange regulations, a financial lease is a lease transaction, which contains an option to purchase the asset at the end of the lease term.[99] Exchange control is more strictly applied to finance leases than operating leases. For example, prior approval of the Reserve Bank of India ("RBI") is necessary for remittance of payment of rentals, opening of letters of credit etc. for import of aircraft or aircraft engines, if the transaction is a finance lease.

96See *Sharyans Resources Ltd. v Joint Commissioner of Income Tax* [2002] 83 ITD 340 (Mum); *Shree Rajasthan Syntex Ltd v Asst CIT* (2005) 93 TTJ (ITAT) 41.

97This is recognized in the Approach Paper as well. See *supra* note 94.

98*Finance lease agreements - Effect of publication of accounting standards on allowability of depreciation* (India), CBDT, Circular No. 2 [F. N. 225/186/2000-ITA-II], (9 February 2001), [*Circular No. 2*]. It clarifies that *AS 19*, which requires capitalization of the asset by the lessee in a finance lease, will have no implication on the allowance of depreciation under the *Income Tax Act*.

99*Import of Aircraft/Aircraft Engine/Helicopter on lease basis* (India), Reserve Bank of India, AP (DIR Series) Circular No. 24, (1 March 2002), online: RBI < http://www.rbi.org.in/home.aspx >.

Such approval is not required for an operating lease, if the necessary permission from the Ministry of Civil Aviation or the DGCA has been obtained.[100]

2. Leveraged Lease

Generally in most countries, in a leveraged lease, the lessor (also called the equity participant) provides only a proportion of the cost of the aircraft from its own pockets and the rest is borrowed from a lender or a syndicate of lenders (also called the debt participant) on a non recourse basis. The proportion ranges between 20% - 40% and this risk is maintained by the lessor throughout the lease term. The loan is repaid from the lease rentals, which are assigned to the lender along with the insurance proceeds, and is secured by a first mortgage on the aircraft. In case of default, the lender has no recourse against the lessor for any amount in excess of what might be realized pursuant to the enforcement of the mortgage or receipt of the insurance proceeds for repayment of its loan.

A leveraged lease hinges on the disproportionately large difference between the investment made by the lessor and the return received on the investment i.e. the lessor puts in only 20 to 40% of the investment but it is able claim 100% of depreciation and investment tax credit. In addition, if the lessor is entitled to the residual value of the aircraft at the end of the lease (which is generally not the practice in cross border leveraged leases), in case of a sale of the aircraft, the amount of the sale price received over and above the residual value assumed at the beginning of the lease term, belongs to the lessor.[101] The lessor can also retain that part of the lease rentals paid to the lenders which is in excess of the principle and interest payment.

Leveraged leases are not specifically mentioned in either accounting standards or taxation laws of India.

3. Sale and Leaseback

A sale and leaseback is a transaction where the owner of the asset sells the asset to a purchaser, who then immediately leases it back to the seller. This enables the previous owner to continue using the asset, in addition to recovering the equity in the asset. An airline normally enters into a sale and leaseback of the aircraft to: improve capital flow; lessen the risk of

100 *Ibid.*

101See Hollow*ay*, *supra* note 46, at 166.

variation in future aircraft value, fix the sale price in expectation of aircraft deliveries for fleet renewal[102]; recover the present value of an aircraft which is liable to be retired in the near future[103]; as a tax planning strategy; refinance aircraft owned by the airline at a reduced cost and/or streamline the ownership structure of the fleet[104].

(i) Accounting of Sale and Leaseback in India.

The accounting of a sale and leaseback is based on the classification of the lease structure. In case of a finance lease, any surplus or deficit sale proceed over the carrying amount is not written off immediately as income or loss in the financial statement of the seller-lessee but is deferred and amortized over the period of the lease in proportion to the depreciation of the leased asset.[105] An operating lease, where the lease rentals and sale price are considered to be at fair value, is treated in a way similar to a normal sale i.e. any profit or loss is recognized immediately.[106] Where the sale price is below fair value, any profit or loss is again recognized immediately but if the loss is offset by future lease payments at less than the market rate, it is deferred and amortized in proportion to the lease payments over the lease period. If the sale price is above fair value, the surplus is deferred and amortized over the lease period.[107]

(ii) Taxation of Sale and Leaseback.

A sale and leaseback transaction is recognized by the Indian tax authorities as long as it is genuine and not a dubious or colorful device or subterfuge aimed at tax evasion.[108] To ascertain the genuineness of the transaction, the intention of the parties, as manifested in the relevant documents and the surrounding circumstances is considered. The purchaser of the asset must be shown to have undertaken the risks and rights attached to ownership. In a decision by the Supreme Court, the full rights of an owner, as recognised by law, were held to be: "(a) power of enjoyment (b) possession, which includes the right to exclude others (c) power to alienate *inter*

102See Bunker, *supra* note 45 at 244-245.

103See Peter Morrell, *Airline Finance*, 2nd ed., (Aldershot: Ashgate Publishing Ltd., 2002) at 208.

104See Hollow*ay*, *supra* note 46 at 154.

105*AS 19*, *supra* note 73, ss. 48 and 49.

106*AS 19*, *supra* note 73, s. 51.

107*AS 19*, *supra* note 73, s. 50.

108*Circular No. 2*, *supra* note 98. See *ICICI Ltd. supra* note 94, for a detailed discussion on sale and leaseback transactions.

vivos or to charge security, and (d) power to leave the asset by will."[109] In case of a *bona fide* transaction, the depreciation allowance will be calculated on the basis of the written down value[110] of the asset at the time of the sale.[111] If it is held to be a mere financing arrangement masquerading as a sale and leaseback, there will be no depreciation available and the lease rentals will be taxed as interest payments.[112]

4. Other Types of Leases

In addition to the leases described above, for regulatory purposes there are also the following three categories of aircraft leases:

(i) Wet Lease

In a wet lease (also called ACMI which stands for aircraft, crew, maintenance and insurance), in addition to the aircraft, the lessor provides the cockpit crew, the cabin crew, maintenance and insurance for the aircraft. In one of the CARs issued by the DGCA, wet lease is defined as "the lease of an aircraft with flight crew provided".[113] It is similar to an aircraft charter except that both the lessee and lessor are airlines and the aircraft is operated under the lessee's flight designator code and route authorization.[114] Throughout the lease term, the aircraft remains registered with the aviation authority of the State of the lessor and the crew members remain the employees of the lessor. Wet lease is usually for a short term and is used to deal with unforeseen situations that result in a sudden shortage of aircraft. The guidelines given by DGCA specify that import of aircraft on a short term wet lease basis will not be permitted except in emergency situations and in the circumstances mentioned below:

109*Commissioner of Income Tax, Bombay etc. v M/s. Poddar Cement Pvt. Ltd. etc.* [1997] AIR 2523 (SC).

110 Written down value means:

in case of asset acquired in the previous year, the actual cost to the assessee;

in case of assets acquired in the previous year, the actual cost to the assessee less all the depreciation actually allowed to him under this Act…

See *The Income Tax Act, 1961* (India), 1961, c. IV, s. 43(6) [*Income Tax Act*].

111*Ibid*, c. IV, s. 43(1), explanation 4A .

112 See *ICICI Ltd.*, *supra* note 94.

113*Airworthiness and Operational Control of Foreign Aircraft Leased by Indian Operators* (India), DGCA, CAR, Section 3- Air Transport, Series 'C', Part I (30 November 1993) at para 3(b), online: DGCA< http://www.dgca.nic.in/rules/car-ind.htm> [*CAR – Foreign Aircraft*].

114See Bunker, *supra* note 45 at 22.

(a) The aircraft is grounded for maintenance, inspection, checks or any unforeseen reasons. Here, wet leasing is permitted only for the period during which the aircraft is grounded.

(b) The aircraft is wet leased to replace an aircraft involved in an accident or incident.

(c) There is depletion of deployment capacity of the operator because of the termination of a lease and delay in execution of a new lease agreement or purchase of aircraft.

(d) To facilitate revival of sick carriers, an initial wet lease of not more than six months which automatically converts into a dry lease for the remaining lease term, is permitted.

(e) In case of emergencies like natural disasters, industrial unrest or any other similar situation. [115]

The guidelines further stipulate that:

(1) The age of the aircraft should not be more than 15 years;

(2) The aircraft should have been type certified by the Federal Aviation Administration of USA ("FAA") or the Joint Airworthiness Authority of Europe or the Civil Aviation Authority of UK or any other authority acceptable to the DGCA. The DGCA may impose additional airworthiness requirements considered necessary for safe operation of the aircraft in India.

(3) The lessor should have a valid operating permit covering the category of operations of the aircraft in India. This means that the lessor can only be an airline that either owns the aircraft or has the authority from the aircraft owner to wet lease the aircraft, or is a charterer.

(4) The maintenance personnel must comply with the maintenance program of the Indian operator and the flight crew should follow the operations manual of the Indian operator, if that type of aircraft is operated in India.

(5) The foreign crew and maintenance personnel would need a security clearance and validation or approval of their licenses by DGCA.[116]

(6) The aircraft shall be subject to the control of the DGCA with regard to operation, maintenance and safety. In this respect, the lessee is required to provide the following:

115*Guidelines for Import of Aircraft on Short Term on a Wet Lease Basis* (India), DGCA, AIC No. 03/1998 (7 August 1998), online: DGCA< http://www.dgca.nic.in/rules/aero-ind.htm> [*AIC No. 03/1998*].

116*CAR – Foreign Aircraft, supra* note 113.

- A copy of the lease that includes an unambiguous agreement between the lessor and the lessee to the effect that the Indian operator and the DGCA shall have the right to exercise airworthiness and operational control on the wet leased aircraft and its operations;
- A letter from the aviation authority of the State of registry of the aircraft, whereby the aviation authority agrees to the overseeing of the aircraft operations and maintenance by DGCA; and
- An undertaking from the lessor stating that it will comply with all the applicable requirements.[117]

India has ratified Article 83bis of the Chicago Convention[118] which provides for transfer of all or a part of the functions and duties of the State of registry of the aircraft, in connection with Articles 12, 30, 31 and 32(a) of the Chicago Convention, which respectively address rules of air, radio licensing, certificates of airworthiness and personnel licenses, to the State in which the aircraft will be operated pursuant to lease, charter or interchange of aircraft or any other similar arrangement, by an agreement between the two States. Accordingly, the guidelines issued by the DGCA, require the aviation authority of the State of registry of the aircraft proposed to be imported on a wet lease by an Indian operator to enter into an agreement with the DGCA. The particular aircraft is required to be identified in this agreement as also the exact duties and functions which are being transferred.[119] Implementation of Article 83bis may be made through administrative arrangements or agreements between civil aviation authorities, usually at the level of the Director General of Civil Aviation or the more formal, bilateral agreements. All such agreements or arrangements are required to be registered with ICAO so that the other States can be notified of such transfer and recognize it accordingly. It is to be noted that although Article 83bis refers generally to 'leases' which would include wet leases, ICAO's guidance circular on implementation of Article 83bis recognizes that the application of Article 83bis to wet leases is rare as it becomes quite complicated for the State of lessee to implement Annex 6 to the Chicago Convention, which deals with operation of aircraft.[120] Moreover, the transfer of duties and

117 *AIC No. 03/1998*, *supra* note 115.

118*Convention on International Civil Aviation*, 7 December 1944, ICAO Doc. 7300/9, (entered into force on 4 April 1947), [*Chicago Convention*]

119*CAR – Foreign Aircraft*, *supra* note 113 at para 6.2.

120 *Guidance on the Implementation of Article 83 bis of the Convention on International Civil Aviation*, ICAO, Cir 295 LE/2, (2003), c.3, s. 3.4.

functions will work well only where there is uniformity in the set of rules of the two States and any discrepancy thereof is likely to cause more mischief and endanger security. Although there have been many instances of wet leases in India, so far, no agreement has been registered pursuant to Article 83bis.

(ii) Damp Lease

A damp lease is the lease of an aircraft with the flight crew but without the cabin crew. The rules mentioned above would also apply to damp leases.

(iii) Dry Lease

The lease of an aircraft without the crew is referred to as a dry lease. Under the DGCA regulations, the aircraft given on a dry lease by a foreign lessor to an Indian operator is required to be registered in India and must comply with the airworthiness certification, maintenance and inspection procedures stipulated by the DGCA, like any other aircraft registered in India. The registration will be valid for the duration of the lease. The Indian operator is required to exercise complete airworthiness and operational control over the aircraft and is responsible for complying with all the applicable regulations issued by the DGCA. If the Indian lessee dry leases an aircraft type which is not currently in operation in India, the lessee would need to provide for the training of at least two DGCA personnel by the aircraft manufacturer or any other approved agency, so that the DGCA is able to regulate the airworthiness and operations of the new type of aircraft.[121] For a description of the procedure to be followed to obtain a type certificate or revalidation thereof, please see chapter three of this paper.

As mentioned elsewhere in this paper, the guidelines on foreign equity participation permit Indian operators to take aircraft on a dry and wet lease basis from foreign airlines but any agreement which give the foreign airline the right to interfere in the management of the domestic operator is prohibited.[122]

121*CAR – Foreign Aircraft, supra* note 113 at paras 5.1-5.4 and 5.20.

122*Guidelines for Foreign Direct Investment in the Civil Aviation Sector*, (India), DGCA, AIC No. 7/2008 (30 June 2008) at para 1.6 read with para 1.8. [*AIC-FDI*].

B. Legal Aspects of Leases and Hire Purchase Agreements in India

Leases of movable property and hire purchase agreements are governed by the Indian Contract Act, 1872[123] and by the case law on the subject. From 1 July 2008, the Cape Town Convention will be applicable in respect of aircraft leases but certain aspects of leases will continue to be governed by the national law, as discussed below.

Under the Contract Act, like any other agreement, for a valid lease to come into existence there must be an offer and acceptance along with consideration. The following basic requirements for a contract must also be fulfilled:

(a) parties must be competent to contract[124];

(b) the contract must be based on free consent of the parties i.e. not tainted by coercion, undue influence, fraud, misrepresentation[125] or a mistake as to a matter of fact, essential to the agreement, made by both parties.[126] A contract is not void if a mistake of fact was made by one party.[127] Furthermore, a contract is not voidable, if there is any mistake as to any law in force in India but a mistake regarding foreign law would make it void[128];

(c) the contract must be for a lawful consideration; The consideration or object of an agreement is unlawful if: "it is forbidden by law; is of such a nature that if permitted, it would defeat the provisions of any law, or is fraudulent; involves or implies injury to the person or property of another; or the court regards it as immoral or opposed to public policy."[129]

(d) the contract should not be expressly declared to be void by the Contract Act.[130]

(1) Bailment.

A lease of movable property is considered to be a contract of bailment. A bailment is defined in the Contract Act as "the delivery of goods by one person [called bailor] to another [called bailee]

123*The* Indian *Contract Act*, 1872, (India), 1872, [*Contract Act*]

124"Every person is competent to contract who is of the age of majority according to the law to which he is subject, and who is of sound mind and is not disqualified from contracting by any law to which he is subject" – *Ibid*, c II, s 11.

125*Contract Act*, *supra* note 123, c. II, s. 10 read with s. 14.

126 *Contract Act*, *supra* note 123, c. II, s. 20.

127 *Contract Act*, *supra* note 123, c. II, s. 22.

128 *Contract Act*, *supra* note 123, c. II, s. 21.

129 *Contract Act*, *supra* note 123, c. II, s. 23.

130*Contract Act*, *supra* note 123, c. II, s. 10.

for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them."[131] The law of bailment is contained in sections 148 to 171 of the Act, which *inter alia*, cover:

- Mode of delivery of goods to the bailee – delivery may be actual or constructive.[132] The latter would be relevant in a sale and leaseback;
- Bailor's duties, responsibilities and rights – the bailor is required to divulge to the bailee any defects in the goods known to him, which significantly affect their proper usage, or may cause harm to the bailee. In the absence of such disclosure, the bailor is liable for all direct damages ensuing from such defects. In case of hire of such goods, the bailor is liable for the damages even if he was not aware of the defect.[133] The absolute liability of bailor imputed here is obviously of some concern. In Indian jurisprudence, the bailor's liability has been linked to an implied warranty of the chattel for a specific purpose, where the hirer i.e. the bailee is relying on the skill and judgment of the bailor. In the absence of such reliance, the question of the implied warranty would not arise.[134] The bailor is responsible for any loss suffered by the bailee caused by the defect in title or agency of the bailor.[135] Where any actions of the bailee are in violation of the conditions of bailment, the bailor has the right to terminate the contract.[136]
- Bailee's duties, responsibilities and rights – the Contract Act imposes upon the bailee a duty to take care of the bailed goods in the same manner as a man of ordinary prudence would take care of his own goods, in comparable circumstances.[137] If the bailee has taken such care, he is not liable for the loss, destruction or the deterioration of the goods, unless there is a contract to the contrary.[138] If the bailee makes any unauthorized use of the goods, he is required to compensate the bailor for any damage arising therefrom.[139] The

131*Contract Act*, *supra* note 123, c. IX, s. 148.

132*Contract Act*, *supra* note 123, c. IX, s. 149.

133 *Contract Act*, *supra* note 123, c. IX, s. 150.

134See *Raman Ezhuthassan v V. Devassi* [1958] AIR 380 (Ker).

135 *Contract Act*, *supra* note 123, c. IX, s. 164.

136*Contract Act*, *supra* note 123, c. IX, s. 153.

137*Contract Act*, *supra* note 123, c. IX, s. 151.

138*Contract Act*, *supra* note 123, c. IX, s. 152.

139*Contract Act*, *supra* note 123, c. IX, s. 154.

bailee is bound not to mix bailor's goods with his own and if he does so without the bailor's consent, he is liable to bear the expenses of separation, to compensate the bailor for any damage arising therefrom and where separation is not possible to compensate the bailor for loss of goods.[140] The bailee is required to return or redeliver the goods according to the instructions of the bailor, without demand, once the period of bailment has ended.[141] If he does not do so, he becomes liable for any loss, destruction or deterioration of the goods after that time.[142] If the bailee has expended labour and skill in respect of the goods, in accordance with the purpose of bailment, he has, in the absence of a contract to the contrary, a lien on such goods until he receives due remuneration for his services.[143]

The parties to a contract are also under a general duty to perform their respective obligations, unless any applicable law exempts such performance.[144] In addition to the above, the following would be applicable under the common law:

(i) The lessee is bound to pay the sums required to be paid under the agreement and in the manner specified therein.

(ii) The lessee is under a duty to protect the lessor's title by informing the lessor as soon as reasonably practicable of any adverse claim on the leased goods.

(iii) In the absence of an express provision, there may be a right to sublease by the lessee, if such intention is inferred from the surrounding circumstances. [145]

(2) Registration.

Under the Indian law, there is no mandatory requirement to register a lease agreement pertaining to a movable property. As mentioned elsewhere in this paper, a copy of the aircraft lease is required to be submitted to the DGCA. For registration of international interest arising out of a lease under the Cape Town Convention, please see chapter six of this paper.

140*Contract Act*, *supra* note 123, c. IX, ss. 156-157.

141*Contract Act*, *supra* note 123, c. IX, s. 160.

142 *Contract Act*, *supra* note 123, c. IX, s. 161.

143*Contract Act*, *supra* note 123, c. IX, s. 170.

144*Contract Act*, *supra* note 123, c. IV, s. 37.

145See Vinod Kothari, *Lease Financing and Hire Purchase*, (Nagpur: Wadhwa and Company, 1986) at p.176 -177 [Kothari].

II. Aircraft Sale

Like any other sale, aircraft sale and purchase in India, is governed by the Sale of Goods Act, 1930. Some of its salient provisions are described below.

A. Contract of Sale.

A contract of sale must fulfill all the requirements of a valid contract which have been discussed above. The subject matter of the contract can be: existing or future goods, or goods which the seller may acquire only upon the happening of a specific event. In case of future goods, the contract is considered to be an agreement to sell.[146] The parties have freedom to contract. The parties can modify the effect of any rights, duties or liabilities arising by implication of law through specific provisions in the contract or by the manner of their dealing.[147]

B. Conditional Sale.

It is a contract where the transfer of the property in the goods takes place, subject to performance of some conditions. Such type of a contract operates as an agreement to sell and becomes a sale only when the conditions are satisfied.[148] A condition is defined as "a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated**.**"[149] The seller may retain the right to dispose the goods until the specified conditions are satisfied**.** Here, even though the goods may have been delivered to the buyer, the title transfer does not take place until the conditions are fulfilled.[150]

For a definition of contract of sale and conditional sale i.e. title reservation agreement provided by the Cape Town Convention, please see chapter six of this paper.

146*The Sale of Good Act*, 1930, (India), 1930, c. II, s. 6 [*Sale Act*].

147*Ibid*, c. VII, s. 62.

148*Sale Act*, *supra* note 146, c. II, ss. 4(3) and 4(4).

149*Sale Act*, *supra* note 146, c. II, s. 12(2).

150 *Sale Act*, *supra* note 146, c. III, s. 25(1).

C. Implied Conditions and Warranties.

A warranty is defined as "a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim of damages but not the right to reject the goods and to treat the contract as repudiated."[151] The characterization of a stipulation as a warranty or a condition depends on the intention of the parties to the contract as manifested by the terms of the contract and not on its wordings.[152] Unless there are provisions to the contrary or the circumstances show otherwise, a contract of sale may have the following:

(i) An implied condition that the seller has the right to sell the goods or will have the right to sell at the specified time in case of an agreement to sell;
(ii) An implied warranty that the buyer will have the right to quiet possession;
(iii) An implied warranty that the goods are free from any charge or encumbrance of which the buyer is unaware;
(iv) The goods shall tally to their description.[153]

There is no implied warranty as to the quality of the goods or their fitness for a particular purpose, except in the following cases:

(i) Where the seller is informed by the buyer of the specific purpose for which the goods are being purchased, with the intention that buyer will rely on the seller's skill or judgment, and if the seller's business involves furnishing goods of that description; there is an implied condition that the goods shall be reasonably fit for that purpose.
(ii) There is an implied condition regarding the merchantable quality of the goods when the goods are purchased by description from a seller who deals in such goods. However, if the buyer has examined the goods, there will be no implied condition in respect of defects which such examination should have exposed**.**
(iii) There may be an implied warranty or condition regarding the quality or fitness for a specific purpose if there is such a trade usage**.** [154]

Otherwise, the doctrine of *caveat emptor*, which enjoins a buyer to satisfy himself of the quality and fitness of the goods before purchase or bear the consequences, is applicable.[155]

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151 *Sale Act*, *supra* note 146, c. II, s. 12(3).

152*Sale Act*, *supra* note 146, c. II, s. 12(4).

153*Sale Act*, *supra* note 146, c. II, s. 14-15.

154*Sale Act*, *supra* note 146, c. II, s. 16.

If the buyer opts to do so, a breach of condition can be treated as a breach of warranty but if the contract is not severable and the goods have been accepted by the buyer, the seller's breach of a condition becomes a breach of warranty and cannot be used by the buyer as a ground to reject the goods and repudiate the contract, unless there is an express or implied provision to the contrary.[156]

D. Risk in Property.

Until the transfer of property takes place, the seller retains the risk in property, unless there is a contract to the contrary, but after such transfer, the risk also passes to the buyer, whether or not delivery has occurred. However, in case of a delay in the delivery caused by the fault of either the buyer or the seller, the party at fault bears the risk in respect of any loss occurring due to such fault.[157]

E. Transfer of Property

The time at which the property in the goods passes to the buyer depends upon the intention of the parties, as ascertained by the terms of the contract, the conduct of the parties and the circumstances of the case.[158]

F. Delivery and Acceptance.

The parties can agree as to which act will constitute delivery, or, any actions of the parties which results in goods being placed in the possession of the buyer or an agent of the buyer can amount to delivery.[159] The goods are deemed to have been accepted by the buyer when he so informs the seller, or when, after the delivery, he does any act that contradicts the position of the seller as the owner, or when, after a reasonable time has passed, he fails to inform the seller that he has rejected the goods, while continuing to retain possession of the same.[160]

155See D. C. Singhania, *Foreign Collaborations and Investments in India*, (Delhi: Universal Law Publishing Ltd., 1999) at 172.

156*Sale Act*, *supra* note 146, c. II, s. 13(1) and (2).

157*Sale Act*, *supra* note 146, c. III, s. 26.

158Sale Act, *supra* note 146, c. III, s. 19. Also see ss. 20-24.

159 *Sale Act*, *supra* note 146, c. IV, s. 33.

160*Sale Act*, *supra* note 146, c. IV, s. 42.

As mentioned in the introduction to this chapter, the most widely used method of aircraft acquisition in India is leasing, out of which operating lease is the most popular. An example of an airline which has extensively used operating leases is Deccan. In March 2006, out of its fleet of 29 aircraft, 26 were acquired on operating lease basis. Furthermore, out of its orders for 96 aircraft (67 A320s and 29 ATRs), scheduled to be delivered by December 2012, 11 are to be taken on operating lease, 4 on hire purchase and the rest have yet to be decided. In its prospectus for initial public offering of shares, the airline stated that it had predominately used operating leases to acquire aircraft, as "leasing aircraft provides several benefits including the following:

- lease payments are tax deductible;
- leasing requires a smaller initial capital expenditure than other methods of acquiring an aircraft, and the smaller capital expenditure is reflected in [the airline's] balance sheet; and
- leasing reduces [the carrier's] exposure to the uncertainty of an aircraft's residual value at the time of its disposal (although leasing also eliminates any residual-value benefit on disposal when the market for second-hand aircraft is strong)." [161]

The factors that influence Deccan's future choice of mode of aircraft acquisition "depend on the status of a number of financial and other factors at the various times various of these aircraft are acquired, including such factors as [its] overall level of borrowings, [its] cash flow needs, prevailing conditions in the leasing market, the demand for the type of aircraft being acquired, tax considerations and prevailing interest rates.[162]

Hire purchase transactions are more prevalent than finance leases. In September 2004, out of a fleet of 42 aircraft, Jet Airways had 23 on hire purchase, one on finance lease and 18 on operating lease. In March 2006, Deccan had three aircraft on hire purchase basis. The benefits of hire purchase according to Deccan are:

- "from the time of delivery of an aircraft pursuant to a hire purchase agreement, [it is] able to recognise the value of the aircraft as an asset on [its] balance sheet, and [it is] able to take tax and balance sheet depreciation in respect of such aircraft;

161Prospectus for Public Issue of Shares, Deccan Aviation Ltd. (31 May 2006) at 58, online: Deccan <http://airdeccan.net/airdeccan/investor/pdf/Deccan_Prospectus.pdf> [Deccan Prospectus].

162*Ibid* at 61.

- the portions of the regular payments under hire purchase arrangements that are attributable to interest are tax deductible; and
- [it] retains the option to acquire outright ownership of the aircraft upon a balloon repayment at the end of the term, which helps [it] to evaluate the benefits of outright ownership or disposal within the appropriate economic context."[163]

Generally, the lease term for operating leases in India ranges from 4 to 7 years, whereas for hire purchase agreements, it is normally 10 years. Outright purchase is increasingly being used by airlines. Although up till May 2006, Deccan had not used this option, it plans to use it in future to take advantages of the benefit of using this method, which are:

- "from the time of delivery of an aircraft acquired outright, [it is] able to recognise the value of the aircraft as an asset on [its] balance sheet, and [it is] able to take tax and balance sheet depreciation in respect of such aircraft;
- where the aircraft has been acquired through finance arrangements, interest payments are tax deductible; and
- pride of ownership, which ….aids employee morale and adds to [its] credibility with customers."[164]

Sale and leaseback has been used by almost all airlines in India, at one time or the other. To give examples of its popularity, in August 2006, SpiceJet finalized a sale and leaseback agreement with Babcock and Brown Aircraft Management for 16 new B737-800s and B737-900s, in addition to the four B737 800 for which a similar arrangement was made earlier in the year.[165]In 2005-2006 Jet Airways concluded sale and leaseback for five B737s and intends to do the same for some of the 30 aircraft it is planning to purchase in the coming years.[166]

III. Permissions and Approvals Required for Acquisition of Aircraft

(i) Permission is required from the Ministry of Civil Aviation for acquisition of an aircraft (please see chapter three for details);

163Deccan Prospectus, *supra* note 161 at 59.

164Deccan Prospectus, *supra* note 161 at 60.

165See "SpiceJet to sell and lease back aircraft", *The Tribune* (14 August 2006) online: The Tribune <www.tribuneindia.com/2006/20060815/biz.htm#6>.

166See "Jet finalises sale of 5 Boeing aircraft", *Business Line* (18 April 2006) online: Business Line http://www.thehindubusinessline.com/2006/04/19/stories/2006041903420900.htm.>

(ii) Permission is needed from the RBI for making advance payments, obtaining foreign currency loans, issuing guarantees etc., for purchase of an aircraft or its acquisition on a finance lease basis. The RBI guidelines prescribe that the application for this purpose should be accompanied by a certified copy of a letter of approval from the Ministry permitting the acquisition of the aircraft; certified copies of the contract and other supporting documents. Where a foreign credit facility will be utilized for the purchase of an aircraft, a certified copy of the credit agreement should also be provided, and it should be specified if the loan will be repaid using the operator's surplus passage, freight collections or earnings which have been retained abroad or through payments made from India. Once approval is granted, the authorized dealer will be permitted to issue bank guarantees and to remit money for interest and loan repayment etc.[167]

167*Purchase of ships/aircraft*, Reserve Bank of India, Exchange Control Manual, (3 June 2005), c. 8, part B, s. 16, online: RBI <http://www.rbi.org.in/scripts/ECMUserParaDetail.aspx?Id=568&CatID=14>

Chapter Two

Sources of Finance and Financing Methods

Once an airline has made the decision to expand its operations or its fleet, the next question that needs to be addressed is how to finance the expansion and how the financing would be structured. Despite the cyclicality of the commercial air transport industry and the poor profit figures, there has never been a shortage of investors that are attracted by its high profile. In their more traditional roles as flag carriers, the airlines have received a fair share of subsidies from the State Governments. A robust support system is also provided by the manufacturers and export credit agencies of the manufacturer's States for those airlines which may have difficulty tapping the more conventional sources of inexpensive financing.

The expansion or the acquisition of aircraft could be funded internally i.e. by using the retained earnings of the airline or the cash generated from sale of existing assets, or externally, i.e. by raising cash through debt or equity, or a combination thereof. Since the former does not require much explanation, this chapter largely concentrates on debt and equity financing.

Debt financing refers to obtaining money through borrowing, whereby the airline enters into a debtor-creditor relationship with a lender or a group of lenders. Equity financing refers to financing through issue of shares. Each of these two modes of financing carries its own costs and risks. The idea is to reduce as much as possible the long-term cost of capital, while keeping financing risk at a tolerable level. This could be achieved by the right mix of debt and equity but there is no easy formula to come up with such a blend.[168] While developing a financial policy, an airline needs to keep in mind the following risks:

(i) risk of uncertain future financial market conditions;

(ii) risk of change in floating interest rates in case of a loan;

(iii) risk of devaluation of the currency in which the airline operates;

(iv) risk of reduction in the value of aircraft owned by the airline – this is relevant where the airline has fleet replacement plans which involve selling or leasing of older aircraft. [169]

168See Van DuBose, "Sources of Finance" in Andrew Littlejohns & Stephen McGairl, eds., *Aircraft Financing* (London: Euromoney Publications, 1998) at 11 [*Aircraft Financing*]

169See *Ibid* at 12.

The financial strategy of an airline depends to a large extent on its access to a sophisticated securities market. India has a robust and a vibrant securities market with 23 stock exchanges which list equities, debt securities and derivatives[170.] The main stock exchanges are the Stock Exchange, Mumbai ("BSE") and the National Stock Exchange ("NSE"). The market is mainly regulated by the Securities and Exchange Board of India ("SEBI") but the Ministry of Company Affairs, the Department of Economic Affairs of the Ministry of Finance and RBI also regulate some aspects of it. There are no restrictions on the number of recognized stock exchanges on which a company can list its securities if it meets their listing criteria.

The main features of debt and equity financing that are relevant from the perspective of the airline industry and their implications under Indian law are described below.

I. Debt Financing

From the airline's view point, debt financing is considered to be inherently riskier than equity financing because it imposes an obligation on the airline to repay the principal and the interest on the loan within a certain time limit and if this is not done, it may lead to default and even winding up of the airline. On the other hand, it may be preferable as it does not cause any reduction in the individual shareholding of the airline and the possible loss of control resulting therefrom. Another advantage of debt financing could be the availability of tax reductions since interest, unlike dividends, is paid out of the before tax income.[171] In the event of bankruptcy of the airline, lenders take priority over the shareholders in apportionment of the assets and are therefore in a better position to recoup their investment. From the financier's perspective, the creditworthiness of the airline and in case of cross border lending, the credit rating of the State of domicile of the airline, its laws and the laws of the country where the aircraft will be registered, if different from the former, play a crucial role in determining the terms on which financing would be made available.

A. Classification of Debt

On the basis of the time given for repayment, debt could be classified as short term i.e. extending for a period of one year or so, medium term i.e. between one to five years, or long

170A derivative is an instrument whose value is dependent on or derived from an underlying asset, security or market index. Examples of derivatives are future contracts, forward contracts, swaps, options etc.

171See Hollow*ay*, *supra* note 46 at 98.

term i.e. beyond five years. An example of short term borrowing used in aircraft financing is bridge loans which are typically used to make pre-delivery payments ("PDP"). Medium and long term borrowing come in a number of guises, the prominent amongst which are term loans represented by bonds, debentures, notes etc. Considering the economic life of an aircraft, long term debt would be more relevant for aircraft acquisitions but short term or medium term debt could be used to meet the operational requirements of the airline in addition to PDP financing.

In view of the interest charged, debt could be classified as fixed rate debt, where the rate of interest is fixed at the beginning and does not change during the term of the loan, or floating rate debt, which means that a benchmark rate like the London Interbank Offered Rate ("LIBOR")[172] is used as a base rate and in addition, a margin is charged by the lender. The airlines may have the option to choose which type of interest rate would be charged. However, lending institutions normally reserve the right to require the borrower to use fixed interest rates if floating rates were to become uneconomical and thus affect the approved credit.

B. Sources of Debt

For the sake of convenience, debt is discussed under the following broad headings:

1. Loans from Financial Institutions.

Traditionally, banks have been a major source of financing for airlines. An airline could make arrangements with a bank to access different types of loan facilities or a combination thereof. Some of these are described below:

(i) Bridge loan – It is an interim loan arrangement made to give the borrower time to look for more permanent financing.

(ii) Umbrella/standby facility - This facility is particularly useful for airlines which have ambitious fleet expansion programmes that stretch over several years. It is a basic framework agreement that sets out the term and conditions for financing of a number of aircraft over a period of time. Normally, not all of the aircraft deliveries are

172"LIBOR is a rate of interest at which a bank offers to place deposits with another bank in a specified amount of a specified currency on a specified date, for a specified period, in the London Interbank Market." See Sue Wright, *International Loan Documentation*, (Basingstoke [England]; New York: Palgrave Macmillan, 2006) at 14 [Wright].

covered by the facility so that the airline has the option to choose which ones it wants to finance using the facility, and has the freedom to find more favorable financing opportunities for others[173.] An airline is normally required to pay a commitment fee to the financier for such standby facility.

(iii) Term loan – as the name suggests, it is a loan which is paid back by the borrower in installments over the course of a specific period of time.

(iv) Syndicated loan – it is a loan given by several lenders under a single credit agreement. The lenders' rights against the borrower are dependent upon the sum that each has contributed.[174.]

(v) Non recourse or limited recourse debt - In this kind of financing, the lenders can only look to a particular stream of income and/or asset for repayment. This could be arranged contractually i.e. under the credit facility, or structurally, by establishing a special purpose company that borrows the funds and owns the asset on which the lenders will have a security interest.[175] Examples of this type include leveraged leases (please see chapter one of this paper for a discussion on leveraged leases).

Under the Indian Companies Act, the board of directors of a company is empowered to borrow money on behalf of the company, subsequent to passing of a suitable resolution at a duly convened board meeting.[176] In case of a public company or a subsidiary thereof, there is a restriction on its board on borrowing money, which when combined with the existing debt of the company, is more than the company's paid up capital and free reserves, except with the consent of the shareholders obtained at a general meeting.[177] If the borrowing by the directors is *ultra vires* their powers, the directors may be personally liable for damages to the lender on the ground of an implied warranty given by them, to the effect that the company had the power to borrow.[178]

173See Stephan Sayre and Stephan Gee, "Commercial Bank Lending", *Aircraft Financing*, *supra* note 168 at 36.

174See Wright, *supra* note 172 at 7.

175See Wright, *supra* note 172 at 5.

176*The Companies Act, 1956*, (India), 1956, part VI, c. II, s. 292(c), [*Companies Act*].

177*Ibid*, part VI, c. II, s. 293(1)(d).

178See *Firbank's Executors v Humphreys* (1886) 18 QBD 54.

The company would be liable to pay back the amount borrowed by the directors[179] if the lender loaned the amount in good faith and without knowing that the company's limit to incur debt has been compromised[180] and it was not clear from a perusal of the company's articles or memorandum of association, how much the directors were authorized to borrow. However, if the borrowing is *ultra vires* a company's articles or exceeds the amount mentioned therein, the lender cannot file a suit against the company for repayment as common law prescribes that a debt has not been incurred[181] and any security which may have been given is also void. Nonetheless, a lender may have the following remedies under equity:

- injunction and recovery under the doctrine of restitution, if the money can be traced or if it can be proved that the company benefited from the loan;
- subrogation – if the money has been used to repay an existing debt of the company, the lender can step into the shoes of a creditor of the company;
- suit against directors for implied breach of warranty.

2. Export Credit Agencies (ECAs).

Since purchase of aircraft from the manufacturers also entails export of the aircraft in most cases, the Governments of the manufacturers' States have set up export credit agencies, which offer attractive financing alternative to airlines. The main ECAs are: EXIM Bank of US, ECGD of UK, COFACE of France and Euler Hermes of Germany. The institutional framework for the ECAs is provided by the Arrangement on Guidelines for Officially Supported Export Credits (called the Consensus) and in particular by the Sector Understanding on Export Credit for Civil Aircraft given at Annexure III thereto ("ASU")[182,] which is a "gentlemen's agreement" between the participants. The maximum amount of financing offered by the ECAs is 85% of the net price of the aircraft[183], with the maximum period for repayment set at 15 years.[184] The fixed rate of interest is provided by the commercial interest reference rate which depends on the

179See *T. R. Pratt (Bom) Ltd v E. D. Sasoon & Co Ltd.* [1936] AIR 62 (Bom) (Kania J. stated that if the borrowed money is "used for the benefit of the principal either for paying its debts, or for its legitimate business, I think the company cannot repudiate its liability on the ground that the agent had no authority from the company to borrow." at para 7).

180*Companies Act*, *supra* note 176, part VI, c. II, s. 293(5).

181See *Sinclain v Brouguham* (1914) 88 LJ Ch 465.

182 TAD/PG(2007)28/Final (27 December 2007), online: OECD < http://www.olis.oecd.org/olis/2007doc.nsf/LinkTo/NT00005A06/$FILE/JT03238355.PDF>.

183 ASU, *ibid*, Article 11.

184 ASU, *supra* note 182, Article 13.

category of the aircraft and is linked to the Government bond yield in the currency of the loan, while the floating rate of interest is based on LIBOR.[185] A premium is also charged based on the credit risk categorization of the borrower.[186] The ASU offers a Cape Town discount if certain qualifying declarations are made by the Contracting State in which the borrower is located.[187] The financing is usually in the form of guarantee or insurance coverage (called pure cover), although direct loans and interest rate support (called official financing support) are also given in some cases.[188] Generally, a finance lease is used in an ECA financing.[189] Example of use of ECA credit in India are - Air India and Jet Airways, which will receive EXIM financing amounting to USD 6 billion for their aircraft acquisition in the next few years. The current EXIM investment India is USD 3.6 billion and it is expected that in the near future, India will overtake Mexico and become the largest market for EXIM.[190]

3. Debt Securities.

Airlines usually use the following types of debt securities:

(i) Bond – a bond is an obligation of the issuer to pay specific sums to the holder throughout a definite time period. It may be secured by a fixed and/or floating charge on the assets of the issuer. A term that deserves a specific mention here is foreign currency convertible bonds ("FCCBs"), as they are frequently used by Indian companies to raise cash in overseas markets. As the name indicates, FCCBs are a type of bonds issued in a currency other than the issuer's home currency, which give the bondholder an option to convert them into equity. Due to the equity element, the interest payments on these bonds are comparatively low. An example of the use of FCCBs by airlines in India is SpceJet's issue in December 2005 of FCCBs worth USD 80 million. The FCCBs were listed on the

185ASU, *supra* note 182, Appendix IV for Minimum Interest Rates.

186ASU, *supra* note 182, Appendix III for Minimum Premium Rates.

187ASU, *supra* note 182, Appendix I for Qualifying Declarations.

188ASU, *supra* note 182, Article 4(b).

189See Robert Murphy, "Export Credit Agency Support", Aircraft Financing, *supra* note 168 at 53.

190See "US Exim Bank Lines up 8 billion Credit for India", *The Economic Times* (14 May 2008), online: The Economic Times <http://economictimes.indiatimes.com/News/Economy/Finance/US_Exim_Bank_lines_up_8_bn_credit_for_India/rssArticleicleshow/3037778.cms>.

Luxembourg Stock Exchange and the money obtained from this issue was to be used to partially finance the acquisition of 20 B737 800 aircraft.[191]

(ii) Debenture – as most commonly understood, a debenture refers to a long term debt instrument, which is not generally secured by a specific asset. It is the term that is most commonly used in India for a debt security and refers to a document evidencing indebtness of the borrower to the holder, which is normally but not necessarily secured by a charge on the property of the borrower. The definition of debenture under the Indian Companies Act specifies that a "debenture includes debenture stock[192], bonds and any other securities of a company, whether constituting a charge on the asset of the company or not."[193] This definition is an inclusive definition and therefore, the term debenture is quite elastic in character. Since this definition includes the term bond, legally speaking, there is no distinction between a bond and a debenture and the two terms are used interchangeably.

Like the power to incur indebtness, the power to enable the company to issue debentures is also given to the board of directors of a company. When a series of debentures are issued, a trust deed is executed by the company[194], wherein the terms and conditions governing the debentures are given, a mortgage or a charge is created in respect of the company's assets and a trustee is appointed. The trustee's responsibilities include protection of the interests of the debenture holders and effective solutions of their complaints.[195]

(iii) Notes – A note or a promissory note is an instrument, wherein the signor promises to pay a person or the bearer, a specified amount of money, at a certain date. In India, as in UK, promissory notes are subject to statutory regulation. The Negotiable Instruments Act, 1881 governs the making, drawing, acceptance, endorsement, delivery and negotiation of a promissory note, bill of exchange and cheque, and prescribes the penalties for their dishonour.

191See "SpiceJet raises US$80 million via FCCB issue", SpiceJet, (5 December 2005), online: SpiceJet < http://www.spicejet.com/newspage.asp?strNews=FCCB>.

192 It is borrowed capital consolidated into one mass which may be divided into convenient units of fixed amount.

193*Companies Act*, *supra* note 176, part I, s. 2(12).

194*Companies Act*, *supra* note 176, part IV, s. 117A(1).

195*Companies Act*, *supra* note 176, part IV, s. 117B(2).

(iv) Commercial paper – these are short term unsecured notes, usually issued by large, well known companies, which often have a maturity period of one - two months.

4. Aircraft Securitization.

It is one of the most important developments of aviation finance in recent years and is likely to become one of the prominent sources of financing in the future. Securitization is essentially a creation of the US financial markets and has mostly been tried and tested there, although it is now gaining some momentum in Asia and Europe as well. Securitization refers to the process of pooling and packaging of homogenous cash flows or receivables or assets or a combination thereof into tradable securities. In the context of aircraft, this would refer to securitization of either the existing or future cash flows from sale of tickets or cargo receivables or the aircraft fleet or a part thereof. A typical securitization structure involves the setting up of a bankruptcy remote special purpose vehicle ("SPV"), the sale of the asset to the SPV and the issue of the securities by the SPV to the investors. The advantages of securitization include (a) the reduction in administrative costs with the increase in size of the transaction, (b) after appropriate credit enhancement[196], the credit rating of the security may be significantly higher than the corporate rating of the originator i.e. the company which initiates the securitization (c) the asset does not appear on the balance sheet of the originator (d) the risk may be spread over a pool of assets and borrowers that may be located in different geographical regions.

Before delving into the forms of aircraft securitization, it is necessary to take a look at the following structures from which they are derived:

(a) Equipment Trust Certificates ("ETCs") – Here, a trust is created to sell the ETCs, on behalf of an airline, to the investors either through a public issue or a private placement. The ETCs may be secured by a first mortgage on an existing aircraft in the fleet. The proceeds from the sale of ETCs are used by the trustee to purchase one or two aircraft. The funds normally amount to 80% of the purchase price and the remaining 20% is supplied by the airline. The aircraft is then leased to the airline at a rent, which covers the

196Credit enhancement refers to the various methods used to spread out the risks that are inherent to a transaction.

principal and interest payment on the ETC as well as the costs of the issue. Upon the expiry of the lease, the airline acquires title to the aircraft.[197]

(b) Pass Through Certificates ("PTCs") – In a pass through structure, the investors are directly exposed to the risks associated with the securitized asset, although the credit enhancements do provide a shield to any delays in payment to a certain extent. A PTC is essentially a bundle of ETCs, which uses "a pool of aircraft rather than one and creates a more liquid security, containing a single maturity with principal paid via scheduled sinking fund payments, thus reducing the collateral risk over the term of the security".[198] PTCs were used in a transaction by Jet Airways in 2001 to raise INR 1600 crores from domestic investors. The lead arrangers were Standard Chartered Bank along with UTI Bank (now Axis Bank) and the credit enhanced PTCs were acquired by UTI, Life Insurance Corporation (LIC), HDFC (Housing Development Finance Corporation) Bank and Bank of Maharashtra. The PTCs were rated AAA by CRISIL Ltd, which is one of the Indian credit rating agencies registered with SEBI.[199] The money was used by an SPV to purchase ten B737s, which were given on hire purchase to the airline and whose future hire purchase rentals were securitized. US EXIM guaranteed 85% of the purchase price. This was the first ever EXIM backed transaction that raised Rupees. On the basis of the EXIM guarantee, funds in dollars were given on loan by Standard Chartered, which were then deposited with the State Bank of India (SBI) as collateral for the standby letter of credit that was issued as the credit enhancement for PTCs. This structure enabled EXIM and Jet Airways to undertake risks only in their respective currencies i.e. Jet Airways made payment in Rupees thereby evading the dollar risk, while EXIM retained only the dollar risk.[200]

Aircraft securitization takes place in the two forms described below:

(i) Enhanced Equipment Trust Certificates (EETCs) – "An EETC securitization enhances the creditworthiness of traditional equipment trust certificates ("ETCs")

197See Bunker, *supra* note 45 at 395.

198Lehman Brothers, "Aircraft Securitization", *Aircraft Financing*, *supra* note 168 at 73.

199 See footnote 203 for information regarding the credit rating agencies in India.

200See "Crisil rate Jet Airways' Offshore Instrument", *Business Line* (24 February 2001), online: Business Line, <http://www.blonnet.com/2001/02/24/stories/022418c2.htm> and Vinod Kothari, "Indian aviation company uses securitization to raise USD 355 million", online: Vinod Kothari's Securitization Website <http://www.vinodkothari.com/secnews10.htm#jet_airways>.

secured by lease receivables and the leased aircraft as follows: First, the issuer of the EETCs is bankruptcy remote (and insulated from a bankruptcy of the lessee) to the satisfaction of the rating agencies. Second, the EETCs are tranched to take advantage of the expected residual value of the aircraft, i.e., the lower the advance level, the higher the rating. Third, a liquidity facility is provided to ensure the continued payment of interest on the EETCs during the remarketing period following a default by the lessee."[201].

EETCs were popular in US from mid 1990s to 2001 but their popularity has considerably waned now. EETCs outside of US are still rare although European carriers like Air France and Iberia have used them. In the Indian context, hitherto the asset repossession laws did not permit the remedy of self help which may have been the cause of EETCs being unable to gain a foothold in the market. With the coming into force of the Cape Town Convention, this may well change.

(ii) Portfolio securitization - it uses "a diversified portfolio of aircraft given on operating leases to a number of airlines….The actual levels of the ratings depend on a number of factors, including the age, initial value and diversity of the aircraft in the portfolio, the diversity (both individually and geographically) of the lessees of the aircraft and (to a much lesser extent) their credit quality, the initial level of lease rents, assumptions as to the timing and costs of defaults and remarketing and other relevant factors. Credit support in a portfolio securitization is tailored to the particular needs of the aircraft and lessees involved, e.g., coverage for potential Eurocontrol liens, major maintenance costs, compliance with noise regulations and similar factors".[202]

To give a couple of examples, operating lease securitization was used in 2005 by Cerberus Capital to finance its acquisition of Debis Airfinance (now AerCap) and by Aviation Capital Group to purchase Boullioun Aviation Services. Both Debis and Boullioun had aircraft leased to Indian airlines, which were a part of the securitized portfolio of aircraft. The Indian portion of the transactions involved creation and

201William Bowers, "Aircraft Lease Securitization" (January 1, 1999) online: Pillsbury Winthrop Shaw Pitman LLP <http://www.pillsburylaw.com/bv/bvisapi.dll/portal/ep/paPubDetail.do?pub=0000531A&channelId=-8595&tabId=0&pageTypeId=9203> [Bowers].

202*Ibid*.

registration of aircraft mortgages, the sale of the aircraft to the SPVs and novation of the lease agreements.

Securitization in India is of recent origin and was used for the first time in 1991 when Citibank securitized a pool from its auto loan portfolio. Since then a number of deals have taken place in a variety of sectors but the way is still fraught with several legal and regulatory difficulties, the exorbitant rate of stamp duty on transfer of assets which may go as high as 4% to 8% of the asset value, the structure of the SPV and the corresponding impact of the Companies Act or the Trust Act, lack of clarity on the extent to which RBI's directions would apply, etc. Aircraft securitization is even rarer and apart from the issue of PTCs, there have been no other instances of transactions resembling securitization by Indian airlines. With the easy availability of credit, this is not surprising. However, with massive orders being placed by almost all of the airlines, it is only a matter of time before this avenue is fully explored. The start would probably be made with the securitization of ticket and cargo receivables.

C. Issue of Debt Securities

A company must fulfill the following criteria/conditions before being permitted to make a public issue or rights issue of debt instruments:

(i) an investment grade credit rating is provided by at least one registered credit rating agencies (all credit ratings are required to be disclosed)[203];

(ii) the company's name does not appear on RBI's list of defaulters; and

(iii) if the company has issued any debentures, the payments of principal or interest for such debentures by the company is in arrears only for a period of six months or less.[204]

The Government's policy *vis a vis* raising of loans by Indian airlines from foreign sources is substantially liberal. There is however, one exception to this policy which completely prohibits an Indian carrier from entering into a credit facility with foreign airlines or any similar

203There are four credit rating agencies in India, which are registered with SEBI under the SEBI (Credit Rating Agencies) Regulations, 1999. These are: Credit Analysis & Research Ltd (CARE is promoted by banks and financial institutions such as the IDBI bank, Canara bank and State Bank of India), ICRA Ltd. (associated with Moody's), CRISIL Ltd (largest shareholder of CRSIL is Standard and Poor's) and Fitch India, which is a part of Fitch Ratings.

204*SEBI (Disclosure and Investment Protection) Guidelines, 2000*, (30 July 2008) at clause 2.5, online: SEBI < http://www.sebi.gov.in/acts/dipguide2008.pdf>; See also chapter X of the Guidelines for further conditions and procedure related to issue of debt instruments.

arrangement which would give the foreign airline a say in the management of the Indian operator.[205]

II. Equity Financing

The raising of capital through issue of new equity is a cumbersome, lengthy and time consuming process and cannot be undertaken by an airline without much forethought and planning. An airline would normally prefer to take this route when the market conditions are favorable. However, it may become necessary if the airline is unable to raise the requisite amount of capital in the debt market without exceeding the airline's target level of debt/equity ratio or if debt becomes too expensive. The most obvious advantage of equity financing, when compared to debt financing, is that there is no loan to be repaid and no consequential charges on the assets of the airline as in the case of secured lending, or guarantees given by the directors or owners. On the other hand, the airline may have to distribute dividends to the shareholders now and then. Debt instruments normally place certain restrictions on the activities of the borrower like maintaining a certain debt/equity ratio, which is not present in equity financing, although there are requirements to hold shareholders' meetings and to obtain their approval before certain actions can be taken. Like debt securities, share offerings also entail compliance with the securities regulations although issue of shares is usually more complicated. All in all, the advantages and disadvantages of equity versus debt seem to be evenly balanced and the choice of which route to take depends on the individual preference of each airline and market conditions. Technically, it is generally preferable to use debt financing when a company's average net profit rate exceeds its average borrowing rate.

A. Nature and Types of Shares

Two kinds of share capital are permitted to be issued under the Companies Act[206]:

1. Preference Share Capital.

By nature, preference shares are more akin to debt. Preference shares carry a preferential right to: (i) payment of dividend and (ii) repayment of amount of paid up capital upon winding

205*AIC – FDI, supra*, note 122 at paras 1.8 and 1.9.

206*Companies Act*, *supra* note 176, part IV, s. 86.

up or repayment of capital.[207] Holders of preference shares have the right to vote only on such resolutions of the company which concern their rights, such as any resolution in respect of winding up of the company or for the repayment or reduction of the share capital of the company[208].

2. Equity Share Capital.

Equity shares, also called ordinary or common shares, are considered to represent the actual ownership interest in the company. The definition of equity share capital given by the Companies Act covers all share capital apart for preference share.[209] Equity share capital may be with:

(a) voting rights; or

(b) the rights in respect of dividends and voting may be varied as prescribed by Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001.[210]

The dividends are paid to equity shareholders out of the portion of the profits remaining after paying the preference shareholders their fixed dividends. The right of the equity shareholders to vote on all resolutions of the company is prorated to the number of shares held by them.[211.]

B. Issue of Securities

After incorporation, the initial capital of a company is normally obtained by a private issue of shares to its promoters or directors and their friends and relatives. There is no restriction on the number of times this process can be repeated but if a company requires large amounts of capital, eventually it has to approach the public. The Companies Act prohibits a private

207*Companies Act*, *supra* note 176, part IV, s. 85(1).

208*Companies Act*, *supra* note 176, part IV, s. 87(2)(a).

209*Companies Act*, *supra* note 176, part IV, s. 85(2).

210*Companies Act*, *supra* note 176, part IV, s. 86.

211*Companies Act*, *supra* note 176, part IV, s. 87(1)(a) and (b).

company[212] from making a public issue of its securities. [213] To do this, a private company must change its status to a public company[214] by following the prescribed procedure.

An issue of securities entails compliance with the relevant provisions of the Companies Act, the Securities Contracts (Regulation) Act, 1956[215], the Depositories Act, 1996[216], the rules made under these acts, the guidelines, notifications and circulars issued by SEBI and the concerned Government authorities, bye laws and regulations of the stock exchange(s) and the provisions of the listing agreement. Amongst these, the principal are the SEBI (Disclosure and Investment Protection) Guidelines, 2000 ("Guidelines"), as amended from time to time.

The capital can also be raised by making a rights issue or a preferential issue. A rights issue involves an issue of further shares to the existing shareholders equivalent to paid-up capital on the existing shares, following the procedure prescribed by Section 81(1) of the Companies Act. The main advantage of a rights issue is that it does not dilute the stake of the existing shareholders.

A preferential issue, also called private placement, is an issue of shares or of convertible securities by listed companies to a select group of persons under Section 81(1A) of the Companies Act, which provides that a preferential issue requires a special resolution or a majority of the votes and the approval of the Central Government.[217]. A preferential issue is a faster way for a company to raise equity capital, since the procedure is not as complicated as the one for a rights issue or a public issue.

C. Foreign Equity Participation in Airlines

As mentioned elsewhere in this paper, foreign direct investment of up to 49% in general and up to 100% in case of non resident Indians, is allowed in domestic airlines, under the automatic route. Equity participation by foreign airlines is not allowed in any circumstances. The

212*Companies Act*, *supra* note 176, part I, s. 3(1)(iii) for a definition of private company.

213*Companies Act*, *supra* note 176, part I, s. 3(1)(iii)(c).

214*Companies Act*, *supra* note 176, part I, s. 3(1)(iv) for a definition of a public company.

215 The Securities Contracts (Regulation) Act, 1956 specifies that a person whose securities are listed in a recognized stock exchange must comply with the conditions given in the listing agreement with the stock exchange. Additionally, it provides for: the recognition, derecognition, corporatisation and demutualization of stock exchanges in India, listing and delisting of securities, penalties for certain actions and also lists the respective powers of the Central Government, the SEBI and the Stock Exchange.

216The Depository Act, 1996 governs depositories and their holding of securities in dematerialized form on behalf of the owners of the securities.

217*Companies Act*, *supra* note 176, part III, s. 81(3) for when this section does not apply.

foreign direct investment is subject to the guidelines issued in this regard by the DGCA, which provide that:

(i) Any foreign financial institution or other entities, which are looking to make an equity investment in the domestic air transport sector, cannot have foreign airlines as their shareholders, or be a subsidiary of a foreign airline.

(ii) The number of directors from the foreign institution or entity that can sit on the board of the airline, is capped at one third of the total number of directors.

(iii) An applicant for an air operator's permit is required to give detailed information regarding the equity participation of any airline in the foreign institution or entity, if any, and about its board of directors and senior management. The applicant must provide a declaration stating that a foreign airline does not hold a management or ownership interest in it and that it has no financial or commercial tie-up with any foreign airlines. The applicant must also state in the declaration (and repeat it every year) that it meets all the requirements specified in the guidelines and undertake to notify the relevant authority within one month if there in any change in its status.

(iv) A domestic airline is not permitted to enter into agreements such as shareholders agreement or management contracts with a foreign airline that would enable such foreign airline to have effective control of the domestic airline or give it the right to interfere in the management of the airline. Any type of lease financing, hire purchase agreements and credit facility is also prohibited.

(v) Domestic airlines are allowed to dry lease aircraft from foreign airlines. Wet leasing may also be permitted if the guidelines issued by the DGCA in this regard are complied with. Marketing arrangements such as ground handling, general sales agency, code sharing, interlining are permitted, as also maintenance, overhaul, repair work and training of pilots or engineers at the facilities of the foreign airlines.

(vi) Any falsification of the requisite information by the domestic airline may result in suspension or cancellation of its operating permit.[218]

(vii) Companies that operate cargo airlines, helicopters and seaplane services are permitted to have foreign airlines as shareholders.[219]

218 *AIC – FDI*, *supra*, note 122 at paras 1.2. – 1.13.

219 *AIC – FDI*, *supra*, note 122 at para 3.2.

Issue of securities by a company to a foreign investor would be subject to the relevant guidelines issued by SEBI and RBI.

Most of the carriers in India use private placement of shares or international debt financing to meet their needs. The domestic banks have been active in arranging financing for PDPs. A recent example of this is Indian's arrangement made in May 2006 with ICICI bank, which is India's second largest bank, for syndicated external commercial borrowing (i.e. foreign loan) of USD 152 million for PDP for its order of 43 Airbus aircraft.[220] There is also an emerging trend to raise money in the domestic market through public issue of equity. The last few years have witnessed the initial public offerings ("IPOs") of two of the biggest private airlines in India - Jet Airways and Deccan, and many others, including those of the two State carriers, are in the pipeline. The IPO of Jet Airways in February 2005 raised around USD 436 million.[221] The 100% book-built issue was 16.2 times oversubscribed.[222] 17,266,801 equity shares of a face value of INR 10 each, comprising of a fresh issue of 14,245,111 equity shares by Jet Airways and an offer for sale of 3,021,690 equity shares by Tail Winds Limited, were offered through a red herring prospectus. 1,200,000 equity shares were reserved for employees. The offer constituted 20% of the fully diluted post offer paid-up equity capital of Jet Airways.[223] According to the prospectus of Jet Airways, the money was to be used to repay existing debt of the company, redeem cumulative convertible redeemable preference shares issued to International Finance Corporation in February 2001, to meet certain capital expenditures relating to its operations and for general corporate purposes of the company.[224] In comparison, the IPO of Deccan in May 2006 was not so successful. One of the reasons for this was market fluctuation. Just a day prior to the opening of the IPO, the BSE fell by 10.2% which was the steepest in its 250 years history. Despite the issue being oversubscribed by 1.21 times, Deccan raised only USD 79 million although it had hoped for USD 250-350 million[225]. The issue was made through

220See "IA going for syndicated ECB to fund aircraft buy", *Business Line* (8 May 2006), online: Business Line <http://www.thehindubusinessline.com/2006/05/08/stories/2006050802780200.htm>.

221See "Jet Airways picks perfect timing", online: Air finance Journal (1 March 2005) <http://www.proquest.com/> (accessed on 20 December 2007).

222 'Jet Airways IPO price fixed at Rs. 1,100' *Business Line* (28 February 2005), online: Business Line <http://www.thehindubusinessline.com/2005/02/28/stories/2005022802090100.htm>

223"Red Herring Prospectus of Jet Airways (India) Limited" (8 February 2005) at 5, online: SEBI <http://www.sebi.gov.in/dp/jetairfinal.pdf>.

224 *Ibid* at 33.

225 See 'Deccan scrapes through black Monday', online: Air finance Journal (1 June 2006) <http://www.proquest.com/> (accessed on 20 December 2007)

a 100% book building process. 24,546,000 equity shares of a face value of INR 10 each were offered through a red herring prospectus. According to the prospectus, the funds obtained from the issue were to be utilized for setting up of: a training facility for pilots, flight engineers and other personnel at Bangalore, a hanger facility for basic and medium level checks at Chennai, infrastructure at airport, market development initiatives and debt repayment. The largest components of the debt were two aircraft PDP loans from United Bank of India and State Bank of India.[226] The shares of Deccan are now listed on the BSE and NSE.

III. Airline Acquisitions and Mergers

The legal framework for a merger between two Indian companies is provided by the relevant provisions of the Companies Act and the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. In addition, the Ministry of Civil Aviation has recently enunciated the draft policy regarding use of airport infrastructure in case of a merger or takeover of airline and sale or transfer of aircraft. According to this policy, the airlines that acquire an aircraft pursuant to a merger, takeover, sale or transfer need not pay for the use of the airport infrastructure like parking bays, landing slots etc., provided by the airport manager. All other rights would be governed by the provisions of the lease or sale agreement between the airport operator and the airline. The transferee airline will be permitted to use the rights which were actually utilized by the transferor airline, upon the condition that the transferee will continue using such rights. All other rights will revert back to the Government or the airport operator.[227]

226"Prospectus of Deccan Aviation Limited" (31 May 2006), online: Deccan <http://airdeccan.net/airdeccan>.

227*Policy to be followed regarding use of Airport Infrastructure in case of merger/take over of airlines and sale / transfer of aircraft*, [Draft] Ministry of Civil Aviation, online: Ministry of Civil Aviation <http://civilaviation.nic.in/moca/DRAFT%20POLICY%20AIRLINES%20MERGER%20TAKE%20OVER.pdf>.

Chapter Three

Import of Aircraft into India and its Registration

Registration of an aircraft in the Aircraft Register maintained by the civil aviation authority of a State pursuant to the Chicago Convention lies at the heart of aviation law. Registration confers nationality on the aircraft[228] and is a prerequisite for the aircraft to fly.[229] The State where the aircraft is registered is deemed to have jurisdiction over the aircraft and consequently, bears a certain amount of responsibility and accountability for any incidents related to the aircraft.[230] Moreover, the civil aviation authority of that State lays down the guidelines for maintenance of the aircraft and for licensing of its crew and engineers. These considerations affect the asset value risk in an aircraft financing transaction. Registration is also important because it controls the access of the financier to the aircraft. It is essential for the lessor/financier to ensure that the operator has complied with all the procedures pertaining to aircraft registration as improper registration or cancellation of registration by the aviation authority may result in an event of default under the lease, mortgage and other financing documents, where the nationality of the aircraft plays a vital role. India offers an additional reason to be vigilant as the name of the owner is recorded in the Certificate of Registration and the mortgage or hypothecation of an aircraft is also endorsed thereon. In light of the above, it is essential that the procedures related to registration should be clear and unambiguous.

This chapter describes the requirements and the procedure for registration of aircraft in India. The majority of aircraft acquisitions in India are on a cross-border basis, which means that the aircraft in question has to be imported into India. Therefore, before dealing with registration, the procedure for import of an aircraft and other related items is briefly discussed below.

228*Chicago Convention*, *supra* note 118, Article 17.

229Pursuant to Article 20 of the *Chicago Convention*, *Ibid*, "[e]very aircraft engaged in international air navigation shall bear its appropriate nationality and registration marks." This is reflected in national law of Contracting States which forbid an aircraft to fly unless it bears its nationality and registration marks.

230For example pursuant to Article 12 of the *Chicago Convention*, *supra* note 118, it is the duty of the Contracting State to ensure that every aircraft branded with its nationality mark follows the applicable rules and regulations relating to aircraft flight and manoeuvres.

I. Import of Aircraft, Spare Parts and Related Items

A. Import of Aircraft

Under the Indian Export Import Policy 2004-2009, aircraft are included in the list of restricted items, whose import into India require a license. Permission is needed from the Ministry of Civil Aviation for acquisition of an aircraft and if it is purchased or leased from a foreign owner/lessor, for its import into India. In certain cases, which are discussed below, an import license from the Director General of Foreign Trade ("DGFT"), Ministry of Commerce and Industry may also be required.

1. Permission from Ministry of Civil Aviation:

The application to import and/or acquire the aircraft is made by the operator in the prescribed format[231] to the Ministry of Civil Aviation. The aircraft to be imported must meet the following criteria in respect of maximum permissible age, number of cycles or hours logged in, type certification etc., as prescribed by DGCA:

- Pressurised aircraft to be imported for scheduled/non scheduled and general aviation operations should not be older than 15 years "or have completed 75% of its design economic cycles or 45,000 pressurisation cycles, whichever is earlier." As regards unpressurised aircraft, the permission is given on an individual basis but the maximum permissible age is normally capped at 20 years. Detailed information about the aircraft must be provided about the date of manufacture of the aircraft, the major checks it has undergone, incidents or accidents in which it was involved and the consequent repairs, status of compliance with the service bulletins issued by the manufacturer and with airworthiness directives, copy of type certificate if such an aircraft type is being imported in India for the first time, etc.;[232]

231*CAR – Grant of Permit*, *supra* note 39 at Annex II.

232*Age of aircraft to be imported for scheduled/non scheduled including chArticleer and general aviation operations* (India), DGCA, CAR, Section 2 – Airworthiness Series 'F' PArticle XX (29 July 1993) at para 3 and 4, online: DGCA <http://www.dgca.nic.in/rules/car-ind.htm> [*CAR – Age*].

- In case of a new type of aircraft, which is not currently operated in India, the permission to import will be given only if the DGCA is convinced that the operator is capable of operating and maintaining the aircraft safely;[233]
- Import of aircraft on a wet lease basis is allowed only in emergency situations and in certain specific circumstances[234] (please see chapter one of this paper for details);
- The aircraft should not be up for any major checks within one year of import or 2000 flight hours, whichever is earlier. The aircraft should have been certified fit for passenger operations by the aviation authority of the manufacturer's State. The applicant must establish the prescribed infrastructure for operation and maintenance of aircraft, as for e.g. hiring and training of personnel, preparation of manuals like the operations manual, the training manual, the maintenance manual etc;[235]
- Aircraft which need a license from the DGFT can be imported only for private use and should not be operated commercially for "hire or reward" unless permission for the same is given by the Ministry of Civil Aviation;[236]
- Where the aircraft is to be taken on a lease, the lease agreement must clearly state that once the aircraft is registered in India, the operation and maintenance of the aircraft will be in accordance with the applicable Indian rules, regulations and procedures and the lease cannot contain any restrictions in this connection. The operator is required to furnish an undertaking in this regard while applying for permission to acquire the aircraft. Additionally, the operator must provide a copy of the executed lease agreement to the DGCA.[237]

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233 *Ibid* at para 5.

234*AIC No. 03/1998*, *supra* note 115.

235 *CAR – Grant of Permit*, *supra* note 39, paras 4.2.1, 5.5 and 5.6.

236*Import/Export of Aircraft, Spares, Items of Equipment etc. for use on aircraft* (India), DGCA, CAR, Section 2-Airworthiness Series 'F' PArticle XXI Issue II, (7 November 1997), para 3.3(a), online: DGCA < http://www.dgca.nic.in/rules/car-ind.htm.> [*CAR- Import/Export*].

237 *Air Operator Certification Procedure* (India), DGCA, Air Transport Advisory Circular No 1 of 1997, (August 1997) at para 6.10, online: DGCA < http://www.dgca.nic.in/rules/statnot-ind.htm> .

- In order for the continued maintenance of the aircraft in the requisite airworthy condition, an adequate supply of the relevant spare parts should be imported along with the aircraft.[238]
- Additionally, if the aircraft is to be used for scheduled/non scheduled air transport services, the importer must hold a valid air operator's certificate or should have started the process for obtaining one and in the meanwhile, hold a preliminary no objection certificate from the DGCA.[239]

The application is first scrutinized by the Domestic Transport Section of the Ministry and if found to be complete, it is placed before the Aircraft Acquisition Committee[240] which meets every month to take such decisions. The permission to import is initially valid for one year from the date on which it is granted and may be extended by an additional three months on a case by case basis. The grounds on which this extension may be granted have not been explicitly provided and it has been left to the discretion of the competent authority. If the aircraft is new, the period of validity of the permission will conform to the delivery schedule.[241]

2. License from DGFT:

A license from the DGFT is required by all categories of importers, except the following:

(a) National carriers - Air India and Indian;
(b) Government companies - Vayudoot Limited and Pawan Hans Limited;
(c) National Airports Authority and International Airports Authority of India;
(d) Indira Gandhi Rashtriya Uran Academi and other flying clubs/academies recognized by the Ministry of Civil Aviation;
(e) a scheduled or non scheduled operator that has permission to import the aircraft from the Ministry of Civil Aviation; and

238*CAR – Age*, *supra* note 232 at para 6.

239 *The Aircraft Rules, 1937* (India), 1937, part XIII, rule 134(1) and (3) [*Aircraft Rules*].

240The Aircraft Acquisition Committee currently comprises of Joint Secretary, Ministry of Civil Aviation; Financial Advisor, Ministry of Civil Aviation; Chairman, Airports Authority India; Director General of Civil Aviation; and Commissioner of Civil Aviation Security, Bureau of Civil Aviation Security.

241 *CAR – Grant of Permit*, *supra* note 39 at para 4.2.6.

(f) The Aero Club of India. [242]

The DGCA receives two copies of the application made to the DGFT, along with the attachments. Once it is established that the aircraft is fit for the proposed operations, the DGCA will provide an appropriate recommendation to the DGFT. The license is granted after an examination of the application by the Special Licensing Committee of DGFT.[243]

3. Ferry Flight Permit.

If an application is made for registration of the aircraft before its import into India, a temporary Certificate of Registration (also called a ferry flight permit) may be granted by DGCA to the owner to facilitate the importation. The DGCA will issue such a certificate only after it has received evidence of de-registration of the aircraft from its previous registry, and/or of transfer of title to the Indian operator.[244] The relevant CAR does not specifically mention a lease but it stands to reason that since leases are the most common mode of aircraft acquisition, the certificate will be issued upon the DGCA being provided confirmation of transfer of possession of the aircraft pursuant to the lease. If the aircraft is to be imported by air, the certificate will cease to be valid once the aircraft lands at a customs aerodrome in India. Thereafter the certificate must be surrendered to the Aerodrome Officer. In case of all other modes of import, the certificate will be valid only until the date of the import, after which it should be sent to DGCA.[245] In case of leased aircraft, the usual practice of DGCA is to require the aircraft to be imported under the existing foreign registration, which is then changed to Indian registration after the aircraft is inspected. Where the aircraft is purchased, the DGCA will normally grant temporary Certificates of Registration and Airworthiness.

242*Aircraft, Spacecraft and Parts thereof* (India), Ministry of Commerce and Industry, Export Import Policy 2004-2009, ITC (HS), Chapter 88, , Import Licensing Notes at paras 1 and 2.

243*CAR- Import/Export*, *supra* note 236 at para 3.3(b) and (d).

244*Procedures relating to registration/deregistration of aircraft* (India), DGCA, CAR, Section 1- General Series 'F' Part 1, (10 September 1998) at para 4, online: DGCA < http://www.dgca.nic.in/rules/car-ind.htm> [*CAR-registration/deregistration*]

245*Aircraft Rules*, *supra* note 239, part IV, rule 32.

4. Import of Spare Parts.

Spares are defined in the Indian Foreign Trade Policy[246] as "a part[247] or a sub-assembly or assembly for substitution, that is ready to replace an identical or similar part or sub-assembly or assembly. Spares include a component[248] or an accessory[249]". Import of new spares for aircraft is permitted without any license.[250] Second hand or reconditioned spares can also be imported without a license from DGFT, if a letter of recommendation is obtained from DGCA.[251] Regional and sub-regional airworthiness offices of DGCA are authorised to recommend import of spares and issue duty concession certificates on behalf of DGCA. The CAR issued by DGCA in this regard, which reproduces the text of the Foreign Trade Policy specifies that only the organizations mentioned in paragraph 2 (a) to (f) above are allowed to import repaired/overhauled/re-conditioned second hand parts. The rest of the organizations, including companies which deal in such spares, must import only new parts.[252] The spares should have been manufactured or overhauled only by the organizations certified by the relevant regulatory authority and must come with the appropriate documents which contain details about the condition of their airworthiness.[253] Import of tools or equipment needed for maintenance or testing of aircraft and its accessories, only requires a no objection certificate from the DGCA.[254]

For any duties and taxes on import of aircraft and its parts, please see chapter five of this paper.

246*Foreign Trade Policy 2004-2009* (India), Ministry of Commerce and Industry, DGFT, Annual Supplement, Chapter 9 at para 9.57, (w.e.f. 1 April 2007), online: DGFT, < http://dgft.delhi.nic.in/> [*Foreign Trade Policy*].

247 Parts are defined as "an element of a sub-assembly or assembly not normally useful by itself and not amenable to further disassembly for maintenance purposes. A part may be a component, spare or an accessory" – *Ibid* at para 9.44.

248 Component refers to "one of the part of a sub-assembly or assembly of which a manufactured product is made up and into which it may be resolved. A component includes an accessory or attachment to another component" - *Ibid* at para 9.14

249 Accessory or Attachment means "a part, sub-assembly or assembly that contributes to efficiency or effectiveness of a piece of equipment without changing its basic functions" - *Ibid* para 9.2.

250*Export Import Policy 2004 to 2009* (India), Ministry of Commerce and Industry, DGFT, Schedule I, Annual Supplement, Chapter 88, Heading 8803, (w.e.f 1 April 2006) [*Export Import Policy*].

251*Foreign Trade Policy*, *supra* note 231, Handbook of Procedures (Vol 1), c. 2, para 2.41.

252 *CAR- Import/Export*, *supra* note 236 at para 4.1 note 1 and 2.

253 *CAR- Import/Export*, *supra* note 236 at para 4.2.

254 CAR- Import/Export, *supra* note 236 at para 6.

II. Registration of Aircraft and Grant of Other Certificates

Once the aircraft has been imported into India, the next step is to register it with the DGCA and to obtain a certificate of airworthiness. The certificates of registration and airworthiness are required to be carried on board the aircraft at all times.[255]

A. Certificate of Registration

The Indian Aircraft Rules prescribe that it is unlawful for any person to fly or assist in flying an aircraft unless it is registered and displays its nationality and registration marks, and the full name and address of the registered owner in the manner prescribed by DGCA or in case of a foreign registered aircraft, in accordance with the applicable laws of its State of registration.[256] Penalty for violation of the above is imprisonment for a term not exceeding one month and/or a fine not exceeding INR 250.[257] The DGCA is empowered to register an aircraft in India and issue a Certificate of Registration ("COR"). The Aircraft Register and the COR include the following particulars:

- Type of aircraft;
- Manufacturer's Serial Number
- Year of manufacture
- Nationality and registration marks
- Full name, nationality and address of the owner
- Usual station of the aircraft
- Date of registration
- Period of validity of such registration – The date of expiry of the registration is indicated on the COR and in case of a leased aircraft, the COR is co-terminus with the lease.[258] Once the registration has expired, the operation of the aircraft becomes invalid, until it is renewed[259];

255 *Aircraft Rules*, *supra* note 239, part II, rule 7.

256 *Aircraft Rules*, *supra* note 239, Part II, rule 5 and part IV, rule 37.

257 *Aircraft Rules*, *supra* note 239, schedule VI.

258 *Procedures relating to registration/deregistration of aircraft* (India), DGCA, CAR, Section 1- General Series 'F' Part 1, (10 September 1998), para 7.3 and 7.6, online: DGCA < http://www.dgca.nic.in/rules/car-ind.htm> [*CAR-registration/deregistration*].

259 *CAR-registration/deregistration*, *Ibid* at para 7.5.

- If the aircraft is leased, the lease term, the names, nationalities and addresses of the lessor and lessee;
- Endorsement of the mortgage or hypothecation, if any on the Certificate of Registration.[260]

The Aircraft Register is a public register, which is open to inspection during the working hours of DGCA.[261] Its limited electronic version is available on the website of DGCA – www.dgca.nic.in. Although the details of the owner of the aircraft are noted in the Register, the aircraft registry is not a registry of title. The DGCA has specified that "registration is only for the purpose of controlling the safety of aviation in India and it does not in any way establish the ownership of the aircraft. Disputes regarding the ownership or the liability of owner have to be decided by a court of law."[262]

In many countries, the owner can register an aircraft only if it satisfies certain qualifications regarding nationality. In UK, the registration of an aircraft cannot be procured or continued where" an unqualified person holds legal or beneficial interest by way of ownership in the aircraft."[263] Only the following persons are considered eligible to register an aircraft:

- "the Crown in right of Her Majesty's Government in the United Kingdom or a share therein;
- Commonwealth citizens;
- nationals of any EEA [European Economic Area] State;
- British protected persons;
- bodies incorporated in some part of the Commonwealth and having their principal place of business in any part of the Commonwealth;
- undertakings formed in accordance with the law of an EEA State and having their registered office, central administration or principal place of business within the European Economic Area; or
- firms carrying on business in Scotland."[264]

260 *CAR-registration/deregistration*, *supra* note 244, para 3.5(viii).

261 *Aircraft Rules*, *supra* note 239, rule 36

262 *CAR-registration/deregistration*, *supra* note 244, para 1.

263 *The Air Navigation Order* (UK), 2005, S. I. 2005/1970, part 1, s. 4(2)(b).

264 *Ibid*, s. 4(3).

An otherwise ineligible person, who resides or has a place of business in UK, and holds a legal or beneficial interest in aircraft, may be allowed by the Civil Aviation Authority to register it in UK but the aircraft cannot be used for public transport or aerial work.[265]

In US, an aircraft can only be registered by and in the legal name of its owner. Here, "owner includes a buyer in possession, a bailee, or a lessee of an aircraft under a contract of conditional sale, and the assignee of that person."[266] An application for registration can be made by a US citizen, a permanent resident, a trustee where the trustee is a US citizen or a permanent resident, a partnership where each of the partners are US citizens.[267] A corporation that is not a US citizen can register an aircraft if it is qualified to do business in one of the States and if the aircraft will be based and primarily used in US.[268] Alternatively, a voting trust, where all the trustees are US citizens and are able to exercise independent judgment, can be used to qualify a domestic corporation as a US citizen.[269]

India also has certain citizenship restrictions regarding registration. However, to encourage in-bound cross border leasing, aircraft which are owned by a foreign company are permitted to be registered as long as the aircraft is on lease to an Indian lessee. An aircraft can be registered in either of the following categories:

(a) "Category A – where the aircraft is wholly owned:
   (i) by a citizen of India; or
   (ii) by a company registered and having its principal place of business within India, of which the chairman and at least two thirds of directors of which are citizens of India; or
   (iii) by the Central or the State Government or any company owned or controlled by either of the said Governments; or
   (iv) by a company registered elsewhere then in India if such a company has leased the aircraft to any of the persons mentioned in [para (i) to (iii)] above.

(b) Category B- where the aircraft is wholly owned either:

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265 *Ibid*, s. 4(4).

266 *Title 14 Code of Federal Regulations Part 47.5(b) and (d).*

267 *Ibid* Part 47.7.

268 *Ibid* Part 47.9.

269 *Ibid* Part 47.8.

(i) by persons resident in or carrying on business in India who are not citizens of India; or

(ii) by a company registered elsewhere than in India and carrying on business in India. [270]

The owner or his authorized representative (usually the operator) can apply to the DGCA for registration in the prescribed form, attaching the following documents:

(i) Customs clearance certificate or the bill of entry of the aircraft;

(ii) Certificate of deregistration from the previous registering authority;

(iii) Temporary COR, if any[271];

(iv) Proof that the aircraft has been bought or is fully owned by the applicant. A copy of the invoice or bill of sale is usually considered sufficient for this purpose. If the aircraft is purchased within India, an affidavit from the prior owner, indicating that the aircraft has been sold to the new owner and the entire sale price has been received is also required[272.] If the aircraft is taken on dry lease, a copy of the lease is required to be submitted;

(v) Where the owner of the aircraft is a company, its documents of registration, and the names, addresses and nationality of its directors;

(vi) A copy of DGFT's import license or permission to import given by the Ministry of Civil Aviation;

(vii) Where the aircraft has been mortgaged or hypothecated, the consent of the owner and the related documents are required– as mentioned above a notation of the mortgage is made on the COR. Since India does not have a central registry for registration of mortgages of movable property, this was another measure which the Government introduced in 2006 to provide some comfort to the financiers and to promote cross border leasing; and

(viii) For payment of the prescribed fee[273], an Indian Postal Order or Demand Draft.[274]

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270 *Aircraft Rules*, *supra* note 239, part IV, rule 30(2).

271*CAR-registration/deregistration*, *supra* note 244 at para 6.2.

272 *CAR-registration/deregistration*, *supra* note 244 at para 5.2.

273 The fee for issue of COR are as follows:

for aircraft having maximum permissible take off wait of 15,000 kg or less – INR 20,000

exceeding 15,000 kg – INR 5000 for every 1000 kg or part thereof.

Temporary COR – 25% of above.

Renewal of COR – 50% of above.

The aircraft will not be registered if it is already registered in another country[275] or if it fails to meet the above-mentioned citizenship requirements. If "the usual station of an aircraft and its ordinary area of operation" is not within India, the DGCA may refuse to register the aircraft, or if already registered, to allow the registration to continue, if it considers that it would be more appropriate for the aircraft to be registered in another country. This is because DGCA may not be able to adequately supervise the operations of the aircraft outside of its jurisdiction. The application may also be rejected if the circumstances of the case are such as would make it inimical to the public interest to register the aircraft. [276]

If the ownership of the aircraft is transferred, the registered owner should notify the DGCA at once and the new owner must immediately apply for a COR. Until the COR is granted to the new owner, the aircraft can only be flown with the written permission of DGCA.[277]

The registration of an aircraft can be cancelled by the DGCA at any time in the following cases:

- the registered owner does not fall within the categories of prescribed ownership, as discussed above;
- the information provided was false;
- it would be more appropriate to register the aircraft in some other country;
- it is against the public interest to permit the aircraft to remain registered in India;
- the lease associated with the registered aircraft has come to an end or has been terminated legally or with the agreement of parties;
- the aircraft has been completely damaged or is no longer in use. [278]

The registered owner or its authorized representative can apply for cancellation of registration. The original COR is required to be submitted along with the application, and it should be specified under which head the cancellation is requested.[279]

CAR-registration/deregistration, *supra* note 244, para 15.

274*CAR-registration/deregistration*, *supra* note 244 at para 3.5.

275Article 18 of *the Chicago Conventio, supra* note 118, provides that at a time, an aircraft can be validly registered only in one State but its registration can be transferred from one State to another.

276 *Aircraft Rules*, *supra* note 239, part IV, rules 30(3),(4) & (5).

277*Aircraft Rules*, *supra* note 239, part IV, rule 33.

278*Aircraft Rules*, *supra* note 239, part IV, rule 30(6) of the Aircraft Rules read with CAR-registration/deregistration, *supra* note 244 at para 9.1.

279 *CAR-registration/deregistration*, *supra* note 244 at para 9.2.

B. Type Certification

Type certification of the aircraft is essential for obtaining a certificate of airworthiness. In India, the DGCA is empowered to issue a type certificate to an aircraft and its engines or propellers which are manufactured in India or abroad and revalidate the type certificate issued by foreign airworthiness authorities in case of foreign manufactured aircraft.[280] As civil aircraft or engines are generally not manufactured in India, DGCA is mostly called upon to revalidate type certificates. An application for this purpose can be made in the prescribed format to DGCA. The main requirements for the revalidation are:

- a valid Certificate of Airworthiness, Type Certificate or a similar document given by the airworthiness authority of the State of manufacture;
- compliance with the airworthiness requirements prescribed by DGCA; and
- submission of appropriate documents and technical data relating to the fitness of the specific item for aviation purposes.[281]

One of the main criteria for revalidation is bilateral agreement between India and the concerned country about acceptance of standards. If required, the representative of the manufacturer may be asked to come to India or representatives of DGCA may visit the manufacturer or the airworthiness authority of the State of manufacturer [282], or the construction site[283]. In order to demonstrate compliance with airworthiness requirements, test flights of the aircraft will be required, for which DGCA may nominate a pilot.[284] Once the type certificate has been issued or revalidated, any modifications in the aircraft, component or equipment will require the approval of DGCA.[285] The type certificate may be cancelled, suspended or endorsed if DGCA has reason to believe that the safety of the aircraft may be compromised due to the existence of any unsafe condition in the aircraft, aircraft component, or item of equipment, or

280*Aircraft Rules*, *supra* note 239, part VI, rules 49 – 49B.

281 *Aircraft Rules*, *supra* note 239, part VI, rule 49B.

282*Procedure for Issue/Revalidation of Type Certificate of Aircraft and its Engines/Propellers* (India), DGCA, CAR, Section 2 – Airworthiness Series 'F' Part II, (24 April 1992) at para 5, online: DGCA <http://www.dgca.nic.in/rules/car-ind.htm > [*CAR-Type Certificate*].

283 *Ibid* at para 7.

284 *Ibid* at para 8.

285*Ibid* at para 11.

DGCA may require a modification to be carried out as a condition for the type certificate to remain valid.[286]

C. Certificate of Airworthiness

An aircraft in India is not permitted to fly unless it has a valid certificate of airworthiness.[287] The DGCA is authorized to grant or renew the certificate, and if the certificate has been granted by another aviation authority, to validate it, where the requisite documents are submitted and the DGCA is satisfied that the aircraft is airworthy.[288] For this purpose, DGCA may require the aircraft to be inspected and/or taken for a test flight and impose such conditions as it deems necessary. The DGCA has approved the design standards specified by the Joint Aviation Authority of Europe in CS/JAR 23 and CS/JAR 25 and by FAA in FAR 23 and FAR 25 for light and transport category aircraft. Otherwise, the DGCA should be consulted prior to the import of aircraft, so that its acceptance is assured.[289] The period of validity of the certificate is linked to the age of the aircraft, for e.g. if the age of the aircraft is five years or less, the period of validity of the certificate is also five years, and it decreases with a proportionate increase in the age of aircraft.[290] An annual review of the aircraft is required to be carried out by the maintenance organization to test the airworthiness of the aircraft and a report thereof must be submitted to the concerned regional office of DGCA.[291] An aircraft may be imported under a foreign certificate of airworthiness but if required, a short term Indian certificate of airworthiness can be issued by the regulatory authority of the country of export, pursuant to a request made by the DGCA.[292]

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286 *Ibid* at para 16.

287 *Aircraft Rules*, *supra* note 239, part II, rule 15(1). An exception to this rule is test flight in the close vicinity of an aerodrome or place of departure.

288*Aircraft Rules*, *supra* note 239, part VI, rule 50.

289 *Issue, Validation and renewal of Certificate of Airworthiness* (India), DGCA, CAR, Section 2 – Airworthiness Series 'F' Part III, (20 March 1992) at para 2.1.1, online: DGCA < http://www.dgca.nic.in/rules/car-ind.htm> [*CAR-Airworthiness*].

290 *Ibid* at para 3 for details.

291*CAR-Airworthiness*, *supra* note 289 at para 3.3.

292 *CAR-Airworthiness*, *supra* note 289 at para 5.1 and 5.2.

Chapter Four

Security Interest in Aircraft

The discussion in the previous chapter has shown that security or collateral in some form or other is required for most types of debt. The purpose of taking security is to protect the creditor against the potential risk that the debtor may default. Without security, a creditor is relegated to the status of an unsecured creditor and may receive only a fraction of what is owed, should the debtor default or be wound up. The assets of an insolvent debtor are seldom sufficient to repay all of its creditors. The secured creditor is in the privileged position of being amongst the first to be repaid out of the proceeds from the sale of the debtor's assets while unsecured creditors only share *pari passu* i.e. equally in the residue, if any. This credit risk may be mitigated to a large extent by holding collateral security on the assets of the debtor or by obtaining a right of recourse against a third party who has undertaken to prop up the debtor's credit by an additional layer of security, as for example by giving a guarantee or an indemnity. The former type of security is known as real security while the latter is called personal security.[293] The taking of security, often in more than one form, is normal in case of "big ticket" assets such as aircraft and engines, which often have value of over USD 50 million. Depending upon the role of the asset, the financing could be classified as secured lending or asset based financing, although the line between the two is often blurred. In secured lending, the asset is given as an additional source of comfort to the creditor. As long as the asset is of the requisite value, it is immaterial which type it is i.e. it could be the aircraft or other assets of the airline like buildings. In asset based financing, the residual value of the asset itself contributes towards repayment of the debt, either by way of sale of the asset at the end of the loan period or through a subsequent lease(s) of the asset. The underlying security is the aircraft and the structure of the transaction usually involves an operating lessor who holds title to the aircraft and acts as an intermediary between the financier and the airline. Where the creditworthiness of the airline is questionable, secured lending may not be available and asset based financing is more likely to be used. Therefore, asset based financing opens the door to weaker credit although because of its advantages, it is also used by credit worthy airlines. In certain transactions, elements of project

293See Roy Goode, Commercial Law, 3rd ed. (London: Lexix Nexis UK, 2004) at 578 [Goode *Com Law*].

financing may also be introduced, wherein the lenders look to the lease payments of the aircraft to pay off the loan and the security over the aircraft is only called upon as a last resort.[294] Described below is the concept of security, the different types of security and the law relating to security relevant in the context of aircraft financing, as also certain aspects of security in UK and US with the aim of providing a comparison with the regime in India.

I. Security Law in India

At present, India does not have a consolidated law relating to security. It is scattered over several acts including the Indian Contract Act, 1872, the Transfer of Property Act, 1882, the Companies Act, 1956, the Registration Act, 1908 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act). However, as far as aircraft objects are concerned, this deficiency will be cured with the coming into effect of the Cape Town Convention. It is to be noted that the Convention does not apply to spare parts. Therefore, any security interest on spares will still need to be created and perfected according to the local law.

II. Concept of Security Interest

Security involves granting of a right or an interest to the creditor by the debtor in one or more assets to secure payment of a loan or performance of an obligation by the debtor or by a third party. Since it normally entails a transfer of an interest, it is referred to as a security interest. Generally in the common law countries, a security interest which is fixed to a specific asset and is consensual i.e. made by agreement between the parties has the following characteristics:

- the right comes into existence as a result of the creation of an interest and not due to a title reservation in favor of the creditor;
- the right is given as a collateral for payment of a loan or performance of an obligation;
- it does not involve passing off the title to the asset;
- until the loan is fully repaid or the obligation is discharged, the debtor's right to freely dispose of the collateral, is restricted.[295]

294See Hollow*ay*, *supra* note 46 at 123

295See Roy Goode, *Legal Problems of Credit and Security*, 3rd ed. (London: Sweet & Maxwell, 2003) at 11 [Goode *Security*].

For a definition of security interest provided by the Cape Town Convention, please see chapter six of this paper.

There are two main approaches to the concept of security, namely the formal approach and the functional approach. The formal approach, which is followed in UK, is more concerned with the legal substance of a transaction rather than its economic effect, where characterization of the transaction is concerned. This means that title retention agreements like conditional sale, finance lease and hire purchase where the ownership continues to vest in the conditional seller, owner or lessor while the buyer, lessee or hirer only has a possessory interest in the asset until the condition is fulfilled or the purchase option is exercised, are not regarded as creating a security interest. In contrast, the functional approach which is followed in US, considers these title retention devices as having the same economic effect as a secured transaction where the conditional buyer, lessee or hirer are the true owners of the asset and the conditional seller, owner or lessor only have a security interest in the asset. These are therefore treated in law as security.[296] An example of the functional approach is that a lease would be regarded as a security interest under US law if:

> …the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is not subject to termination by the lessee, and: (1) the original term of the lease is equal to or greater than the remaining economic life of the goods; (2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.[297]

The position in India on the concept of security and indeed, on the entire law of security is somewhat similar to the one in UK.

296See *Ibid* at 3- 4.

297 U.C.C § 1-203(b)

Even in case of lease or hire purchase the Indian courts, like the courts in UK, have the prerogative to look at the substance of the transaction to determine its true form. For example, as discussed in chapter one, the Supreme Court of India in *Sundaram Finance* has distinguished between a hire purchase agreement and a transaction which is disguised as a hire purchase agreement but is in reality a secured financing transaction which "could have taken the form of a mortgage or pledge, but the parties, for their mutual benefit and convenience, entered into a hire-purchase transaction."[298]

The proper characterization of a transaction is important under the Cape Town Convention also as it would determine which remedies are available to the creditor. For a discussion on this, please see chapter six of this paper.

III. Classification of Security

Security can be classified in a number of ways. Some of these are as follows:

A. Consensual and Non-Consensual Security.

As mentioned above, consensual security refers to a security interest which has been created by agreement between two or more parties. Examples of consensual security include mortgage, pledge etc. In contrast, non-consensual security is created by operation of law or by common law. Examples of this type of security are a banker's lien, attorney's lien, mechanic's lien etc.

B. Possessory and Non-Possessory Security.

In possessory security, possession of the asset by the creditor is an essential ingredient for the security to come into existence. Since transfer of possession is a prerequisite here, it necessarily follows that the asset in question must be movable, tangible property. Examples of possessory security interest are pledge and mechanics lien. In non-possessory security interest, as the name implies, there is no requirement of possession for the security to exist and the debtor continues to be in possession of the asset, which could be movable or immovable, tangible or intangible property. Examples of this type of security interest are mortgage and charge.

298*Sundaram Finance*, supra note 87.

C. Real and Personal Security.

These have been described at the beginning of this chapter.

IV. Forms of Security

There are many forms of security prevalent in aviation finance but as a consequence of the implementation of the Cape Town Convention, the distinction between these has become considerably blurred and the only clear demarcation which is left now is between a charge and a lien. Although these words are used in the Convention, a definition thereof has not been provided. Therefore, a brief description of what constitutes charge and lien is given below:

A. Charge.

Under the Transfer of Property Act, a charge is said to come into existence when the asset of one person is used as collateral for payment of money to another, either by act of parties or by operation of law and the transaction does not come within the ambit of a mortgage.[299] In general, a mortgage is regarded as a species of charge which means that all mortgages are charges but not all charges are mortgages. The Supreme Court of India in *JK (Bombay) Private Ltd. v New Kaiser-I-Hind Spinning and Weaving Co Ltd.*[300], distinguished between a charge and a mortgage as follows:

> While in case of a charge, there is no transfer of interest of property or any interest therein, but only the creation of a right of payment out of the specified property, a mortgage effectuates transfer of property or an interest therein.

Thus, in a charge there is a *jus ad rem* i.e. right to receive payment out of the specified property while in a mortgage there is a right *in rem.* Consequently, the chargee's power to enforce the security is more restrictive than a mortgagee's. However, such a distinction is not made by the Cape Town Convention.

Generally, there are two types of charges, namely fixed and floating charges. If the charge is created in respect of a specific asset, it is referred to as a fixed charge. In contrast, a floating charge is a charge on all the assets of a company or on a changing pool of assets for e.g.

299 *The Transfer of Property Act, 1882* (India), 1882, c. IV, s. 100.

300 [1969] 2 SCR 866.

a charge on stock in trade of a company is a floating charge. It was defined in the *Governments Stock and Other Securities Investment Co Ltd v Manila Railway Company*[301] as: "[a] floating security is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time. It is of the essence of such charge that it remains dormant until the undertaking charged ceases to be going concern or until the person in whose favour the charge is created intervenes." In *Re Yorkshire Woolcombers Association Ltd.*[302] the following main characteristics of the floating charge were identified by Romer L.J.[303]:

> "…I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge. (1) If it is a charge on a class of assets of a company present and future. (2) If that class is one which in the ordinary course of the business of the company would be changing from time; and (3) If you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way so far as concerns the particular class of assets I am dealing with."

The intervention of the chargee mentioned in the first case refers to any action of the chargee, taken in accordance with the terms of the charge instrument, which enables the charge to crystallize for e.g. appointment of an administrative receiver by the chargee on happening of certain trigger events. Once the charge crystallizes either because of the intervention of the chargee or because the company ceases to be a going concern i.e. upon winding up, it fastens upon the property which is described in the security agreement. Henceforth, it becomes a fixed charge. Thereafter, the chargor cannot deal freely with the charged asset during the course of his business.

A floating charge is generally used as security in a debenture issue.

301 [1897] AC 81.

302 [1903] 2 Ch. 284 at 295

303 Romer L.J. clarified in the case that it is not essential that a floating charge should contain all the three characteristics.

B. Lien.

Generally speaking, the word lien is used to denote a security interest arising from a contract, mercantile usage or by operation of law. The most common usage of this word is in respect of a security interest which occurs due to the operation of law. It is also used in context of a right of set off as in a banker's lien, and as a generic word for security interest. Depending on the mode of creation, liens can be classified as common law liens, equitable liens and statutory liens. Common law liens are possessory liens which are created in common law and arise out of transactions wherein a person does some work for another person, as a consequence of which he becomes entitled to retain the property of the latter as a security for payment of charges due for the work done. Common law liens are further divided into general and particular liens. A general lien permits the lienee to retain possession of the asset until all the money which is owed to him by the owner of the asset has been paid, irrespective of whether or not such money is owed because of work done on that specific asset. A particular lien, on the other hand, entitles the lienee to retain only that asset in respect of which the charges have been incurred. A particular lien mainly occurs where the person in possession of the goods improves them by his skill or labor, while general liens arise out of mercantile usage. An example of a particular lien is a mechanic's lien and examples of general lien are liens of banker's, solicitors, factors, stockbrokers etc. An equitable lien arises in equity and unlike the common law lien, is not dependant on possession. Statutory liens, as the name implies, are created by a statute.

In India, common law liens and statutory liens are prevalent but equitable liens are rare. The concept of a lien was described in *In re: the Kapila Textile Mills Ltd.[in Liquidation]*[304] as follows:

> "Lien" in its real sense is a possessary right, a right to detain a specific movable in order to enforce some payment or the performance of some obligation which, by virtue of some previous contract between the owner of the thing and the detainer, the owner becomes, bound to pay. It is in fact in earlier stages a right to convert one's position as a workman into the position as a pledgee. Workman for example or a tailor has a lien to retain the article on which he has expended his work until his wages or cost of material, if any are paid. Such also are liens known in India as,

304 [1966] 36 CompCas 63 Kar at para. 35.

> for example banker's lien or lawyer's lien or the lien of an agent. All these liens are lost once the banker parts with the security in his possession, or the lawyer parts with papers in his possession or the agent parts with cash or other articles in his possession acquired by him in the way of his agency business.

For a discussion of liens which are applicable in respect of an aircraft in India under the Cape Town Convention, please see chapter six of this paper.

Apart from the above-mentioned security devices, a creditor normally requires an additional layer of security in any of the following forms or a combination thereof:

C. Guarantee.

A guarantee is a promise given by the guarantor to the creditor to take on the liabilities of the debtor *vis a vis* the creditor, if the debtor fails to perform any of his obligations. Guarantees and indemnities in India are governed by the Indian Contract Act. A contract of guarantee is defined in section 126 of the Act as "a contract to perform the promise, or discharge the liability of a third person in case of his default." The guarantor is called the "surety", the person on whose behalf the guarantee is given is referred to as the "principal debtor" and the person who is the recipient of the guarantee is called the "creditor". A guarantee can be given orally or in writing.[305] The purpose of a guarantee is that the creditor would have two sources from which to collect the debt.

One of the essential requirements of a valid contract is that there must be some consideration. The surety normally does not receive any corresponding benefit from giving the guarantee. However, in this regard, the Contract Act provides that "[a]nything done, or any promise made, for the benefit of the principal debtor, may be a sufficient consideration to the surety for giving the guarantee."[306]

Unless the contract provides to the contrary, "[t]he liability of a surety is coextensive with that of the principal debtor".[307] In this respect, the Supreme Court of India has observed in *Bank of Bihat Ltd. v Dr. Damodar Prasad*[308] that the liability of the surety pursuant to section

305*Contract Act*, *supra* note 123, c. VIII, s. 126.

306 *Contract Act*, *supra* note 123, c. VIII, s. 127.

307*Contract Act*, *supra* note 123, c. VIII, s. 128.

308 [1969] 39 Comp Cas 133 at paras 3, 4 and 6.

128 of the Contract Act is "not deferred until the creditor has exhausted his remedies against the principal debtor….In the absence of some special equity the surety has no right to restrain an action against him by the creditor on the ground that the principal is solvent or that the creditor may have relief against the principal in some other proceedings.…The very object of the guarantee is defeated if the creditor is asked to postpone his remedies against the surety." This position is similar to English law wherein it is well settled that a creditor is entitled to be paid by the surety without first suing the debtor or showing that it has explored all available remedies against the debtor.[309] The liability of the surety will remain unaffected even if the contract between the creditor and principal debtor becomes unenforceable.[310] A surety steps in shoes of the creditor and becomes vested with all the rights which the creditor has against the principal debtor on payment or performance of all that he has undertaken to do pursuant to the contract of guarantee.[311] The surety also becomes vested with every security that the creditor holds against the principal debtor at the time of giving of the guarantee, irrespective of whether the surety is aware of the existence of such security or not. If the creditor disposes off such security without the surety's consent, the value of such security is deducted from the amount of guarantee.[312] A guarantee is also discharged in the following circumstances:

- the provisions of the contract between the creditor and the principal debtor are changed without the consent of the surety[313];
- the principal debtor is released pursuant to any contract with the creditor or by any act or omission of the creditor, which has the effect of discharging the principal debtor[314];
- the creditor and principal debtor enter into a contract, without the consent of the surety, whereby the creditor enters into a compromise with the principal debtor

309See Goode - Com Law, *supra* note 293 at 815 and 820.

310A contract between the principal debtor and creditor may become unenforceable due to a statutory notification. See for e.g. *State Bank of India v Saksaria Sugar Mills Ltd*. (1986) 2 SCC 145 SC.

311*Contract Act*, *supra* note 123, c. VIII, s. 140.

312*Contract Act*, *supra* note 123, c. VIII, s. 141.

313*Contract Act supra* note 123, c. VIII, s. 133.

314*Contract Act*, *supra* note 123, c. VIII, s. 134.

and gives him extra time to discharge the debt or agrees not to sue the principal debtor[315]; or

- any act of the creditor violates the rights of the surety or the creditor fails to take such action as his duty to the surety requires him to take, which results in the remedy of the surety being harmed in some way.[316]

The bankruptcy of the principal debtor does not generally affect the liability of the surety. In this regard the Supreme Court has held that "[t]he liability is absolute and unconditional….a discharge which the principal debtor may secure by operation of law in bankruptcy (or in liquidation proceedings in the case of a company) does not absolve the surety of his liability."[317]

D. Indemnity.

An indemnity is an undertaking by one person to make good the loss suffered by another person. The Indian Contract Act defines a contract of indemnity as "a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by any the conduct of any other person"[318] This definition is confined only to losses caused by a person and does not cover losses resulting from events outside the control of the person like *force majeure*, acts of terrorism, war etc. However, the law on the subject as contained in the Contract Act is not exhaustive and a contract of indemnity with a wider ambit is certainly feasible. Such a contract would be governed by the principles of common law.[319] An indemnity may also exist due to operation of law. An indemnity holder, acting within the scope of his authority, is entitled to recover the following from the indemnifier:

- all damages in a suit in connection with any matter which comes within the ambit of the indemnity;
- all costs in such a suit, if he has the authorization from the indemnifier to institute or defend the suit or in doing so he did not disregard any orders of the indemnifier, and acted in a prudent manner; and

315*Contract Act*, *supra* note 123, c. VIII, s. 135.

316*Contract Act*, *supra* note 123, c. VIII, s. 139.

317*Maharashtra State Electricity Board, Bombay v Official Liquidator, High Court Ernakulam and Anr* [1982] 3 SCC 358 at para 7.

318*Contract Act*, *supra* note 123, c. VIII, s. 124.

319See Shardul Thacker, "India" in Norton Rose ed., Cross Border Security (London: Butterworths, 2000) at 178.

- all sums which may have to be paid as a result of a compromise in the suit, provided that the indemnifier has sanctioned the compromise or the compromise does not contravene the instructions of the indemnifier and the compromise is such as would have been prudent for the indemnity holder to make if the contract of indemnity did not exist.[320]

E. Letter of Credit.

A letter of credit ("LC"), like a guarantee, is another form of assumption of liability by a third party. It is an undertaking by a financial institution or a person to pay a specific sum of money to another person to whom the LC is addressed or to accept or purchase a bill of exchange drawn or held by that person[321] upon fulfillment of the conditions specified in the LC. The parties involved in a typical LC are:

- the applicant i.e. the person who applies to a financial institution, normally a bank for issue of the LC. The applicant is the customer of the bank[322];
- the issuing or originating financial institution;
- the beneficiary – in whose favour the LC is issued; and
- sometimes an intermediary bank may also be involved. The issuing bank may pass on the LC to another bank known as the correspondent, advising or confirming bank whose job is to notify the beneficiary of the opening of the LC and/or fulfill the payment or acceptance obligations given in the LC.

An LC can be revocable i.e. retractable by the applicant at any time before the beneficiary presents his claim to the bank, or irrevocable which means that it is a binding commitment that cannot be changed or cancelled without the consent of all the parties. LCs are used in sale and purchase transactions, particularly those involving export and import of goods to *inter alia* avoid risk of non payment by the buyer, and in lease agreements as a security for lessee's obligations. The latter type of LC is called a stand-by LC which means that the LC will not be used unless there is a default by the lessee.

320*Contract Act*, *supra* note 123, c. VIII, s. 125.

321 See Kevin Patrick McGuiness, *The law of Guarantee*, 2d ed.(Scarborough: Carswell Thompson Professional Publishing, 1995) at 772 quoting R. R. Pennington & A. Hudson, Commercial Banking Law (Plymouth: MacDonald Evans, 1978) at 311.

322See *Ibid* at 800.

In India, as in most countries of the world, LCs are subject to the Uniform Customs and Practice for Documentary Credits ("UCP"), which are a set of rules established by the International Chamber of Commerce to govern LCs.[323] The provisions of the UCP have to be specifically incorporated by reference in an LC. The courts in India have been very reluctant to interfere in matters concerning LCs and bank guarantees. Numerous cases on the subject have held that judicial interference is justified only in cases of *prima facie* fraud or where otherwise irretrievable harm or injustice would be done.[324] The issuing bank must honor the LC as long as all the conditions specified therein are met and the documents are in order. Any dispute between the seller and the buyer will not have any effect on the obligation of the issuing bank, since the contract between the bank and the beneficiary is independent of the contract between the seller and the buyer.[325]

As mentioned elsewhere in this paper, most aircraft in India are taken on a lease. In a typical lease transaction, the following types of security are likely to be used to secure the obligations of the lessee:

(a) a refundable security deposit equivalent to 2-3 months of lease rental, in the form of cash or an irrevocable stand-by letter of credit;

(b) assignment of insurance and reinsurance policies in favour of lessor. The lessor is usually named the sole loss payee in the policies, so that in case of total or partial loss of the aircraft, the insurance proceeds are paid directly to lessor;

(c) assignment of requisition compensation - this ensures that if the aircraft is requisitioned by the Government of the State in which it is registered, the compensation paid by Government for the use of the aircraft is paid directly to the lessor;

(d) a third party guarantee – this is usually given by the parent company or it can be a bank guarantee;

(e) indemnity for license fees, registration fees, taxes, duties and other charges levied in the lessee's State, if it is a net lease;

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323 The latest version of the Uniform Customs and Practice for Documentary Credits is UCP 600 which revises UCP 500 of 1993. The date of implementation of UCP 600 is 1 July 2007.

324 For e.g. see *Tarapore and Co., Madras v. V.O Tractors Export Mosco*., [1970] AIR 891 SC; *United Commercial Bank vs. Bank of India* [1981] 2 SCC 766; *Hindustan Steel Works Construction Ltd. Vs. Tarapore & Co.*, [1996] 5 SCC 34 etc.

325*U.P. Coop. Federation v. Singh Consultants & Engineers (P) Ltd*., [1988] 1 SCC 174.

(f) indemnity for any losses incurred by third parties and for damage caused by the aircraft except where the lessor is responsible for such loss or damage.

If a lender is also involved in the transaction, then in addition to the applicable security interests described above, after being suitably modified to accommodate the lender or the security trustee appointed by the lender or a group of lenders to manage the transaction, the following may also be used:

- a first priority mortgage over the aircraft;
- assignment of the lease rentals in favour of the lender by the owner;
- assignment of all product related warranties and indemnities like the warranties of the manufacturer, supplier, maintenance performer etc, in favour of the lender, in case the owner defaults, so that the lender can step into the shoes of the owner.

In aircraft financing, the value of the security taken by a lender is almost always higher than the amount of the loan. This difference is expressed by the security coverage ratio, which is generally between 120 to 130%. This means that where the security is the aircraft, the value of the aircraft should be 120 – 130% more than the unpaid portion of the loan, throughout the term of the loan. Hence, the actual loan will amount to only 75 – 85% of the price of the aircraft. The reason for this high security coverage ratio is that in case of sale of the aircraft, pursuant to a default by the borrower, the lender should be able to not only recover the arrears in principal and interest payments from the sale proceeds but also any of the following or a combination thereof:

- charges incurred by the airline in respect of the aircraft that have priority over the lender's security interest, payment of which may become necessary before the lender is allowed to repossess the aircraft. An example of this is landing and parking charges;
- cost of repossession for e.g. fees for a ferry flight permit and cost of exporting the aircraft out of the State of registration, if required;
- renovation and remarketing costs including insurance and storage charges during renovation and remarketing;
- charges of a broker.[326]

326 See Hollow*ay*, *supra* note 46 at 129.

V. Registration of the Security Interest

In common law, a security interest is enforceable without the need for any registration. However, legislation intervened to require mandatory registration of certain security interests to enable a third party to have notice of the existence of the security interest. Under the Cape Town Convention, registration of the security interest with the International Registry is the only perfection requirement. In 2006, the CAR on the registration of aircraft in India was amended to provide for recording of the existence of a mortgage or hypothecation in respect of an aircraft in the COR issued by the DGCA. Details about the mortgage or hypothecation are required to be disclosed in the application for registration of an aircraft along with the consent of the owner/operator to such mortgage/hypothecation and the documents to this effect. The record of the mortgage or hypothecation can be removed from the COR on an application made by the owner of the aircraft along with documents substantiating his claim.

VI. Detention and Confiscation of Aircraft

The detention or confiscation of an aircraft by the Government, authorities or service providers is a situation which considerably dilutes the efficacy of the security of the lender as it results in the loss of control and possession of the aircraft by the borrower. In extreme cases, it is possible that the aircraft may also be sold. The Cape Town Convention specifically provides that the right of the Government to arrest or detain an aircraft will not be affected by its application (please see chapter six of this paper). The following are the circumstances in which an aircraft can be detained or confiscated in India:

A. Detention and Confiscation under the Aircraft Act.

The Central Government can authorize any authority to detain an aircraft where:

- the flight of that aircraft poses a danger to the persons on board the aircraft or any other person or property;
- the detention is required to ensure that the Aircraft Act and the applicable rules are complied with;
- the detention is needed to prevent violation of the rules relating to entry of an aircraft into India, its flight over India, places where it can land, prohibition of flight over a specified area etc.

- the detention is required to execute any orders of a court.[327]

Furthermore, in an emergency, the Central Government may in the interest of public safety or tranquility requisition any aircraft or class of aircraft and instruct that such aircraft be surrendered immediately or within a certain time period to any authority, for the requisite public service. The Government offers compensation for any direct injuries or losses suffered due to such requisition. The amount of compensation is established by an authority appointed by the Central Government for this purpose. The contravention of an order to deliver the aircraft is punishable by imprisonment which can extend to three years, a fine or both and/or forfeiture of the aircraft.[328]

In case any person is convicted for contravention of provisions relating to carriage of arms, explosives and other dangerous goods in the aircraft or giving of information about such carriage, the court by which such a person is convicted, may also order forfeiture of the aircraft.[329]

B. Detention by the Airport Authority of India.

The Airport Authority may detain an aircraft for any unpaid charges, fees or rent for:

- landing, parking or housing of an aircraft or for any other facilities or services in relation to the operation of the aircraft at any airport, airstrip etc.;
- air traffic services, ground safety services, aeronautical communication, navigational aids and metrological services. [330]

C Detention for Contravention of Customs Laws.

Under the Customs Act, an aircraft can be detained or confiscated by the customs authorities in the following instances:

- if the aircraft is improperly imported into or exported out of India[331];

327*The Aircraft Act*, 1934 (India), 1934, s. 8 [*Aircraft Act*].

328*Ibid*, s. 6.

329 *Ibid*, s. 13.

330Under section 22 of the *Airport Authority of India Act, 1994*, the Airport Authority has the power to charge fees or rent for providing such services. The power to detain the aircraft on non payment of these charges is not provided for explicitly in the act but the Airport Authority may have a contractual or common law lien.

331 *The Customs Act, 1962*, (India), 1962, ss. 111 and 113 [*Customs Act*].

- an aircraft can be stopped and searched if there is reason to believe that the aircraft is being used for smuggling of goods or is carrying such goods on board.[332]Where an aircraft that has been ordered to land and submit to a search, fails to do so, it can be confiscated[333];
- if the aircraft is being used for smuggling, it is liable to be confiscated unless the owner can prove that it was done without the knowledge or connivance of the owner, his agent if any and the person in charge of the aircraft;
- where an aircraft has been constructed, adapted, altered or fitted in any manner for the purpose of concealing goods;
- if any part of the goods are destroyed to prevent seizure by the custom authorities; or
- where a significant portion of the imported goods, after entry into India, are missing unless the commander of the aircraft is able to explain the loss.[334]

If the aircraft is being used for carriage of goods or passengers for hire, the owner of the aircraft will be given an option to pay a fine instead of confiscation of the aircraft.[335]

D. Confiscation and Detention in an Emergency.

In a general emergency proclaimed by the President of India under Article 352 of the Constitution, where the security of India or any part thereof, is threatened by armed rebellion, external aggression or war, the Government or its agencies may confiscate, detain or requisition any aircraft. For instance, a general emergency was declared in 1962 as a result of the war between China and India. During the emergency, pursuant to the Defence of India Rules, 1962 that were made under the Defence of India Act, 1962, the Central Government was empowered to:

- order the seizure of any aircraft belonging to the enemy or any aircraft or class of aircraft which was owned or operated by, or in the possession or custody of any person domiciled or resident in an enemy territory or any aircraft or class of aircraft, the operation of which was likely to aid or

332*Ibid*, s. 106(1).

333*Ibid*, s. 115(c).

334*Ibid*, s. 115(e).

335*Ibid*, s. 115 *proviso*.

assist the enemy or was likely to be prejudicial to the defence of India or to public safety and also to require any aircraft or class of aircraft to be placed at the disposal of any authority specified therein[336];

- authorize any person to, where it appeared necessary in the interest of the defence of India and civil defence to do so, order that any particular aircraft at any place in India shall not leave that place until permitted to do by such authority or person as prescribed in that order[337];
- requisition any aircraft if it was considered necessary or expedient to do so. During the period of requisition, the property rights in the aircraft vested in the Government, which could deal with the aircraft in such manner as appeared expedient. The authority which requisitioned the aircraft was enjoined, as far as possible, to restore the aircraft in such condition as it was when possession of it was taken[338];
- acquire any requisitioned aircraft, which would vest absolutely in the Government after the acquisition, free of any encumbrances or charges[339]; and
- offer compensation for the above requisition or acquisition of the aircraft.[340]

This power was again exercised by the Government during the emergency declared in India in 1971 under Defence of India Act, 1971 and the rules made thereunder. In both the above-mentioned cases, the acts and the rules became inoperative six months after the revocation of the emergency order.

E. Miscellaneous:

- If an aircraft is being used as a conveyance to transport illegal drugs, it can be confiscated under the Narcotic Drugs and Psychotropic Substances Act, 1985;

336 *The Defense of India Rules, 1962* (India), 1962, s. 105A.

337 *Ibid*, s. 105.

338*Ibid*, ss. 108 and 109.

339*Ibid*, 1962, s. 110.

340*Ibid*, ss. 111 and 112.

- Under section 201(2) of the Income Tax Act, 1961, the taxes which have become overdue, along with the interest, form a charge on all the assets of the person or company. Under section 222 of the Income Tax Act, the Tax Recovery Officer is empowered to recover the arrears in taxes "by attachment and sale of the assessee's movable property".

Chapter Five

Insurance and Taxation

Insurance and taxation are two of the most important aspects of an aircraft financing transaction. Due to the extremely high potential for damage in aircraft crashes and other accidents, adequate insurance is a prerequisite for an aircraft to fly anywhere in the world. It also serves as a second layer of security for the financier, after the aircraft itself. Taxation has to be taken into account for the structuring of every aircraft financing transaction as its incidence or the lack thereof has a considerable impact on the overall cost of the transaction. In fact, a number of innovative financing techniques owe their inception to efforts to minimize taxes. An in-depth discussion of the two topics is outside the scope of this paper but a brief description is given below. It is to be noted that the taxes and duties that are described in the following section are meant to be illustrative rather than exhaustive.

I. Insurance

A. General Characteristics of Insurance

Insurance works by spreading the risk that an individual would otherwise bear alone to the rest of the community. An insurance contract is a contract where one party (called the insured) makes fixed payments to another party (called the insurer) for the right to receive compensation upon the happening of a specified event which causes economic loss to the insured. An insurance contract traditionally has the following characteristics:

(i) The insured must have an insurable interest i.e. the insured must bear a risk of sustaining economic loss;

(ii) The economic loss must result from the happening of an uncertain event. Therefore, insurance contracts are said to be aleatory contracts where the economic obligations of the insured and insurers are unequal i.e. the insured must pay a fixed premium during the lifetime of the insurance policy irrespective of whether or not the specified trigger event

occurs whereas the obligation of the insurer to pay only arises when the event takes place;

(iii) There must be transfer of some risk from the insured to the insurer for valuable consideration;

(iv) The contract must be based on the principle of *uberrimae fidei* i.e. utmost good faith which means that there must be complete disclosure of relevant information by the insurance purchaser to enable the insurance company to properly assess the risks involved. The contravention of this obligation can be in the form of a breach of warranty, concealment or misrepresentation;

(v) It must fulfill the requirements of a contract i.e. there must be offer and acceptance and the object of the contract must be lawful and not contrary to public interest;

(vi) Insurance contracts are generally contracts of adhesion. In interpreting the contract clauses, the rule of *contra proferentum* is applied which confers the responsibility for the clarity of the language of the contract on the party who drafts it (the insurance company in this case). The rule provides that if the language is open to more than one interpretation, ambiguities are construed against the drafter i.e. the interpretation which is favorable to the insured will be upheld;

(vii) The insurance contract usually contains a right of subrogation whereby the insurance company has the right to step into the shoes of the insured and pursue a claim against the person who has caused damage to the insured's property, for which the insurance company has paid under the policy; and

(viii) The term of the insurance contract is normally an year.

An insurance contract can be a contract of indemnity which is compensatory in nature i.e. the payment to be made by the insurer under the policy is restricted to the actual economic loss suffered by the insured, or it can be a valued contract where the insurer is required to pay a fixed amount.

The insurance company further transfers the risks of the policyholder to other insurance companies through reinsurance, enabling it to increase its underwriting capacity and to diminish its liability in case of serious and costly accident. The main forms of reinsurance are:

- Facultative[341] – it refers to reinsurance of a single risk which is either the same as the original risk or a part thereof. This means that reinsurance of every policy is separately negotiated;
- Treaty[342] – it is the reinsurance of the entire account of the insurance company i.e. reinsurance of a collection of policies which fall within a set of pre-defined parameters. This is particularly advantageous to the insured as reinsurance is automatically affected whenever there is a new addition to the insured's account;
- Excess of loss - here a certain claim limit is fixed beforehand and any payment beyond this limit and up to a specific maximum limit is made by the reinsurance company. Thus small claims can be paid by the company that has bought reinsurance while for larger claims separate layers of excess of loss coverage can be obtained until the maximum payment limit is attained.

Normally, when an event of loss which is not a total loss occurs, the insured is required to pay a deductible which literally means a deduction from the amount that the underwriters owe to the insured. The rationale behind the deductible is to prevent the insured from looking to the insurance company for small claims and to encourage prudential risk management. If the deductible is high, as for example in the case of large aircraft, it is possible to reduce it by taking a deductible insurance policy.

In India, the contract of insurance, like any other contract is governed by the Indian Contract Act, 1872 (please see chapter one of this paper, where the basic requirements of contract have been discussed). Where a specific insurance statute has been enacted, which is rare in India, the provisions of that statute are applicable but otherwise the remaining portion of this area of law is mostly covered by certain provisions of the Companies Act, 1956, principles of law of torts, mercantile usage and customs, and court decisions.

341Facultative has been defined in section 2(d) of the *(General Insurance – Reinsurance) Regulations 2000* (see *infra* note 365) as "reinsurance of a part or all of a single policy in which cession is negotiated separately and that the reinsurer and the insurer have the option of accepting or declining each individual submission." Here cession (as defined in section 2(c) of *the Regulations*) refers to "the unit of insurance passed to a reinsurer by the insurer which issued a policy to the original insured and, accordingly, a cession may be the whole or a portion of single risks, defined policies or defined divisions of business, as agreed in the reinsurance contract."

342 Treaty is defined in section 2(i) of the *(General Insurance – Reinsurance) Regulations 2000* (see *infra* note 365) as "a reinsurance arrangement between the insurer and the reinsurer, usually for one year or longer, which stipulates the technical particulars and financial terms applicable to the reinsurance of some class or classes of business."

B. Aviation Insurance

Aviation insurance is somewhat different from the rest as its premium-paying customer base is very narrow i.e. the airlines are limited in number but the potential for damage is enormous. Therefore, the insurance generally has several layers and the policies are underwritten by a number of underwriters, each carrying a small percentage of the risk. There are mainly two types of policies: aircraft hull and liability. The former provides coverage for damage or destruction of the airframe while the latter covers the liability of the operator or the owner arising from damage caused by the aircraft to life and property as for e.g. injuries to the passengers, damage to the cargo or property on ground etc. The following are the main categories of aircraft insurance:

1. Hull All Risks.

This policy normally covers every type of physical loss or damage to the aircraft, while it is in flight, taxing, on ground or moored, apart from certain exceptions which normally include: wear and tear, gradual deterioration, structural defects, mechanical or electrical breakdowns, damage to the engines caused by ingestion of stones, grit, ice, dust etc. as these are considered to be operating expenses and not insurable perils. The aim of the policy is to restore the aircraft to its pre-loss condition which may be done by the insurance company replacing the aircraft at its option or by paying its insured value. The insurance company usually undertakes to pay on an agreed value basis when the aircraft in question is new and its model and type are in demand. However, the reduction in the resale value of the aircraft caused by the accident and the consequent repair is not taken into account when the claim is settled. If, as a consequence of repairing the aircraft, an enhancement is effected in the aircraft, a payment called 'betterment' is usually required to be made by the insured. Where only a part of the aircraft needs to be repaired, a 'component parts clause' in the policy is used to limit the liability of the underwriter to a certain percentage of the total insurance value relating to that part, so that the cost of repairing it does not exceed the value of the aircraft, which may happen if the aircraft is old.[343] Engines are covered by the hull all risk policy but it is also possible to get separate insurance coverage for them.

343See Bunker, *supra* note 45 at 463-466.

2. War Risk.

It covers physical loss of or damage to the aircraft and its passengers caused by war, hijacking and allied perils and third party liabilities resulting therefrom. Although the hull all risk policy uses the word 'all', it is a misnomer as the policy excludes damage to the aircraft resulting from war and other related risks. For this purpose, the London aviation insurance market has used a standard exclusion clause called AVN48B - War Hijacking and Other Perils Exclusion Clause, since 1968. AVN48B provides that "[t]he policy does not cover claims caused by:

(a) War, invasion, acts of foreign enemies, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, martial law, military or usurped power or attempts at usurpation of power.

(b) Any hostile detonation of any weapon of war employing atomic or nuclear fission and/or fusion or other like reaction or radioactive force or matter;

(c) Strikes, riots, civil commotions or labour disturbances.

(d) Any act of one or more persons, whether or not agents of a sovereign Power, for political or terrorist purposes and whether the loss or damage resulting therefrom is accidental or intentional.

(e) Any malicious act or act of sabotage.

(f) Confiscation, nationalisation, seizure, restraint, detention, appropriation, requisition for title or use by or under the order of any Government (whether civil military or de facto) or public or local authority.

(g) Hijacking or any unlawful seizure or wrongful exercise of control of the Aircraft or crew in Flight (including any attempt at such seizure or control) made by any person or persons on board the Aircraft acting without the consent of the Insured."

Additionally, the claim arising while the aircraft is not under the insured's control because of any of the abovementioned perils is outside the scope of the policy. The control of the insured over the aircraft is deemed to have been restored when the aircraft returns to the insured at a suitable airfield within the geographical limits of the policy and the aircraft is parked with its engines shut down and under no duress. In August 2006, AVN48C and AVN48D were

introduced by the Aviation Insurance Clauses Group (AICG)[344], which provide alternative forms of clause (b) of AVN48B to enhance the scope of the exclusion to cover hostile use of weapons of mass destruction that include radioactive contamination (dirty bombs), electromagnetic pulse devices, chemical and biological weapons.

On payment of additional premium, it is possible to 'write back' or restore the insurance cover for certain areas of exclusion mentioned above by way of an extended endorsement coverage which is then attached to the policy. For example, in respect of aircraft hull, AVN51 provides write backs for clauses (c), (e) and (g) of AVN48B, while for aircraft liability, AVN52C reinstates almost all the clauses of AVN48B subject to certain conditions. Other variations of the write back clauses that can be used by aircraft operators and service providers include AVN52D, AVN52E, AVN52F, AVN52G and those produced by AICG – AVN51A for hull and AVN52H, AVN52J, AVN52K and AVN52L for liability. However, it is to be noted that writing back of the weapons of mass destruction, including atomic and nuclear detonation exclusion in clause (b) of AVN48B, is not available although some part of its extended form, as specified in AVN48C and AVN48D, can be written back into the policy. Coverage is also not provided for an outbreak of war between any two or more of the following countries, namely China, France, Russia, UK and USA, and for requisition of the aircraft either for title or use. All war risk endorsements have an aggregate limit and are normally on an agreed value basis. They also contain clauses which permit the insurers to cancel: (a) one or more parts of the endorsement after a 48 hour notice upon occurrence of a hostile detonation, and (b) the entire endorsement after a seven day notice to enable them to preserve their solvency if there is a catastrophic event. The full cancellation provision was invoked worldwide for the first time when the terrorist attacks occurred in US on 11 September 2001.

The tragic events of 9/11 lead to unprecedented losses and paralysis of the market which had never been encountered or contemplated before. The capacity of the underwriters could not cover their exposure and as a result, the State was obliged to step in. Since such attacks are directed towards States, it was felt that the States have a responsibility to provide coverage where the underwriters were unable to do so. In October 2001, a Special Group on Aviation War Risk

344Aviation Insurance Clauses Group (AICG) was established on 24 June 2005 to propose and publish insurance policy wordings and clauses in the London market. AICG replaced the Joint Technical and Clauses Committee which had performed this function from 1961. AICG comprises of members from the Lloyd's Market Association (LMA) Aviation Committee and the International Underwriting Association (IUA) Aviation Technical Committee and other individuals who have the relevant legal or technical expertise.

Insurance was set up by ICAO's Council to come up with recommendations for an appropriate worldwide assistance mechanism for airlines and other affected parties, which would become operational as and when required and cover the gap left open by the coverage provided by insurance markets. As a short term solution, the Group recommended that an international mechanism called Globaltime should be set up to provide non-cancellable third party aviation war risk coverage through a non profit special purpose insurance entity, which would be funded by insurance premiums and have multilateral Government backing during the initial years. Globaltime was never implemented as a sufficient number of States failed to confirm their intention to participate. For a long term solution, it was proposed that an international convention should be developed to limit third party liability for losses arising from war and allied perils. At present, efforts are underway to modernize the Rome Convention of 1952[345] under the auspices of ICAO to provide a comprehensive liability regime. The insurance cover was reinstated by the underwriters after the crises was over and the market had stabilized at full policy limits for passenger liability but limited to a maximum of USD 50 million for all third party injury and property damage. Eventually, additional capacity became available in excess of this limit to a maximum of USD 1 billion for any one occurrence subject to a USD 2 billion in aggregate. At present, full liability coverage is provided for weapons of mass destruction but there is a possibility that the insurers may withdraw this and go for total exclusion.

Despite the failure of Globaltime and other similar initiatives, some Government supported programs were launched on a national level. One such example is in USA, where pursuant to the Homeland Security Act, 2002, the FAA provides war risk hull loss and passenger, crew, and third-party liability insurance. At present, the insurance is available until 31 August 2008.[346] The definition of 'War Risk Occurrences'[347] in the policy is very similar to the exclusions of AVN48B. The FAA coverage places the US carriers in an advantageous position as the insurance coverage for passenger and third party liabilities for US airlines is approximately USD 0.70 per passenger compared to almost USD 3.00 outside of the US. The

345*Convention on Damage Caused by Foreign Aircraft to Third Parties on the Surface*, 7 October 1952, (entered into force on 4 February 1958), [*Rome Convention, 1952*].

346Aviation War Risk Insurance Program, Federal Aviation Administration, online: Federal Aviation Administration < http://www.faa.gov/about/office_org/headquArticleers_offices/aep/insurance_program/> (accessed on 26 January 2008).

347Extent of Coverage, Federal Aviation Administration, online: Federal Aviation Administration < http://www.faa.gov/about/office_org/headquArticleers_offices/aep/insurance_program/ext_coverage/media/Boilerplate%20ThreepArticle%20Mar%2031-Aug%2031%202008.pdf > at para V(F) (accessed on 26 January 2008).

total cost in US is USD 140 million per year while for outside of US, it is over USD 1.5 billion per year.[348]

In India, a similar effort was made by the private sector. The general insurance industry set up an independent pool comprising of funds collected from all insurers to offset such losses. In 2001, the limit per risk was INR 300 crores, which was increased in February 2005 to INR 500 crores. The cover through the pool is available as a buy back. The pool is managed by the General Insurance Corporation of India. The events of 9/11 led to an increase in the insurance premiums for third party liability, which resulted in some Indian airlines being left with no cover at all as they were unable to come up with the difference in premium at such short notice. Air India was forced to ground four of its newly leased aircraft, when the lessors exercised their rights under the lease agreements to have the aircraft grounded in absence of adequate insurance. The cover was restored only when the Government provided a letter of comfort to cover the shortfall for the two State carriers.

Another ancillary policy entitled 'political risks' policy may be used by the owner or lessor of the aircraft to cover financial loss arising from various political perils like terrorism, political turmoil, expropriation of aircraft, non payment by a sovereign obligor, breach of contract, currency conversion and transfer etc.

3. Liabilities.

The main types of aircraft liabilities for which insurance coverage is obtained are:

(a) Passengers liability – this policy covers all amounts which a carrier is legally liable to pay for death or bodily injury of a passenger caused while embarking, disembarking or on board the aircraft and for baggage claims. A limitation of liability of the carrier is provided by the Warsaw Convention of 1929 and the Montreal Convention of 1999[349] in case of international carriage. Article 50 of Montreal Convention requires the operator to procure and maintain adequate insurance to cover its liabilities under the Convention. The conventions also

348War Risk Insurance, International Air Transport Association, online: International Air Transport Association < http://www.iata.org/pressroom/facts_figures/fact_sheets/war-risk-insurance.htm>.

349 *Convention for the Unification of Certain Rules for International Carriage by Air*, 28 May 1999, ICAO Doc 9740, (entered into force 4 November 2003) [*Montreal Convention*].

places an obligation on the carrier to compensate the passengers for denied boarding or any delay thereof, which may also be covered by the policy. India is a party to the Warsaw Convention, 1929[350] as amended by the Hague Protocol 1958[351] and has decided to adhere to the Montreal Convention.

(b) Cargo liability – it provides coverage for an air carrier's liability arising from damage, destruction or loss of cargo during shipment.

(c) Third party legal liability – this policy protects the insured from claims made by third parties other than passengers, where death or injury of such parties or damage to property on ground or in air (i.e. outside the aircraft) is caused by the aircraft or an object falling from the aircraft. Generally, damage arising from sound or pollution is not covered unless it is caused by an accident in which the aircraft is involved but it can be purchased separately.[352] The liability of the aircraft operator usually depends upon the national law and may range from absolute liability for damage caused on ground to more ordinary claims under the tort law or the concerned legislation, unless the State is a party to the Rome Convention, 1952. The convention provides that any person on ground who suffered damage resulting from an aircraft in flight or because of any person or thing falling from the aircraft, is entitled to compensation from the aircraft operator where the direct cause of such damage is the incident and not the flight itself.[353] The convention also provides a limitation of liability of the operator[354], who may be required to carry insurance or provide security to cover its liability by the Contracting State in which the damage occurs, where the aircraft is registered in another Contracting State.[355] India is not a party to this convention.

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350 *Convention for the Unification of Certain Rules Relating to International Carriage by Air,* 12 October 1929, ICAO 7838 (French text), [entered into force on 13 February, 1933].

351 *Protocol to Amend the Convention for the Unification of Certain Rules Relating to International Carriage by Air signed at Warsaw on 12 October 1929*, 22 September 1955, ICAO Doc 7632, [entered into force on 1 August 1963]

352 Bunker, *supra* note 45 at 456

353*Rome Convention, supra* note 345, Article 1(1) read with Article 2(1).

354*Rome Convention, supra* note 344,, Article 11.

355*Rome Convention, supra* note 344, Article 15(1) and (4).

Often, the airlines use a single policy to cover their liability exposure, usually on a combined single limit basis which means that bodily injury is combined with property damage for passenger and third party liability.

(d) Aircraft product liability – this policy provides coverage to manufacturers of aviation and aerospace products like airframes, engines, avionics and other components against claims resulting from an accident caused by faulty design or workmanship, and providers of services such as ground handling, repair, maintenance of aircraft etc. The policy could be on the 'risk attaching' basis or 'losses occurring' basis. In case of the former, all aircraft that are built during the term of the policy are covered by it, irrespective of when the product liability claim actually arises. The latter policy covers all claims which occur during the term of the policy, irrespective of the date of manufacture of the aircraft.[356]

4. Aircraft Spare Parts.

It covers aircraft engines, spare parts, and equipment while the property is on the ground or is being carried as cargo by air, land, or waterborne transit. Once the equipment has been fitted to or placed on board the aircraft, it is excluded from coverage. The policy also does not insure engine loss or damage while it is running or being tested, mechanical or electrical derangement, loss or damage to detached property that will be refitted to the aircraft and not replaced, or property carried on the aircraft as a spare parts kit.

Under Indian law, an aircraft registered in India can only be insured by an insurance company whose principal place of business is located in India, unless prior permission of the Central Government to use a foreign insurer is obtained.[357] As mentioned elsewhere in this paper, there is usually a statutory requirement to maintain aircraft insurance and in some jurisdictions, minimum standards are also provided. In India, the rules laid down by the DGCA for grant of an operator's permit require the operator to acquire sufficient insurance "to cover its liability towards passengers and their baggage, crew, cargo, hull loss and third party risks in compliance with the requirements of the Carriage by Air Act, 1972, or any other applicable

356See Bunker, *supra* note 45 at 460 - 461.

357*General Insurance Business (Nationalisation) Act, 1972*, (India), 1972, c VII, s. 25.

law."[358] The Carriage by Air Act was enacted to implement the Warsaw Convention and its amendment by the Hague Protocol and specifies that the liability of the carrier for each passenger is limited to 250000 francs.[359] For registered baggage and goods it is limited to 250 francs per kilogram, unless a declaration regarding the value of the package is made by the consignor at the time of delivery, and for objects which the passenger takes charge of, it is 5000 francs per passenger.[360] Apart from this, no minimum threshold of insurance coverage has been prescribed. At present, a Bill[361] to give effect to the Montreal Convention is pending in the Indian parliament.[362] If the Bill is passed, the limits for the carrier's liability will be increased[363] and there will be a statutory requirement to maintain adequate insurance to cover such liability. Aircraft leases in India also specify the exact amount of insurance for the different types of policies which a lessee is required to maintain during the lease term. The Indian aviation insurance policies use language similar to the AVN templates but some of the provisions may not be available.

With respect to reinsurance, every insurer in India is required to cede to the national reinsurer - General Insurance Corporation, a given percentage of each policy for different classes of insurance (not exceeding 30%) as specified by the Insurance Regulatory Development Authority (IRDA).[364] The reinsurer is required to "retrocede at least 50% of the obligatory cessions received by it to the ceding insurers after protecting the portfolio by suitable excess of loss covers."[365] The rest of the percentage of reinsurance can be placed with Indian or foreign reinsurers. As regards foreign reinsurers, the relevant regulations specify that only reinsurers, who have been rated at least BBB for the last five years by Standard & Poor or have received an equivalent rating by any other international rating agency, or Lloyd's syndicates, can be used.

358*CAR - Grant of Permit, supra* note 38 at para 10.12.

359 *The Carriage by Air Act, 1972*, (India), 1972, Schedule II, c III, rule 22(1).

360 *Ibid*, rule 22(2) and (3).

361 Bill 50 of 2007, The Carriage by Air (Amendment) Bill, 2007, 14th Lok Sabha 11th Sess., 2007.

362 The Bill was passed by the Lok Sabah (the lower house of the Parliament) on April 30, 2008 and now awaits the approval of the Rajya Sabha (the upper house of the Parliament).

363The limits of liability imposed by the Montreal Convention are: (i) 100,000 Special Drawing Rights (SDR) in case of death or injury to the passenger (where the death or injury is not caused due to negligence or other wrongful act or omission of the carrier), (ii) 4,150 SDR for delay in carriage and (iii) 1,000 SDR for loss, damage or delay in carriage of baggage. See *supra* note 353, Articles 21 and 22.

364*The Insurance Act, 1938*, (India), 1938, part IV-A, s. 101A (1) and (2) [*Insurance Act*]

365*(General Insurance – Reinsurance) Regulations, 2000* (India), 2000, Insurance Regulation Development Authority, c II, s. 3(11), [*Reinsurance Regulations*].

Placements with other reinsurers will require the approval of IRDA.[366] An example that can be mentioned here is insurance carried by Air India. Its annual insurance cycle runs from 1 July to 30 June. For the year 2006, Air India's domestic insurers were a consortium of public sector insurance companies led by New India Insurance Company, and 90% of the risk was placed with Lloyd's.[367] The insurers were selected through a bidding process.

It is to be noted that under the Insurance Act, "[t]he holder of a policy of insurance issued by an insurer in respect of insurance business which is transacted in India, after the commencement of this Act, shall have the right, notwithstanding anything to the contrary contained in the policy or in any agreement relating thereto, [to] receive payment in India of any sum secured thereby and to sue for any relief in respect of the policy in any court of competent jurisdiction in India. Where the suit is filed in India, any question of law arising in connection with such policy will be determined according to the law in force in India."[368]

C. Insurance in Aircraft Financing

Since insurance serves as collateral in an aircraft financing transaction after the aircraft itself, it is vital for the financier to ensure that adequate cover is obtained. In an aircraft leasing transaction, the obligation to procure and maintain insurance according to the legal requirements of the State of registry or any other State in which the aircraft operates, normally falls on the shoulders of the lessee, with the exception of a wet lease where the lessor provides the insurance. Since the lessor or lender will not have a direct relationship with the insurers and the reinsurers, its main objective is to ensure that if any damage to the aircraft occurs, a commensurate value will be recoverable through insurance, the lessor/lender will be entitled to collect the insurance proceeds, such entitlement will not be jeopardized by the actions of the lessee and there will be a direct right to move against the insurer and reinsurer.[369] This is accomplished by means of including detailed provisions in the lease about the scope and level of insurance cover and the contents of the policy, which *inter alia* specify that:

366*Ibid*, c II, s. 3(7).

367S. Anil Radhakrishnan, "AI aviation renewal in July", *The Hindu* (24 February 2007), online: *The Hindu* <http://www.hindu.com/2007/02/24/stories/2007022401762100.htm>.

368*Insurance Act*, *supra* note 364, part II, s 46.

369See Hollow*ay*, *supra* note 46 at 252.

(a) Throughout the lease term, the lessee will at its own expense, effect and maintain insurance/reinsurance through brokers and with insurers of recognised standing who normally participate in aviation insurances in the leading international insurance markets. This ensures that the underwriters are well capitalized and are not located in a difficult jurisdiction.

(b) The lessee will be responsible for payment of any deductibles under the insurance.

(c) The insurance policy shall name the lessor and/or financier as additional insured. This ensures that:

- "there is a direct contractual relationship with the insurers;
- any claim would have to be negotiated with the lessor/mortgagee as well as the operator; and
- as the interest of the lessor/mortgagee in the insurance is original and not derivative (i.e. through the operator), the interest is not liable to prejudice to the same extent (e.g. on a breach of warranty by the operator)."[370]

With regard to hull policies, the reason for the inclusion of the lessor or the financier is apparent. In respect of liability insurance, the lessor/financier is included as the additional assured because although the lessor/financier is not involved in the day to day operations of the aircraft, it may nevertheless be impleaded as a party in a lawsuit along with the airline, because of its perceived 'deep pockets'. Moreover, the owner or lessor may have some liability on the basis of a duty of care, exercise of control or interference in the operation of the aircraft, or because the contracted act to be done is unlawful or dangerous. Therefore, not only the owner, lessor and financier but their shareholders, affiliates, directors, officers, agents, employees, servants, successors, assigns and transferees are named as additional insured.[371] To keep the interests of all the insureds separate, the liability policy operates in all respects as if a separate policy had been issued covering each insured party. This also establishes a direct contractual relationship between the lessor/lender, autonomous from that of the lessee, and ensures that the lessor/lender has the same rights as if it had indeed obtained a separate policy.[372]

370 Peter J.C. Viccars, "Insurance Considerations", *Aircraft Financing supra* note 168, 305 at 314 [Viccars].

371See *Ibid* at 316.

372 See Hollow*ay*, *supra* note 46 at 259.

Another point worth mentioning here is the indemnity given by the operator. Generally, the lease/financing documents contain a provision whereby the operator agrees to indemnify the lessor/financier and to hold it harmless against any claims arising out of ownership or operation of the aircraft, where the lessor/financier is not at fault. In case a third party claim is made against the lessor or the lender, the indemnity of the operator coupled with the insurance provides a cover for the exposure of the lessor/lender.

(d) A loss payable clause shall be included in the policy whereby the lessor/financier/mortgagee is named as the (sole) loss payee which means that on the happening of certain specified events like total loss, all payments will be made directly to the named person, bypassing the lessee. This provision is not applicable to liability policies as payments pursuant to such policies are made to third parties.

(e) The lessee shall assign its right, title, benefit and interest in certain insurances to the lessor or any other person specified by the lessor. This supports the loss payable clause.

(f) With respect to the interests of each of the additional insureds, the insurances will not be invalidated by any act or omission of any other person which results in a breach of any term, condition or warranty of the policy, provided that the additional insured has not caused, contributed to or knowingly condoned the said act or omission. The effect of this clause is to ensure that the financier receives its money even though the airline may have forfeited its right to payment by not complying with any term, condition or warranty of the policy. Examples of such non compliance are: the airline using pilots who are not properly qualified, the aircraft is operated outside of the manufacturer's limits etc.

(g) The lessee is not permitted to take out any other insurance or reinsurance apart from what is required under the lease agreement. If there is more than one policy covering the same loss, the insurers have a right to ask for ratable contributions from other insurers. Their liability is then limited to a certain percentage of the total cover provided by all the applicable insurance policies. Thus, the sum collected could be less than the requisite amount, which is the reason for the above prohibition.[373]

(h) To protect the interests of the lessor/financier/mortgagee, the insurers are required to give a notice of at least 30 days before the provided cover may be cancelled or materially altered in a manner adverse to the additional insureds, except in respect of any provision

373See Viccars, *supra* note 370 at 315.

for cancellation or automatic termination specified in the relevant policy or any endorsement thereof. Notice is usually deemed to commence from the date on which it is given and not when it is received.

(i) The additional insureds will have no obligation or responsibility for the payment of any premiums due (though they may reserve the right to do so at their option) and that the insurers will not exercise any right of set-off or counter-claim in respect of any premium due other than outstanding premiums relating to the relevant aircraft.

(j) The reinsurance is on the same terms as the original insurances and the obligation of the reinsurers to make payment under the policy overrides their bankruptcy, insolvency, liquidation, dissolution or similar proceedings. The policy usually contains a 'cut-through' clause which requires payment of a claim to be made directly to the person named as loss payee under the original insurance policy instead of the primary insurers, subject to proof of loss and such a provision not contravening any applicable law. The 'cut-through' clause is not recognized in many jurisdictions. Under English law, it was initially unenforceable due to lack of privity of contract between the reinsurers and the person named as loss payee (usually the lessor or the lender), until the coming into force of the Contract (Rights of Third Parties) Act of 1999. Although the 'cut-through' clauses are used in India, their efficacy has not been tested yet.

(k) Any changes in the insurers and reinsurers will be subject to the approval of the lessor/financier.

(l) If at any time the full insurance cover or any part thereof is cancelled, the lessee is required to forthwith ground the aircraft and keep it grounded until the cover is restored. If the lessee does not abide by the terms and conditions of the insurance policy, lessee is liable to the lessor for any damage sustained to the aircraft up to its insured value.

The insurance industry also uses a standard endorsement called AVN67B - Airline Finance/Lease Contract Endorsement to address the insurance requirements of the lessor/financier. If there is a conflict between the policy and AVN67B, it is the provisions of AVN67B which prevail.[374] AICG is working on a new version of AVN67B, namely AVN67C and a Finance/Lease Continuing Liability Endorsement which would provide a standard

374Bunker, *supra* note 45 at 483

approach to address ongoing obligations of the underwriters to the lessor or the financiers after the termination of the lease or the financing.

In a cross border lease transaction in India, the following insurance related documents are usually required by the lessor:

- Certificate of insurance for the aircraft;
- Broker's letter of undertaking where the insurers undertake to pay to the loss payee all insurance and reinsurance proceeds and promptly notify the lessor/owner/security trustee of any event which affects the policy and their interest in it;
- Assignment of insurance wherein the lessee assigns by way of security its rights and interests in the insurance proceeds and requisition compensation to the lessor or any other person nominated by the lessor. Sometimes, the lessor may also ask for an assignment of reinsurances by the lessee. However, the effectiveness of this is not certain as the lessee is not a party to the reinsurance which is between the reinsurers and the primary insurers. Another option could be to ask the primary insurers to assign their interest in the reinsurance but it is likely that the reinsurance contract may forbid this.[375] However, the reinsurers can be asked to acknowledge that they are aware of the assignment of the primary insurance policy[376];
- Notice of the assignment of insurance to the brokers and their acknowledgement thereof.

II. Taxation and Duties

Most aircraft leases are on a net basis i.e. the payment to the lessor is made net of any taxes, which are paid by the lessee, unless such taxes are imposed in the jurisdiction in which the lessor is located. A brief description of taxes and duties that may have to be paid in India in relation to an aircraft is given below:

A. Withholding Tax.

Pursuant to section 10(15A) of the Income Tax Act, 1963, an exemption was available to the Indian carriers until 1 April 2007, with respect to withholding taxes chargeable on payments made for the purposes of leasing an aircraft or an aircraft engine, except for payment made in connection with spares, facilities or services required for operation of the leased aircraft. Now,

375See Hollow*ay*, *supra* note 46 at 261. Also see Viccars, *supra* note 370 at 318.

376 See Viccars, *supra* note 370 at 318.

the lessee is required to deduct withholding tax at the specified rate that can range from 0% to 40% depending upon the rate given in the Double Taxation Avoidance Agreement between India and the country where the lessor is located.

B. Value Added Tax (VAT).

VAT was introduced from 1 April 2005 and has replaced sales tax in India. The governing legislation differs with each State. Under the Delhi Value Added Tax Act, sales for the purpose of charging VAT is defined as "transfer of property in goods by one person to another for cash or for deferred payment or for other valuable consideration" and includes "a transfer of goods on hire purchase or other system of payment by installments, but does not include a mortgage or hypothecation of or a charge or pledge on goods".[377] Therefore, leases are also included in this definition. However, the following sales are exempt from levy of VAT:

- Sales made outside of Delhi;
- Sales made in the course of inter-State trade or commerce; and
- Sales made in the course of import of the goods into or export of the goods out of India.[378]

Otherwise, VAT on sale of aircraft is charged at the rate 12.5%.[379]

C. Tax on Profits and Gains.

A non-resident aircraft operator is charged tax at the rate of five percent of the total of the following amounts as profits and gains of business or profession:

(a) "the amount paid or payable (whether in or out of India) to the assessee on account of the carriage of passengers, livestock, mail or goods from any place in India; and

(b) the amount received or deemed to be received in India by the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India."[380]

377*Delhi Value Added Tax Act, 2004*, (India), 2005, c I, s 2(zc) [*Delhi VAT Act*].

378*Ibid*, c II, s. 7.

379*Ibid*, c II, s. 4(1)(e).

IV. Investment Allowance.

Section 32B of the Income Tax Act provides for investment allowance or investment tax credit in respect of newly acquired aircraft in India. However, since 1990 the allowance under this section has not been available.[381]

V. Stamp Duty.

Pursuant to the Indian Stamp Act, stamp duty is charged on the following instruments:

- every instrument executed in India;
- bill of exchanges (not payable on demand) or promissory notes executed abroad but which are or will be accepted and paid or dealt with in any manner in India as for example endorsed, transferred or negotiated in India;
- all other instruments executed abroad that are associated with any property in India, or concern any matter or thing done or to be done, in India, when they are brought into India.[382]

If the instrument is executed by a person in India, it is mandatory to have it stamped prior to or at the time of execution[383] but in case of an instrument (except for a bill of exchange or promissory note) executed outside of India, it can be stamped within three months of being initially brought into India.[384] Depending upon the type of the instrument and the prescribed rules, stamping can be done by means of adhesive stamps or paper stamped with impressed stamp can be used.[385] The amount of duty charged differs with each State in India, for example: stamp duty charged in Delhi[386] for mortgage deed is 2% of the amount secured, subject to a ceiling of INR 200,000, while in Mumbai it is INR 5 for every 1000 or part thereof for the

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380 *Income Tax Act*, *supra* note 110, c IV, s 44BBA.

381(India), Ministry of Finance, Department of Revenue, Income Tax Notification No. SO 233(E) (19 March 1990).

382*Indian Stamp Act, 1899*, (India), 1899, c II, s. 3, [*Stamp Act*].

383 *Ibid*, c II, s. 17.

384 *Ibid*, c II, s. 18(1).

385 *Ibid*, c. II, ss. 10-13.

386*Ibid*, *Stamp Act as applied to the National Capital Territory of Delhi*, Article 40, schedule 1A. Additional duties may also be levied. For e.g. pursuant to section 3B of the *Stamp Act (Delhi)*, additional duty of 10 paise on most instruments is charged for refugee relief.

amount secured, subject to a minimum of INR 100 and a maximum of INR 1,000,000.[387] The obligation to pay the stamp duty rests with the person executing the deed.[388]

An instrument which is not stamped or improperly stamped is inadmissible as evidence for any purpose.[389] Moreover, if such an instrument is produced before any person who has, by operation of law or consent of parties, the authority to receive evidence, or a person holding a public office (except a police officer), it is liable to be confiscated.[390] A penalty equal to ten times the amount of the entire duty or the portion of the duty which has not been paid may be charged.[391]

VI. Custom and Excise Duties.

Aircraft imported by the Central Government, the State Governments, public sector undertakings[392] and scheduled air operators are exempt from custom and excise duties. However, aircraft and parts of aircraft imported for private use are subject to 3% customs duty[393], 16% excise duty[394], 16% countervailing duty and 4% additional duty[395]. Aircraft, which are brought in India only for the purpose of flight to or across India, and are not registered or intended to be registered in India and which will be removed from India within six months of the date of entry, are also exempt.[396] Helicopters are also subject to a 3% custom duty.[397]

387*Bombay Stamp Act, 1958*, (India), 1958, Article 40, schedule 1.

388 *Stamp Act*, *supra* note 358, c. II, s. 29

389*Stamp Act*, *supra* note 358, c. IV, s. 35.

390 *Stamp Act*, *supra* note 358, c. IV, s. 33.

391*Stamp Act*, *supra* note 358, c. IV, s. 35.

392(India), Ministry of Finance, Department of Revenue, Custom Notification No. 39/96, (23 July 1996), online: Central Board of Excise and Customs < http://www.cbec.gov.in/customs/cs-act/notifications/notfns-before2k/cs39-96c.htm> .

393 (India), Ministry of Finance, Department of Revenue, Custom Notification No. 21/2002 as amended by Notification No. 20/2007, (1 March 2007), online: Ministry of Finance < http://indiabudget.nic.in/ub2007-08/cen/cus2007.pdf> [*Custom Notf No. 21/2002*].

394(India), Ministry of Finance, Department of Revenue, Central Excise Notification No 6/2006 as amended by Notification No 6/2007, (1 March 2007), online: Ministry of Finance < http://indiabudget.nic.in/ub2007-08/cen/cex0607.pdf>.

395See "Aviation Provisions in Budget 2007-2008", Federation of Indian Airlines, online: Federation of Indian Airlines <http://www.fiaindia.in/budget_Statement.htm>.

396*Custom Notf No. 21/2002*, *supra* note 393.

397*Ibid.*

Chapter Six

The Cape Town Convention

As mentioned elsewhere in this paper, India has recently adhered to the Cape Town Convention and the Aircraft Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment ('the Protocol') which were signed on 16 November 2001 during a Diplomatic Conference held at Cape Town under the joint auspices of ICAO and UNIDROIT, and entered into force on 1 March 2006. At the time of writing of this paper, 23 Contracting States are party to the Convention and the Protocol. This will entail a number of changes in the current legal regime of India, parts of which have been described in the previous chapters. An in-depth discussion of the Convention and the Protocol are outside the scope of this paper but its main provisions are described below.

The Convention establishes a uniform legal regime for governing security interests in three types of movable assets namely (a) aircraft objects i.e. airframes, aircraft engines and helicopters, (b) railway rolling stock, and (c) space assets, through individual Protocols for each type. Only the Aircraft Equipment Protocol has come into force as yet although the Railway Rolling Stock Protocol has been adopted on 23 February 2007 but awaits the requisite number of ratifications to come into force. The main objectives of the Convention and its Protocols are:

(i) To facilitate the acquisition and financing of economically important items of mobile equipment by providing for creation of an international interest which will be recognized in all Contracting States.

(ii) To provide the creditor with a range of basic default and insolvency related remedies and, where there is evidence of default, means of obtaining speedy interim relief pending final determination of its claim on merits.

(iii) To establish an electronic international registry for the registration of an international interest which will give notice of its existence to third parties and enable the creditor to preserve its priority against subsequently registered interests and against unregistered interests and the debtor's insolvency administrator.

(iv) To ensure through the relevant Protocol that the particular needs of the concerned industry sector are met.

(v) By these means to give intending creditor greater confidence in the decision to extend credit, enhance the credit rating of equipment receivables and reduce borrowing costs to the advantage of all interested parties.[398]

With the coming into effect of the Convention and the Protocol, the International Registry also became operational on 1 March 2006. It is a state-of-the-art, electronic, notice-based registry, first of its kind, which can be accessed from anywhere in the world twenty four hours a day. The Registry is operated by Aviareto Limited, a joint venture between SITA SC and the Irish Government, which is based in Dublin. Aviareto works on a not-for-profit, cost recovery basis and has been contracted to run the Registry for five years. The ICAO is the Supervisory Authority for the International Registry and its functions, *inter alia*, include:

(a) establishing the International Registry;

(b) appointing, dismissing and supervising the Registrar and the operations of the International Registry;

(c) establishing, amending and promulgating the Regulations and Procedures[399] dealing with the operation of the International Registry;

(d) stipulating the fees to be charged for the use of the International Registry.[400]

The Convention and the Protocol are supposed to complement each other and should be construed as one document but in case of any inconsistencies between the two, the provisions of the Protocol shall override those of the Convention.[401] A user friendly consolidated text[402], combining the provisions of the Convention and the Protocol, was drawn up by the joint efforts of the Secretariats of ICAO and UNIDROIT and is widely used although it does not have any legal standing. Unless the context requires otherwise, the articles mentioned below and in the footnotes are of the consolidated text ("CT") and the word "Convention" refers to the combined provisions of the Convention and Protocol.

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398 Professor Sir Roy Goode, CBE, QC, *Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment Official Commentary*, (2002: International Institute for the Unification of Private Law (UNIDROIT), Rome), p 2 and 6 [*Commentary*].

399 *Regulations and Procedures for International Registry* ICAO [2007] 2nd ed., ICAO Doc 9864 [*Regulations*],[*Procedures*].

400*Cape Town Convention*, *supra* note 42, Article 17.

401*Ibid*, Article 6.

402*Consolidated Text of the Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*, Attachment to *Resolution No. 1relating to Consolidated Text of the Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*, ICAO Doc 9795 (16 November 2001), [*CT*].

I. Interests Covered by the Convention

The following types of interests come within the ambit of the Convention:

(i) International interest comprising of:

- the interest granted by a chargor under a security agreement. For the purposes of the Convention, a security interest is defined as "an interest created by a security agreement"[403], which is in turn defined as "an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure the performance of any existing or future obligation of the chargor or a third person."[404] This definition is broad enough to cover a pledge, security created by way of a transfer of title, and a charge or any other type of consensual security, created to secure future and/or existing obligations of the chargor or a third person.[405]
- the interests of a conditional seller under a title reservation agreement, which refers to "an agreement for the sale of an object on terms that ownership does not pass until fulfillment of the condition or conditions stated in the agreement"[406], and
- the interests of a lessor under a leasing agreement, defined as "an agreement by which one person (the lessor) grants a right to possession or control of an object (with or without an option to purchase) to another person (the lessee) in return for a rental or other payment".[407] Any agreement that concerns a right to possession or control of an object in lieu of payment comes within the ambit of this definition but if there is no handing over of possession as for example in case of a wet lease, the Convention will not apply.[408]

It has been left to the applicable national law to determine in which of the above-mentioned categories an interest falls in.[409] A discussion of what is regarded as security interest in India is given in chapter four of this paper.

403*Ibid*, Article 1(ww).

404*Ibid*, Article 1(vv).

405*Commentary*, *supra* note 398 at 57.

406*CT*, *supra* note 402, Article 1(zz).

407 *Ibid*, Article 1(dd).

408*Commentary*, *supra* note 395 at 54.

409 *CT*, *supra* note 402, Article 2.3.

The Convention provides very simple requirements for constitution of an international interest, namely:

- the agreement creating the interest must be in writing;
- it should cover an aircraft object that the chargor, conditional seller or lessor has the "power to dispose" (the use of the word 'power' here makes the scope of this criterion broad enough to include ostensible authority to dispose as distinguished from real authority[410]);
- the aircraft object is clearly identifiable – the manufacturer's serial number, the name of the manufacture and the model designation are the prescribed identification criteria[411]; and
- where a security agreement is concerned, the secured obligation should be determinable although the maximum sum secured in not required to be mentioned.[412]

The first three criteria also apply to a contract of sale.[413] Thus, it is the Convention which prescribes the parameters for valid creation of an international interest and not the national law but it is the applicable law which will determine whether or not the basic requirements for a valid contract to come into existence like capacity to contract, absence of fraud or mistake, illegality etc. have been met (please see chapter one of this paper for the basic requirements of a valid contract in India).[414]

(ii) Prospective international interest i.e. a future international interest which can be registered but is only effective when it comes into existence. However, the priority of such interest is determined from the date of its registration. It is to be noted that although the concept is sound, in practice it may not work out as well since not all parties permit prospective international interest to be registered. An example is Airbus which has a policy of not allowing the prospective interest of the buyer of any new aircraft to be registered until the purchase price has been paid in full;

410 *Commentary*, *supra* note 398 at 66.

411 *CT*, *supra* note 402, Article 8.

412 *Ibid*, Article 10.

413 *CT*, *supra* note 402, Article 11.

414 *Commentary*, *supra* note 398 at 66.

(iii) National interest created by internal transaction[415] which is not registrable itself but a notice thereof is required to be registered and is subject to the Convention's rules of priority;

(iv) Registrable non-consensual rights or interests – which refer to interests arising out of the operation of law which are made registrable pursuant to a declaration to that effect made by Contracting States[416];

(v) Non consensual rights or interests, which do not require registration in order to have priority over international interests, pursuant to a declaration[417];

(vi) Associated rights, which refer to "rights to payment or other performance by a debtor under an agreement which are secured by or associated with the object"[418]; and

(vii) Pre existing rights or interests i.e. rights or interests that were created before the Convention came into effect.

Assignment, prospective assignment and subrogation also come within the ambit of the Convention. The registration and priority provisions of the Convention are extended by virtue of the Protocol to cover sale and prospective sale.[419]

II. Application of the Convention

The Convention applies when the debtor[420] is situated in a Contracting State and/or the airframe/helicopter is registered in a Contracting State.[421] A debtor is considered to be situated in a Contracting State if it has been incorporated or formed under its laws, or it has its registered office, statutory seat, centre of administration or place of business in such Contracting State.[422] If the debtor has more than one place of business, its principal place of business should be situated in a Contracting State or where it has no principal place of business, its habitual residence should

415 Internal transaction is a category of transaction, which although covered by the Convention, does not have international elements i.e. the Contracting State is the centre of main interests of all parties and the aircraft is also located therein. See *CT, supra* note 402, Article 1(bb) for definition of internal transaction

416 *CT, supra* note 402, Article 53.

417 *Ibid,* Article 52.

418 *CT, supra* note 402, Article 1(h).

419See Article III of the Protocol.

420 "Debtor means a chargor under a security agreement, a conditional buyer under a title reservation agreement, a lessee under a leasing agreement or a person whose interest in an aircraft object is burdened by a registrable non-consensual right or interest" - *CT, supra* note 402, Art 1(r) of CT. In case of sale, the debtor is deemed to be the seller - the Protocol, Article III.

421 *CT, supra* note 402, Article 3.

422 *Ibid,* Article 4(1).

be situated in a Contracting State.[423] The place where the creditor is situated is immaterial. The time for the purposes of the determining applicability is the time when the agreement creating the international interest is concluded.[424]

As mentioned above, the Convention and the Protocol apply to:

(i) airframes that are not used in military, customs or police services and which have a type certificate by the regulatory authority to transport:

(a) "at least eight persons including crew; or

(b) goods in excess of 2750 kilograms,

together with all installed, incorporated or attached accessories, parts and equipment (other than aircraft engines), and all data, manuals and records relating thereto"[425];

(ii) helicopters refer to "heavier-than-air machines (other than those used in military, customs or police services) supported in flight chiefly by the reactions of the air on one or more power driven rotors on substantially vertical axes and which are type certified by the competent aviation authority to transport:

(a) at least five persons including crew; or

(b) goods in excess of 450 kilograms,

together with all installed, incorporated or attached accessories, parts and equipment (including rotors), and all data, manuals and records relating thereto"[426], and

(iii) engines means "aircraft engines (other than those used in military, customs or police services) powered by jet propulsion or turbine or piston technology and:

(a) in the case of jet propulsion aircraft engines, having at least 1750 lb of thrust or its equivalent; and

(b) in the case of turbine-powered or piston-powered aircraft engines, having at least 550 rated take-off shaft horsepower or its equivalent,

together with all modules and other installed, incorporated or attached accessories, parts and equipment and all data, manuals and records relating thereto."[427]

423 *CT, supra* note 402, Article 4(2).

424 *CT, supra* note 402, Article 3.

425 *Ibid*, Article 1(f).

426 *Ibid*, Article 1(v).

427 *Ibid*, Article 1(c).

III. Registration of International Interest

The Registry is not a title based registry, which means that there is no *prima facie* presumption of ownership in favor of the person who is listed as the owner of the aircraft object in the International Registry. Ownership is determined by the applicable law. Since the Registry only provides a public notice of the registration, only minimal information about the underlying transaction is required to be provided. In order to register interests and perform all related activities, a user is first required to register with the International Registry and obtain the approval of the Registrar. The Regulations provide for two categories of Registry User Entities[428], namely a Transacting User Entity, which is "a legal entity or natural person intending to be a named party in one or more registrations"[429], and a Professional User Entity which refers to "a firm or other group of persons (such as an internal legal department of a transacting user entity) providing professional services to transacting user entities in connection with the transmission, to the International Registry, of information relating to registrations".[430] These entities are required to appoint an Administrator who interacts on behalf of the respective Registry User Entity with the International Registry concerning administrative matters.[431] In order to have access to the registration system, both the entity and the Administrator are required to be approved by the Registrar. The approval process involves proving to the reasonable satisfaction of the Registrar that such entity and administrator are who they claim to be and that the Administrator is authorized to act on behalf of the Registry User Entity.[432] The Administrator in turn approves other registry users which are individual employees, members or partners of the respective Professional User Entity or Transacting User Entity or its affiliate.[433] The parties to the transaction like the seller and the purchaser or the lessor and lessee become a Transacting User Entity prior to closing and authorize the Professional User Entity, which is usually a law firm to effect the registrations on their behalf.

The following information is required to register an international interest:

428 *Regulations, supra* note 399, s 2.1.8.

429 *Regulations, supra* note 399, s 2.1.11.

430 *Regulations, supra* note 399, s. 2.1.6 .

431*Regulations, supra* note 399, s 2.1.1 for a definition of Administrator.

432 *Regulations, supra* note 399, s. 4.1.

433 *Regulations, supra* note 399, ss 2.1.6 and 2.1.8.

(a) "the identity and electronic signature of the registering person and a statement on whose behalf that person is acting;

(b) the identity of the named parties;

(c) the following information identifying the aircraft object (i) type of aircraft object; (ii) manufacturer's name, (iii) manufacturer's generic model designation, and (iv) manufacturer's serial number assigned to the aircraft object;

(d) in case of an airframe or helicopter, the following information, if it is known: (i) the current and, if different, intended State of Registry for nationality purposes; and (ii) the current and, if different, intended aircraft nationality and registration marks assigned pursuant to the Chicago Convention [it is to be noted here that the Sate of Registry for nationality purposes and aircraft nationality are the same];

(e) the duration of the registration, if the registration is to lapse prior to the filing of a discharge;

(f) in the case of an international interest or a prospective international interest, the consent of the named parties, given under an authorization;

(g) in the case of an international interest acquired through subrogation, the file number of the registration of that interest; and

(h) the names and electronic addresses of persons to which the Registrar is required to send information notices pursuant to the Regulations."[434]

The information required for registration of a contract of sale and assignment is similar to the above, modified appropriately to suit the transaction.[435] The Regulations also enable a registration to be amended, which refers to the change in any of the above-mentioned information and requires the approval of all the parties, who consented to the original registration.[436] In order to discharge a registration, "the consent of the named parties benefiting from the registered interest, but not of the debtor, assignor or person subordinating the registered interest, or of the prospective seller in case of a registration relating to a prospective sale", is

434 *Regulations*, *supra* note 399, s 5.3.

435 *Regulations*, *supra* note 399, ss 5.4 and 5.5.

436 *Regulations*, *supra* note 399, s 5.9.

required.[437] A fee of USD 100 is charged for registering an aircraft object at the International Registry.[438]

A registration is considered to be valid only when it becomes searchable on the International Registry. There are two types of searches available on the International Registry, namely priority search and informational search. Priority search is conducted using a manufacturer's name, model designation and serial number[439] and at the end of the search, a Priority Search Certificate is generated which gives a list of all the interests registered against a specific aircraft object.[440] The other kind of search – Informational Search is broader in nature and is performed using the manufacturer's serial number of an aircraft object and where available, the nationality and registration mark of the aircraft, either alone or in conjunction with other criteria.[441] An Informational Search is supposed to provide the user with enough information to conduct a priority search.[442] One of the problems that has cropped up in relation to these searches is the precise nature of the information, which needs to be fed in as the search criteria - for instance if the model designation of an aircraft is incorrectly typed in, the search results will be incorrect. To prevent the user from getting such false search results, the use of pre-populated drop down lists have been made mandatory, although where such information is not provided by the International Registry, free text entry is still permitted.[443] It is envisaged that in the future there will be only one type of search to make the system more user friendly. A search can be conducted for a Contracting State also. The International Registry charges a fee of USD 35 for a single search session.[444]

IV. Priority of Interests

The rules for determination of priority of interests are quite simple. Registered interest has priority over an unregistered interest even if the holder of the registered interest was aware of

437 *Regulations, supra* note 399, s 5.6.

438 *Procedures, supra* note 399, Appendix, Table 1 of the Fee Schedule.

439 *Regulations, supra* note 399, s 7.2.

440 *Regulations, supra* note 399, s 7.4.

441 *Regulations, supra* note 399, s 7.3.

442 *Procedures, supra* note 399, s 13.2.

443 *Procedures, supra* note 399, s 12.1 read with *Regulations supra* note 396, s. 5.

444 *Procedures, supra* note 399, Appendix, Table 1 of the Fee Schedule.

the existence of the unregistered interest.[445] This avoids any disputes related to pre-knowledge of unregistered interest. *Vis a vis*, registered interests, priority is determined on the basis of time of registration.[446] The order of priority of competing interests can be changed by an inter-creditor agreement except that it is not applicable to an assignee of a subordinated interest unless the subordination was registered when the assignment took place.[447] Other anomalies in the registration system are: (i) the interest of a conditional buyer or lessee cannot be registered but is protected, nevertheless, against the charge created by the conditional seller or lessor if the interest of the corresponding conditional seller or lessor was registered prior to creation of such charge.[448] This is because the registered interest can enable the chargee to learn about the existence of the conditional sale or lease; and (ii) in case the lessor, who has leased the aircraft to a lessee, enters into a sale and lease back with a buyer and consequently becomes the sub-lessor, the sub-lessee's right to quiet enjoyment is protected against both the sub-lessor and the head lessor. Since registration is necessary only in relation to third parties who would not have notice of the existence of interest otherwise, a lessee cannot use lack of registration of lessor's interest to have priority over the lessor.[449]

A Contracting State may make a declaration under Article 52(1), specifying which types of non-consensual rights or interests shall have priority even without registration. Under Article 53 of CT, a State can make a declaration that a non consensual right or interest arising under national law needs to be registered. Examples of such rights or interests can include – any judgment or order affecting aircraft, repairer's lien etc. Pursuant to Article 76, unless a Contracting State makes a declaration to the contrary, the Convention will not affect the pre-existing rights or interests, which will continue to maintain their priority under the applicable law. Otherwise, a State can make a declaration under Article 76(1) specifying that the priority of the pre-existing rights or interests will be determined in accordance with the provisions of the Convention after three years (or any date thereafter) from the date when the declaration becomes effective.

445 *CT, supra* note 402, Article 42(1) and (2).

446 *Ibid*, Article 42.

447*Ibid*, 42(6).

448 *Ibid*, Article 42(5).

449 See *Commentary*, *supra* note 398 at 109-110

The order of priority also applies to the insurance proceeds and requisition compensation.[450]

V. Insolvency Regimes and Related Remedies

In case of insolvency of the debtor, an international interest should have already been registered in accordance with the provisions of the Convention in order to be effective, before the beginning of the insolvency proceedings. It is immaterial whether the local perfection requirements are complied with or not but its corollary is not true i.e. if the international interest is effective under the applicable law, its effectiveness in an insolvency proceeding is not marred, where such interest has not been registered properly under the Convention.[451] Here, effective means that the international interest will rank ahead in preference over the claims of the unsecured creditor[452], while applicable law refers to the domestic law, applicable pursuant to the rules of private international law.[453] The domestic rules of law relating to fraudulent conveyance or preferences or any procedural rules regarding enforcement of rights to property, which is in the custody of the insolvency administrator, remain unaffected.[454]

The Convention gives the option to the States to choose from two alternative insolvency regimes. Alternative A, which is referred to as the "hard or rule based version", permits the creditors to bypass the courts altogether to get possession of the aircraft object, upon the occurrence of an insolvency-related event.[455] The insolvency administrator or the debtor is required to hand over possession of the aircraft object to the creditor by the end of the waiting period[456] (which begins with the occurrence of the insolvency-related event), or if occurring earlier, the date on which the debtor was bound to return the aircraft object to the creditor

450 *CT, supra* note 402, Article 42(7) read with Article 1(jj).

451 *Ibid,* Article 43(1) and (2) of CT.

452See *Commentary*, *supra* note 398 at 114.

453 *CT, supra* note 402, Article 5(3) of CT.

454 *Ibid*, Article 43(3) of CT.

455"Insolvency-related event means: (i) the commencement of the insolvency proceedings; or (ii) the declared intention to suspend or actual suspension of payments by the debtor where the creditor's right to institute insolvency proceedings against the debtor or to exercise remedies under the Convention is prevented or suspended by law or State action." *CT, supra* note 402, Article 1(y). "Insolvency proceedings mean bankruptcy, liquidation or other collective judicial or administrative proceedings, including interim proceedings, in which the assets and affairs of the debtor are subject to control or supervision by a court for the purposes of reorganisation or liquidation." – *CT, supra* note 402, Article (x).

456 The waiting period ranges from 30 to 60 days, pursuant to the declarations made by the States in this regard. Here, waiting period refers to "period specified in a declaration of a Contracting State which is the primary insolvency jurisdiction." – *CT, supra* note 402, Article 23(3). "Primary insolvency jurisdiction means the Contracting State in which the centre of the debtor's main interests is situated, which for this purpose shall be deemed to be the place of the debtor's statutory seat or, if there is none, the place where the debtor is incorporated or formed, unless proved otherwise ." - *CT, supra* note 402, Article 1(ii).

according to the terms of the agreement.[457] While the aircraft object is in custody of the insolvency administrator or the debtor, they are enjoined to preserve and maintain it and its value in accordance with the operative agreement between the creditor and the debtor and subject to this, the insolvency administrator may permit the use of the aircraft object.[458] The insolvency administrator can terminate the agreement, if authorized to do so under the applicable law.[459] However, during the insolvency proceedings, the obligations of the debtor arising out of the agreement cannot be altered in any way except with the permission of the creditor.[460] The creditor can utilize any other interim remedies that the applicable law offers.[461] Under the Convention, the creditor can also apply for the de-registration and export of the aircraft and the registry and administrative authorities of the Contracting State where the aircraft is located are directed to do so within five business days of being informed by the creditor that it is entitled to such remedies under the Convention[462] and to aid the creditor in availing such remedies as promptly as possible without compromising the applicable aviation safety laws and regulations.[463] Furthermore, the exercise of all the remedies that are available to the creditor under the Convention cannot be disallowed or deferred, in any event, beyond the time period specified above.[464] It is assumed that prior to the commencement of the insolvency proceedings; the creditor has a validly registered international interest and consequently, only non consensual rights or interest in respect of which the Contracting State has made a declaration will have priority over the creditor's registered interest.[465]

If the insolvency administrator or the debtor is able to cure the default by the end of the above-mentioned time period and further undertakes to fulfill all future obligations, the insolvency administrator or the debtor need not part with the possession of the aircraft object.

457*CT, supra* note 402, Article 23(2) and (3) (Alternative A).

458 *Ibid*, Article 23(5) and (6).

459 *CT, supra* note 402, Article 23(11) (Alternative A).

460 *Ibid*, Article 23(10) (Alternative A).

461 *CT, supra* note 402, Article 23(5)(b) (Alternative A).

462 *Ibid*, Article 23(8) (Alternative A).

463 *CT, supra* note 402, Article 23(8) (Alternative A).

464 *Ibid*, Article 23(9) (Alternative A).

465*CT, supra* note 402, Article 23(12) (Alternative A).

However, in case of another default, such a curing period will not be available and the debtor or the insolvency administer must forthwith hand over the aircraft object to the creditor.[466]

The second option – Alternative B which is referred to as the soft regime does not permit self help. Here, when an insolvency-related event occurs, the debtor or the insolvency administrator is required to (and only if the creditor has so requested) notify the creditor of its intention to cure all defaults and discharge all of its obligations pursuant to the agreement and other transaction documents, or to allow the creditor to repossess the aircraft object under the applicable law.[467] It is to be noted that this provision mentions related transaction documents in addition to the main agreement, which could refer to promissory notes and other agreements embodying the undertaking and obligations of the debtor.[468] The creditor may be required to take extra actions or furnish additional guarantees, if the *lex fori* enables the courts to impose such conditions on the creditor.[469] In the event that the insolvency administrator or the debtor neglects to notify the creditor, as requested or reneges on its undertaking to permit the creditor to obtain possession of the aircraft object, the court may allow the creditor to repossess the aircraft object on such conditions as the court may deem fit.[470] Thus, it has been left to the discretion of the court whether or not to hand over the possession of the aircraft object to the creditor. The creditor is also required to prove its claim and that its international interest is registered.[471] The inference that can be drawn here is that without a registered international interest, Alternative B is not applicable. While the court is deliberating upon the claim, the aircraft object is not going to be sold.[472]

There is also a third option which is available to the Contracting States – that of making no declaration at all, in which case the domestic insolvency laws of the relevant State are applicable. An example of a State which has not made such a declaration is USA.

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466 *CT, supra* note 402, Article 23(7) (Alternative A).

467 *Ibid*, Article 23(2) (Alternative B).

468 See *Commentary*, *supra* note 398 at 202.

469 *CT, supra* note 402, Article 23(3) (Alternative B).

469 See *Commentary*, *supra* note 398 at 202.

469 *CT, supra* note 402, Article 23(3) (Alternative B).

470 *Ibid*, Article 23(5) (Alternative B).

471 *Ibid*, Article 23(4) (Alternative B).

472 *Ibid*, Article 23(6) (Alternative B).

VI. Default Related Remedies

It is the normal practice to provide a detailed definition of default in the documents related to the transaction. Most aircraft leases contain the following events of default, which describe the circumstances in which the lessor can exercise the remedies provided in the agreement:

- Non payment – the lessee fails to pay the lease rentals or make any other payment required under the lease agreement or other related documents, within the specified number of days (normally 3 to 10 business days) after the same has become due;
- Letter of credit – in case the lessee is required to provide a letter of credit as a substitute for a security deposit and fails to deliver, maintain, renew or reissue it as and when required or the letter of credit ceases to be valid and binding;
- Insurance – the lessee fails to procure and maintain the requisite insurance in relation to the aircraft (please see chapter five for details about aircraft insurance);
- Redelivery – the lessee fails to return the aircraft at the end of the lease term;
- Breach – the lessee fails to perform or observe any undertaking or obligation assumed by it under the lease or other related documents;
- Representation - any representation or warranty made or deemed to be made by the lessee under the lease or related documents, other than that which is disclosed to and accepted by the lessor, proves to be incorrect or misleading in a material way at the time when it was made or deemed to have been made;
- Approvals - any consent, authorization, license, certificate or approval of or registration with or declaration to any Government entity required to be obtained by the lessee in connection with the lease (for e.g. certificates of registration and airworthiness of the aircraft, air operator's certificate etc.) is withheld, revoked, suspended, cancelled, withdrawn, terminated or not renewed, or otherwise ceases to be in full force and effect;
- Sublease – the aircraft or any part thereof is given on a sublease, where a sublease is not permitted by the lease agreement;
- Attachment - any attachment, sequestration, distress or execution of any of the assets of the lessee of over a certain value, or of the aircraft, occurs;

- Unlawfulness - it becomes impossible or unlawful for the lessee to fulfill or perform any of the covenants or obligations under the lease or for the lessor to exercise the rights vested in it;
- Discontinuation - the lessee suspends or ceases to carry on all or a substantial part of its airline business or sells or otherwise conveys or transfers all or substantially all of its assets, or threatens to do so;
- Rights and remedies - the existence, validity, enforceability or priority of the rights of the lessor as the owner and as lessor in respect of the aircraft are challenged by lessee or any other person deriving its claim through it;
- Change of control - any person or group, acquires control of the lessee without the prior consent of the lessor;
- Bankruptcy or insolvency – any proceeding is commenced against the lessee/borrower under the bankruptcy or insolvency laws, which seeks to appoint a receiver, liquidator or similar official for its property, or seeks the winding-up or liquidation of its affairs, and such case or proceeding remains undismissed for a certain period (usually 30 to 60 days) or an order to such effect is passed by any court and such order is final or remains in force for a specific period (30 to 60 days); or the lessee/borrower suspends payment on its debts or other obligations exceeding a specific sum (for e.g. ranging from USD 250,000 to 500,000), and is unable to or admits its inability to pay its debts or other obligations as they fall due or voluntarily commences any proceedings under the bankruptcy or insolvency laws or consents to the appointment of or taking possession by a receiver, liquidator or other similar official of its property, or makes any compromise or assignment for the benefit of its creditors or takes any corporate action to authorize or facilitate any of the foregoing;
- Statutory dues – the lessee fails to pay any of the statutory dues like landing and parking charges, airport dues etc. which may result in the aircraft being seized or detained;
- Cross default - any indebtness of the lessee up to a certain amount is not paid when due or there is a cross default i.e. an event of default occurs and is continuing under a related lease agreement;

- Material adverse change - any event occurs or circumstances arise which, in the reasonable opinion of the lessor have a material adverse impact on the financial condition of the lessee or on its ability to perform all of its obligations, or otherwise comply with the terms of the lease and related documents.

The main criterion for an event of default is that it is reasonably foreseeable that such an event will have an adverse impact on the ability of the lessee to discharge its obligations. If it is a minor default, the lessor is likely to waive it as it is in the interest of the lessor to continue keeping the aircraft on lease. Otherwise, the lessee is generally given a certain period of time to cure the default and if the lessee is unable to do so, the lessor can terminate the lease agreement and exercise any of the remedies described below. The events of default in an aircraft mortgage are similar to the ones described above apart from certain exceptions as for example the provision relating to redelivery would not be applicable. If a guarantee has been given for the loan, some of the default provisions may be applicable to the surety also, as for example bankruptcy and insolvency.

Giving effect to one of the core principals of the Convention - party autonomy, the Convention recognizes such definitions but also specifies that where a definition is not given in the underlying agreement (which would be quite atypical), "default" would refer to "a default which substantially deprives the creditor of what it is entitled to expect under the agreement."[473] This will be determined at the time of the execution of the agreement. It is open to interpretation what would constitute a substantial default. Depending upon what is given in the agreement; failure to pay the lease rent in a timely fashion may not be considered to be a substantial default unless it is done repeatedly. It is likely that failure to carry proper insurance or to maintain the aircraft in an airworthy condition would be regarded as substantial default as also unauthorized sale or lease of the aircraft.[474]

Upon an event of default, an aircraft lease agreement usually provides that the lessor may do all or any of the following at its option:

- require the lessee to provide access to the aircraft, and hand over all the original documents pertaining to the aircraft;

473 *CT, supra* note 402, Article 17.

474 See *Commentary*, *supra* note 398 at 76 and 77.

- enter upon any premises where the airframe, the engines or any of the parts are located or believed to be located, without liability and to take immediate possession thereof;
- require the lessee to immediately move the aircraft to a designated airport or the redelivery location or any other location;
- recover from the lessee all unpaid and accrued amounts under the lease agreement and other related documents, all costs and expenses incurred by the lessor which are directly or indirectly related to the event of default, including any loss of profit suffered by the lessor because of its inability to place the aircraft on lease with another lessee, any payment of indemnity under the lease and any cost or premium which may be incurred in repaying funds raised to finance the aircraft or in unwinding such financing;
- apply all or any portion of the security deposit, the letter of credit or any other deposit held by the lessor for any amount due;
- deregister and export the aircraft;
- sell, give the aircraft on lease or otherwise deal with the aircraft free and clear of any interest of the lessee;
- proceed by appropriate court action, either at law or in equity, to enforce performance by the lessee of the applicable covenants of the lease and to recover damages for its breach thereof; and
- recover all legal costs incurred for the above.

The Convention provides for different remedies for a chargee and a conditional seller/ lessor in an event of default, as follows:

(a) Chargee – subject to the agreement of the chargor or in its absence an order from the court, the chargee as the secured party, is entitled to obtain possession or control of the security i.e. the aircraft object, dispose it by way of sale or lease[475] after giving prior written notice of at least ten business days to interested persons[476] who are

475 The right of the chargee to grant a lease can be restricted by a declaration made by a State under Article 70(1) of *CT*, stating that while the charged object is situated within, or controlled from its territory the chargee shall not grant a lease of the object in that territory.

476 Interested persons means: (i) the debtor; (ii) any person who, for the purpose of assuring performance of any of the obligations in favour of the creditor, gives or issues a suretyship or demand guarantee or a standby letter of credit or any other form of credit insurance; (iii) any other person having rights in or over the object - *CT, supra* note 402, Article 1(z).

required to be notified under the Convention, and to utilize any revenue or profits obtained from management or operation of the aircraft object.[477] Through the unanimous consent of the chargee and all interested persons, the ownership of the aircraft object may be transferred at any time after an event of default has occurred to the chargee in order to discharge the secured obligation, or the chargee can apply to the court for such an order.[478] The requirement for obtaining the assent of all interested persons, the definition of which includes debtor also (see footnote 420 for the definition of debtor) is to safeguard their rights, especially where the value of the aircraft object surpasses the amount of secured debt. It is to be noted that only after the event of default has occurred can such agreement be obtained and not prior to default. To prevent the creditor from getting more money than due, the court will order the ownership of the aircraft object to be transferred only if the court considers the amount of the secured debt to be proportionate to the value of the aircraft object. In cases where there is more than one chargee, any one of them is entitled to exercise these remedies although the order of priority amongst the chargees would govern the distribution of the proceeds.[479] The chargor has the right of redemption until the time of sale of the aircraft object.[480] Thereafter, the buyer takes free of any interest subordinate to that of the chargee.[481]

(b) Conditional seller or lessor: the Convention permits the conditional seller or lessor to simply terminate the agreement and repossess the aircraft object, within the parameters of the relevant declarations made by a Contracting State, or alternatively to obtain a court order for the same. The remedies for the conditional seller or lessor are less extensive than the remedies of the chargee because the conditional seller or lessor is the owner of the aircraft object and as such requires only the right to terminate the agreement and retrieve its property. Thereafter, what it does with its property is not dependent upon the consent of any other person. As discussed elsewhere in this paper, in certain jurisdictions like USA, title reservation agreements

477 *CT, supra* note 402, Article 12 .

478 *Ibid*, Article 13(1) and (2) of CT.

479 *Commentary*, *supra* note 398 at 72-73.

480 *CT, supra* note 402, Article 13(4).

481 *Ibid*, Article 13(5) of CT

and certain types of leases are regarded as creating a security interest and therefore, the conditional seller or lessor in such cases would be considered to be the chargee and not the owner. Thus, it will only be entitled to the remedies of the chargee, as described above.

Additionally, subject to the debtor's concurrence and prior written consent of any higher ranking holder of registered interest, all creditors are entitled to deregister and export the aircraft object.[482] Without compromising the parameters of aviation safety, the registry authorities in a Contracting State are obliged to deregister and permit exportation of an aircraft object, if the proper procedure is followed, including the prior recordation of an irrevocable deregistration and export request authorization, and if required, a certification is given regarding the release or consent of all registered interests that are ahead in the order of priority.[483] The Convention also allows the creditor to use any other remedies offered by the applicable law, as also remedies which the parties have agreed upon, if such remedies are not incompatible with the provisions of the Convention.[484]

Interim relief is also available to a creditor if the relevant Contracting State has made a declaration in this regard.[485] The creditor is entitled to obtain one or more of the following orders from the court, upon submission of satisfactory evidence of default of the debtor and if the debtor had consented to the exercise of such remedies in an event of default:

(a) "Preservation of the object and its value;

(b) Possession, control or custody of the object;

(c) Immobilization of the object;

(d) Lease or, except where covered by sub-paragraphs (a) to (c), management of the object and the income therefrom; and

(e) If at any time, the debtor and the creditor so agree, sale of the object and the application of the proceeds therefrom."[486]

482 *CT, supra* note 402, Article 15(1).

483 *Ibid*, Article 15(3).

484 *Ibid*, Article 16.

485 *Ibid*, Article 71(2).

486 *Ibid*, Article 20(1).

The creditor can also obtain deregistration and export of the aircraft within five working days from the date on which the authorities are notified that such relief has been sanctioned or endorsed in case of a foreign court order, by the relevant court.[487]

The relief is required to be made available to the creditor within a certain time period, as specified by the Contracting State in its declaration. In case of (a) and (b) the time period usually ranges from five to ten days while for (c) it is 20 to 30 days. The court is empowered to order taking of such measures that it considers necessary for safeguarding the interested persons in case the creditor is unable to discharge any of its obligations *vis a vis* the debtor or is not successful in establishing its claim[488] but the creditor and debtor can agree in writing not to apply this provision.[489] Such measures may include the creditor being asked to post a bond or guarantee which would compensate the debtor for any breach[490] or to give notice of its application to all interested persons[491.]

The Convention further provides that the procedural law of the Contracting State would govern the application of the remedies described above.[492] This means that if the procedural laws of a State impose a certain requirement, as for example obtaining the consent of an administrative agency before exercising a specific remedy, such requirement would need to be complied with, even if the Contracting State has made a declaration pursuant to which the remedies can be exercised without the leave of court.[493]

VII. Pro-Debtor provisions

Since one of the main purposes of the Convention is to provide comfort to the creditor in the form of definite remedies that minimize the risks borne by the creditor, the Convention is somewhat creditor centric but there are some pro debtor provisions, which although not as numerous as those for the creditors, do provide a balance. These pro debtor provisions are the embodiment of what has become standard industry practice in asset finance and are as follows:

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487 *CT, supra* note 402, Article 20(7) read with Article 15(1).

488 *Ibid*, Article 20(4).

489 *Ibid*, Article 20(5).

490See *Commentary*, *supra* note 398 at 79.

491 *CT, supra* note 402, Article 20(6).

492 *Ibid,* Article 21.

493See *Commentary*, *supra* note 398 at 80.

(i) As long as there is no default, the debtor has a right to quiet enjoyment of the aircraft object according to the provisions of the agreement.[494] The Convention does not specify what happens if the debtor's right of quiet possession is breached. This has been left to the agreement or local laws to determine.[495]

(ii) All remedies provided by the Convention must be applied in a commercially reasonable manner. A remedy is considered to be so applied "when it is exercised in conformity with a provision of the agreement except where such provision is manifestly unreasonable."[496] This provision supports the principal of autonomy of the parties and the freedom to contract, which goes to the heart of the Convention. As to what constitutes reasonableness will be determined by the established custom in aircraft financing.[497] The Convention of course does not entitle the creditor to use violent or other unlawful means.

(iii) As mentioned above, the ownership of an aircraft object which is subject to a security interest can be transferred after the occurrence of default, only with the consent of the chargor and other interested persons.[498]

(iv) Sale, as an interim remedy, is only available upon the express agreement of the debtor and the creditor.[499]

(v) Parties have been given the right under the Convention to deviate from or change the effect of provisions dealing with default remedies, apart from certain exceptions, which relate to the protection of the interest of the debtor.[500]

VIII Assignment

Assignment is defined as "a contract which, whether by way of security or otherwise, confers on the assignee associated rights with or without a transfer of the related international

494 *CT, supra* note 402, Article 18(1).

495 See *Commentary*, *supra* note 374 at 209.

496 *CT, supra* note 402, Article 19.

497See *Commentary*, *supra* note 398 at 193-194.

498 *CT, supra* note 402, Article 13.

499 *Ibid*, Article 20(1)(e).

500 *Ibid*, Article 22.

interest."[501] Associated rights refer to "all rights to payment or other performance by a debtor under an agreement which are secured by or associated with the aircraft object."[502] Examples of such rights are: rights to repayment of loan, interest, default interest, maintenance rent, procuring of insurance, indemnities etc. The definition of associated rights does not cover any rights related to obligations of third party or the debtor himself, the debtor's undertaking to discharge them is contained in the agreement itself. Furthermore, rights which are not associated with the aircraft object will not qualify as associated rights and therefore, cannot benefit from the system of priority provided by the Convention. Pursuant to the definition of assignment, only a creditor can be an assignor and an assignment by lessee would not *per se* come within its ambit unless the lessee also has the option to purchase the aircraft and can register its interest as a prospective buyer or in case of a sublease, the assignment is made by the lessee as a sublessor.[503] Partial assignments[504] and future assignments are permitted as long as the rights are identifiable[505] but the assignment of an international interest created or based on a security agreement is not effective under the Convention unless some associated rights are also transferred,[506] as the security cannot exist in vacuum and needs to attach to some rights. As a corollary to this, unless the parties have agreed otherwise, the assignment of associated rights also transfers the related international interest and the priority of the assignor.[507] The requirements for assignment of associated rights are the same as those for creation of international interest i.e. the assignment must be in writing, facilitate identification of associated rights, and determination of secured obligation, where the purpose of the assignment is to create a security.[508] In order for the assignment to bind the debtor, the debtor must be notified of the exact details of the associated rights being assigned and must consent to the same in writing.[509] The remedies that are available to the assignee are the same as would be available to the assignor, as discussed above.[510] The

501 *CT*, *supra* note 402, Article 1(g).

502 *Ibid*, Article 1(h).

503See *Commentary*, *supra* note 398 at 117.

504 *CT*, *supra* note 402, Article 44(2).

505 See *Commentary*, *supra* note 374 at 119.

506 *CT*, *supra* note 402, Article 45(3).

507 *Ibid*, Article 44(1).

508 *Ibid*, Article 45(1).

509 *Ibid*, Article 46(1).

510 *Ibid*, Article 47.

remedies are only available *vis a vis* the assignor and not against the debtor unless the debtor has defaulted or agreed to subject its rights to that of the assignee[511] (as usually happens in a typical aircraft financing transaction). The assignee enjoys the same priority as the assignor had, before the assignment.[512] The assignee of a registered interest has priority over the assignee of a subsequently registered interest or an unregistered interest.[513] The priority of the assignee depends upon the connection of the associated rights to the object i.e. the contract giving rise to the associated rights must specify that the security for such rights is the object or they are related to the object. The priority applies only to the extent that the associated rights are connected to the object[514] i.e. "they consist of rights to payment or performance that relate to:

(a) a sum advanced and utilized for the purpose of the purchase of the aircraft object;

(b) a sum advanced and utilized for the purpose of the purchase of another aircraft object in which the assignor held another international interest if the assignor transferred that interest to the assignee and the assignment has been registered – this category obviously covers cross collateralization;

(c) the price payable for the aircraft object;

(d) the rentals payable for the aircraft object; or

(e) other obligations arising from a transaction referred in any of the preceding sub - paragraphs.[515]

Apart from the above, the determination of the priority of competing assignments has been left to the applicable law.[516] The priority of the assignment of the rights which are not related to the aircraft object will be covered by the United Nations Convention on the Assignment of Receivables in International Trade.[517] The Cape Town Convention has no impact on any legal or contractual subrogation under the applicable law, which transfers the associated rights and the corresponding international interest.[518] The order of priority between a subrogee

511See *Commentary*, *supra* note 398 at 125.

512 See *Commentary*, *supra* note 398 at 128.

513 *CT, supra* note 402, Article 48. Also See *Commentary*, *supra* note 398 at 127-128 for priority of competing assignments.

514 *CT, supra* note 402, Article 49(1).

515 *Ibid*, Article 49(2).

516 *Ibid*, Article 49(3).

517See *Commentary*, *supra* note 398 at 130.

518 *CT, supra* note 402, Article 51(1).

and the holder of a competing interest can be changed by a written agreement but such agreement would not apply to an assignee of the subordinated interest, unless the subordination was registered on or prior to the assignment.[519]

IX. Choice of Law and Forum

The provision in respect of choice of law is applicable only if a Contracting State has made a declaration under Article 71(1) of CT. Pursuant to the declaration, the parties to an agreement will have the freedom to decide which law will govern their contractual relationship.[520] Where such a declaration has not been made, certain restrictions may be imposed on the parties' choice of law, for e.g. choice of law which has no nexus to the parties or the transaction may be held to be invalid by the courts.[521]

The parties also have the right to choose the Contracting State whose courts will have jurisdiction irrespective of any connection between the parties/the transaction and the State.[522] To be effective, the parties' choice of law must be expressed in a written agreement or otherwise comply with the legal requirements of the chosen State.[523] The exclusivity of jurisdiction is modified by Articles 55 and 56 of the CT; the former confers jurisdiction on other courts for interim relief while the latter prohibits any other court from exercising jurisdiction over the Registrar other than the courts of the place where the Registrar has its centre of administration. The jurisdiction of non Contracting States is not precluded but it is up to the specified court to choose whether or not it will take jurisdiction on the basis of the national law. In the absence of choice of jurisdiction, it will be determined by the *lex fori.* Thus, the courts of a non Contracting States can apply the provisions of the Convention, as for example where the contract is governed by the law of a Contracting State.[524]

519 *CT, supra* note 402, Article 51(2).

520 *Ibid*, Article 9.

521 See *Commentary*, *supra* note 398 at 190.

522 *CT, supra* note 402, Article 54(1).

523 *Ibid*, Article 54(2).

524See *Commentary*, *supra* note 398 at 143.

X. Designated Entry Points

A Contracting State can designate an entity as compulsory or optional entry point for sending registration information to the International Registry.[525] The Regulations further specify that there are two types of entry points that can be designated by a Contracting State, namely an authorizing entry point, which will sanction the conveyance of information required for registration, and a direct entry point through which information required for registration will flow directly to the International Registry.[526] Such a designation is intended for the national aircraft registries therefore, it works only in relation to an airframe or a helicopter registered with that State. Under the Convention, use of entry point for aircraft engines cannot be made compulsory.[527] Furthermore, a Contracting State is not permitted to designate an entry point for notices of national interest or of registrable non consensual rights or interests arising under law of another State.[528] A State can impose its own requirements and restrictions for access to its designated entry point though such requirements should not compromise the efficiency of the International Registry. Examples of Contracting States which have designated entry points are Mexico and USA. In both cases, the designated entry point is an authorizing entry point, where upon application, a specific code is granted, after which the user can access the International Registry. Mexico has designated the Mexican Aeronautical Record while USA has designated the FAA, acting through its Aircraft Registry at Oklahoma as the mandatory entry point for airframes and optional for engines. USA has further declared that the requirements of chapter 441 of title 49, United States Code (Transportation Code), and part 49 of title 14, Code of Federal Regulations (recording of aircraft titles and security documents), have to be fully complied with before information will transmitted by the FAA to the International Registry. Examples of such requirement are filing of the relevant FAA Form and documents such as bills of sale, security agreements and leases in an acceptable form.

XI. Declarations Made by India

In its instrument of accession, India has made the following declarations:

525 *CT, supra* note 402, Article 29(1).

526 *Regulations, supra* note 399, s. 12.1.

527 *CT, supra* note 402, Article 29(2) .

528 *Ibid*, Article 29(1).

(i) Declaration under Article 52(1)(a) of CT – "The following non-consensual rights or interests have priority over an interest in an aircraft object equivalent to that of the holder of a registered international interest and shall have priority over a registered international interest, whether in or outside insolvency proceedings:

(a) liens in favor of airline employees for unpaid wages arising since the time of a declared default by that airline under a contract to finance or lease an aircraft object;

(b) liens or other rights of an authority of India relating to taxes or other unpaid charges arising from or related to the use of that aircraft object and owed by the owner or operator of that aircraft object, arising since the time of a default by that owner or operator under a contract to finance or lease that aircraft object; and

(c) liens in favour of repairers of an aircraft object in their possession to the extent of service or services performed on and value added to that aircraft object."

(ii) Under Article 52(1)(b) of CT – "Nothing in the Convention shall affect the right of the Government of India or that of any entity thereof, or any intergovernmental organization in which India is a member, or other private provider of public services in India, to arrest or detain an aircraft object under its laws for payment of amounts owed to the Government of India, any such entity, organization or provider directly relating to the service or services provided by it in respect of that aircraft object";

(iii) Under Article 53 of CT – "The following categories of non-consensual rights or interests shall be registrable under the Convention as regards any category of aircraft object as if the right or interest were an international interest and shall be regulated accordingly:

(a) liens in favour of airline employees for unpaid wages arising prior to the time of declared default by that airline under a contract to finance or lease an aircraft object;

(b) liens or other rights of an authority of India relating to taxes or other unpaid charges arising from or related to the use of an aircraft object and owed by the owner or operator of that aircraft object, arising prior to the time of a declared

default by that owner or operator under a contract to finance or lease an aircraft object; and

(c) rights of a person obtaining a court order permitting attachment of an aircraft object in partial or full satisfaction of a legal judgment".

(iv) Declaration under Article 69 of CT – "All the High Courts within their respective territorial jurisdiction are the relevant courts for the purposes of Article 1 and Chapter XII of the Convention."

(v) Under Article 70(2) of CT – "Any and all remedies available to the creditor under the Convention which are not expressed under the relevant provision thereof to require application to the court may be exercised without court action and without leave of the court."

(vi) Under Article 71(1) of CT – India has chosen to implement Article VIII of the Protocol (Article 9 of CT), which deals with choice of law;

(vii) Under Article 71(2) of CT – "India will apply Article X of the Protocol [Article 20 of CT] in its entirety and the number of working days to be used for the purposes of the time limit laid down in Article X(2) of the Protocol [Article 20 (2) of CT] shall be that equal to no more than:

(a) Ten working days in respect of the remedies specified in Article 13(1)(a),(b) and (c) of the Convention[529] (respectively, preservation of aircraft objects and their value; possession, control or custody of aircraft objects; and, immobilization of aircraft objects); and

(b) thirty working days in respect of the remedies specified in Article 13(1)(d) and (e) of the Convention[530] (respectively, lease or management of aircraft objects and the income thereof; and, sale and application of proceeds from aircraft objects)."

(viii) Under Article 71(3) of CT – "India will apply Article XI [Article 23 of CT], Alternative A, of the Protocol in its entirety to all types of insolvency proceedings, and that the waiting period for the purposes of Article XI(3) of that Alternative shall be two calendar months."

529 *CT*, *supra* note 402, Article 20(1)(a),(b) and (c).

530 *Ibid*, Article 20(1)(d) and (e).

(ix) Under Article 71(1) of CT – India will implement Article XII of Protocol (Article 24 of CT), which requires the Indian courts to cooperate to the maximum extent possible with foreign courts and foreign insolvency administrators to give effect to the insolvency related remedies; and

(x) Under Article 71(1) of CT – India will implement Article XIII of Protocol (Article 25 of CT), which is concerned with de-registration and export request authorization.[531]

The declarations which have been made by India are remarkably liberal and in some instances diametrically opposite to the existing laws as for e.g. the choice to apply the Alternative A which bypasses the courts where as hitherto there was no self-help remedy available in India. Considering the orders for new aircraft that have been placed by the Indian airlines and how aggressively foreign investment is being pursued, this is not surprising. The declarations meet the criteria established by the ASU on the basis of which the Cape Town discount is made available by the ECAs. Although some of the Boeing aircraft on order have already been delivered, there are still a sufficient number remaining so as to make a significant difference in the cost of their financing. This is perhaps one of the reasons why the adherence to Cape Town Convention was put on a fast track while its contemporary bill on implementation of the Montreal Convention is still languishing in the parliament.

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531 "Declaration Lodged by Republic of India under the Cape Town Convention/Aircraft Protocol at the time of the deposit of its instrument of accession thereof", UNIDROIT, online: UNIDROIT < http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/bycountry/india.htm >

Conclusion

During the course of writing this paper, the author has been a witness to the continuing metamorphosis of the Indian aviation sector, an unintended consequence of which was the revamping of this paper, as a result of India's adherence to the Cape Town Convention. In the span of the last fourteen years, aviation in India has matured, following a paradigm shift from a heavily regulated area in which the State carriers' monopoly was zealously guarded, to an era of active partnership of the Government and the private airlines fostering healthy competition. However, like any other transition, the way has been fraught with obstacles and the growing-up pains of India are not over yet. There are still critical issues that need to be addressed and areas, where the lack of a proper policy and infrastructure is proving to be a hindrance.

An examination and comparison of the legal regimes of India, UK and USA in chapter one revealed that there are no clear guidelines in India, which make a distinction between operating lease and finance lease in taxation and that there is no coverage for leveraged leases. In chapter two, it was observed that Indian airlines would find it difficult to tap securitization as a source of generating capital due to lack of a proper framework. Although a number of mergers and consolidations have taken place (including that of the State carriers), the Government has yet to proclaim a policy in this regard. A draft of the policy has been pending for sometime but it has not been finalized yet. The discussion in chapter five showed that there is no specific statute in India which governs aviation insurance and the provisions which are applicable to this area, are general provisions. This is in complete contrast to marine insurance which is covered by the Marine Insurance Act, 1963, and motor vehicles insurance which has been provided for in the Motor Vehicles Act, 1988. Apart from passenger liability, no statutory provision has been made for the limits of other types of insurance, which has been left entirely at the discretion of the airlines. The duties that airlines in India pay in connection with ATF are some of the highest in the world and constitute a major operating expense for airlines, which are already running into loss.

The implementation of Cape Town Convention in India will cover many loopholes which existed in the Indian legal regime, as for example the lack of self help remedy, absence of a proper registration system for security interest in aircraft, a time consuming, complicated and cumbersome repossession process etc. However, the Convention has many grey areas which

have not been properly chartered yet. An example is Article 70(1) of the CT which permits a State to make a declaration to the effect that "while the charged object is situated within, or controlled from its territory, the chargee shall not grant a lease of that object in that territory". It is unclear in which circumstances a State would make such a declaration and a discussion with the practitioners has failed to shed any light on the subject. Despite being one of the strongest advocates of the Convention, the bizarre situation exists in US, where due to the uncertainty regarding the consequences of breach of certain provisions caused by the absence of any litigation related to these provisions, many financiers choose to forego the remedies given in the Convention altogether and use the domestic law. Furthermore, in general US airlines don't give de-registration and export request authorizations. While the functioning of the International Registry has been quite successful so far, it is unclear what would be the consequences of a mistake in registration, which would result in the creditor losing its priority. In such circumstances, it is difficult to say if in the long run, the Convention will prove to be the panacea that it has been advertised to be.

However, despite the above-mentioned shortcomings, there is no doubt that India has recovered from the disaster of the post liberalization era and has consolidated its position as a favorable jurisdiction for financiers, aircraft lessors and owners. With so many opportunities on the horizon, the dream of having "every Indian to fly at least once in his/her lifetime"[532] may well become a reality.

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532 Capt. G. R. Gopinath, Chairman of Deccan.

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