October 2009

Introduction

Welcome to our Autumn edition of Legalflyer where we once again review a series of topical issues for the aviation industry.

Our first article considers some of the commercial, industrial and legal issues that arise in relation to Pre-Delivery Payment (PDP) financings when used as a financing tool for airlines and lessors. The article is written by Duncan Batchelor, a partner specialising in aviation finance and leasing, based in London.

Our next article is the second in a two part series looking at competition compliance policies in the airline industry. The first article in this two part series appeared in our Summer edition of Legalflyer and focused on the key differences between compliance policies for low cost carriers and traditional carriers before examining in more detail compliance policies for air carriers operating a "hub and spoke" model. In this follow-up article, our EC and competition colleagues Marc Waha in Hong Kong and Eliza Jurss in Brussels, look at the main compliance issues for carriers operating a point-to-point network.

In our third article, Anna Anatolitou, a senior associate in our dispute resolution team based in Abu Dhabi, considers the impact of Islamic Sharia in an aviation context in relation to passenger settlements.

We complete this Autumn edition with two short update articles. In the first of these, Matthew Hodkin and David Ward from our tax department in London provide an update to a tax article in our Summer edition in relation to possible changes in UK VAT zero-rating for aircraft in order comply with the EU VAT directive. In the fifth and final article of the edition, Ian Giles and Caroline Thomas, our competition colleagues in London, look at the implications of the September interim ruling from the WTO in relation to the long running EU-US dispute as to whether support from European governments to Airbus to develop new large aircraft constitutes illegal subsidies.

As always, I hope that you will find our articles to be of interest and I would be delighted if readers could provide any comments on the content, or suggestions for future editions of Legalflyer, by using the comments box which can be accessed through this hyperlink. Likewise please feel free to pass on the details of colleagues who may wish to receive Legalflyer.

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Recent developments in PDP financing

In the last few years, Pre-Delivery Payment (PDP) financing has developed into a commonly used financing tool for airlines and lessors. Pre-delivery payments are stage payments which are payable by the purchaser to the manufacturer under an aircraft purchase contract over a period of months or years before delivery of the aircraft, and can account for a substantial portion of the total aircraft purchase price. From apparently simple beginnings, the large increase in the number of aircraft orders which have been the subject of PDP financings has led to a close scrutiny by the manufacturers (both airframe and engine manufacturers) of the industrial and commercial issues...
which arise as a result of the involvement of a financier. In particular, the manufacturers are concerned that they cannot always see who will be purchasing, taking delivery of and possibly remarketing their aircraft. They also have concerns about the day-to-day running of the contract, which requires constant communication, for example in electing options to change configurations or aircraft types, or to choose or install equipment.

**Documenting a PDP financing**

As a result, manufacturers have introduced detailed “standard form” Consent Agreements, which have then become the subject of detailed negotiation with lenders. This has also led to a development in the understanding, and the documentation, of the complex commercial and contractual relationships which exist between the parties when a bank finances PDPs. Most recently, the economic downturn has brought into sharp focus some of the issues and risks which are inherent in PDP financing.

A PDP financing is not like a normal secured financing for a bank. Most importantly, the “security” which is given for the loan is an assignment of the aircraft purchase contract. This is not at all the same thing as having a mortgage over an aircraft, or even an assignment of a lease or a receivable. Upon enforcement, the bank has the option to step in to the purchase contract and to exercise the rights of the purchaser; but these rights come with obligations, the most important of which is to pay the balance of the purchase price and to buy the relevant aircraft. This is an onerous obligation.

Every PDP financing transaction is a matter for negotiation, which can take time and effort. It is essential to have a good understanding of what is involved in the process of ordering, building and delivering an aircraft, and it is essential to understand how a lender’s position can be prejudiced and how it can be protected. Some of the main issues are set out below.

**French law contract issues**

Many Airbus purchase contracts have been written under French law. Cases in France have held that a ‘security assignment’ of certain types of French law contract, such as an aircraft purchase contract, may in fact be treated as a ‘pledge’ with very different enforcement rights which are not of use in a PDP financing. As the effectiveness of any assignment of a French contract will be decided by the laws of France (even if the assignment document is governed by a foreign law) this is an important issue. A French law purchase contract should therefore be amended and restated so that it has a different governing law, before suitable effective security can be taken over it.

**The Manufacturer’s option**

Manufacturers have introduced the concept of an ‘option’ which allows the manufacturer effectively to ‘buy back’ control over the aircraft before delivery, by requiring the financier to release security and re-assign the assigned rights, in exchange for a payment. This is done to help the manufacturer protect against ‘industrial risk’, but can raise several issues for a financier. First is the question: “What is the option price?”. Before a bank takes any enforcement action under its security assignment, there would quite likely be accrued interest on the Loan for at least one whole interest period, and possibly considerably more. Furthermore, the bank may have other costs and losses, in addition to principal and interest. Therefore, a bank would want to recover all of its losses before releasing its security. However, the manufacturer would want to limit the amount of the option price and so the exact scope of the option price can be a subject of much negotiation. The timing of the availability of the option, and the trigger for exercising the option, are also topics of much discussion.

**Multiple aircraft orders**

Where there are several aircraft under one purchase agreement, which are the subject of PDP financing, complicated issues can arise. If some aircraft are financed by one bank, and some aircraft are financed by another bank, each bank will want its ‘own’ aircraft (those for which it has assigned rights) ring-fenced, so that each lender cannot be prejudiced by matters relating to other aircraft, for example by seeking to exclude the manufacturer’s rights of set-off. A lender will want to be able to choose to enforce its rights on an individual aircraft-by-aircraft basis, in the hope that the sale of one, or a few, aircraft could produce sufficient excess sales proceeds to repay all of the other loans. However, the existence of the manufacturer’s option can lead to problems, as - by exercising the option in respect of only a few aircraft - the manufacturer is effectively removing the full value of the aircraft (i.e. including the ‘excess’ which could be obtained by selling the aircraft) from the security pool. So a lender would want to limit the use of the option to avoid ‘cherry picking’ by the manufacturer of the most valuable aircraft positions.

**Clawback**

The issue of “clawback” in PDP financing has been a hot topic in the last couple of years. The term can be used loosely; it could mean different things in different situations and in different jurisdictions. The issue arose when a manufacturer inserted an indemnity clause in the standard Consent Agreement, requiring financing banks to give an indemnity to the manufacturer if, having given ‘value’ to the bank for an assigned pre-delivery payment (either by

delivering an aircraft to the bank and crediting the payment towards the purchase price, or by refunding the payment to the bank), the manufacturer was required by a court to repay the pre-delivery payment. But such a ‘clawback’ could arise for a variety of reasons. It could be purely because of the domestic insolvency laws which apply to the purchaser, for example if all contracts can be set aside by a court. This is something which should be checked at the outset of any transaction, and local legal advice should be taken about the effect of the transaction and the security in insolvency. However, the clawback might also arise because something in the manufacturer’s purchase agreement (which is sometimes not seen in full by a financier) was void or unenforceable from the outset, or it might be because of a breach of contract or a wrongful termination by the manufacturer itself. The issues can be addressed by negotiation and drafting and by careful structuring, so that the parties can reach agreement on how these risks are dealt with.

*Negotiating allocation of risk*

Other issues to be addressed can include engines, credits, escalation, buyer furnished equipment (BFE) and the development of new aircraft models for launch customers. Ultimately, the allocation of the risks in each PDP financing transaction is a matter for commercial negotiation, and a lot will depend on the relative commercial positions of the parties. Nevertheless these issues, and others, must be properly understood before starting negotiations. If a default occurs, it is important to have the best possible legal and contractual protections. However, from a financier’s point of view, it is also best to choose - at the outset - a marketable asset with a low assignable price and a sufficient equity cushion. Otherwise there might be difficult decisions to be made as the delivery date approaches.

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**Competition compliance policies for airlines Part II - low cost carriers**

In the last edition of Legalflyer, we examined competition compliance policies in the airline industry with a focus on air carriers operating a “hub and spoke” model. In this second part of our series on competition compliance, we consider the main issues relevant to the design of a compliance policy for carriers operating a point-to-point network.

Low cost carriers have managed to stay away from the current investigations into alleged collusive practices, with regulators focusing on the cargo activities of traditional hub and spoke airlines. This largely reflects their different business model. Low cost point-to-point airlines typically do not entertain significant business relations with other airlines. As they do not rely on interline traffic and connectivity, they are much less at risk of crossing the line between legitimate business cooperation and illegal collusive activities in their dealings with other airlines.

This is not to say, however, that low cost airlines have been ignored by competition regulators. In Europe, their arrangements with airports and other suppliers have attracted scrutiny under the EC state aid rules to assess whether the airlines may be benefiting from government support through subsidies or other financial measures. The European Commission’s decision to block attempts by Ryanair to acquire rival Aer Lingus is a sign that low cost carriers will increasingly face market power and dominance issues. Lastly, and this applies both within and outside Europe, with a significant part of their revenues generated through sales of other products online or in-flight, their business model exposes low cost carriers to competition law issues which have faced major retailers and online distributors.

A competition compliance programme for low cost airlines needs to reflect these differences, both in terms of content and implementation. For example, contacts and information exchanges with competitors are much less frequent, and in any case, rarely justified, as low cost airlines are much less likely to have cooperation agreements with competitors, such as joint ventures, interline or codesharing agreements. In addition, low cost airline operations in Europe will often depend on support from public or semi-public authorities, leading to EC state aid issues cropping up in many aspects of their business development. Finally, the compliance structure needs to take into account the specific management model of a low cost airline, which would typically operate with a much thinner layer of management.

**A compliance policy for the low cost model**

The following summary outlines the main issues relevant to the design of an effective competition law compliance programme for low cost carriers, having regard to their point-to-point business model.
**Contents of the policy**
As with traditional airlines, a set of general guidelines should apply to all staff with commercial responsibility within the company, while certain specific categories of staff should follow guidelines addressing the specific issues they may face.

The general policy will contain a list of prohibitions applicable to all staff and some general recommended best practices.

In addition to the general issues mentioned above, low cost airlines may also be faced with specific issues which should be addressed by specific policies.

Although, to a certain extent, the contents of a compliance policy for low cost airlines will overlap with the policy of traditional airlines, both in terms of general and specific issues, there are some fundamental differences reflecting the specific business model of low cost airlines which should be addressed in their compliance policy.

**Scope and compliance structures**
As with traditional carriers, flight deck and cabin crew as well as junior check-in and airport staff need not be subject to the compliance policy. All other staff with commercial responsibilities should be subject to the policy, including technical and human resources staff. In general, it will not be necessary to have more specific compliance procedures and policies for outports, if the majority of staff are located at headquarters.

Specific guidelines with safe harbours will apply to specific categories of staff, such as senior management, individuals in charge of airport negotiations, procurement staff, etc. In particular, specific guidelines should apply to individuals in charge of relations and negotiations with airports and local authorities involving potential subsidies or advantages.

The policy should be endorsed at Board level and a clear message should be sent by the Chief Executive Officer to all staff. Although each member of staff is individually responsible for following the compliance policy, the compliance policy should be supported by senior management.

A specific body or department must be in charge of implementing and monitoring the competition compliance policy. The legal department will generally be the most appropriate body to carry out this function. Although not compulsory, the creation of a Compliance Officer position may be envisaged. The relevant body should be responsible for daily implementation of the policy. In particular, staff should be able to address their queries to the responsible body.

**Monitoring and disciplinary action**
An internal alert system for potential competition law breaches should be put in place.

Although this may be delicate to implement, sanctions and disciplinary action should be considered, as these will increase the efficiency of a competition compliance policy. However, should the implementation of a disciplinary regime be envisaged, it is best to refer to existing disciplinary procedures, in order to ensure compliance with applicable employment laws and regulations of the relevant country.

**Training and communication**
Proper internal communication is vital to ensure that a compliance policy is effective. We would suggest the following steps in designing an effective programme:

- favour business language with clear examples rather than lengthy descriptions of the legal framework;
- provide management solutions for the reader, such as when to end a discussion, when to put a negotiation on hold, who to contact for assistance, etc;
- inform staff personally via email from the airline’s CEO or the responsible body of any new major compliance policies.

Training is key to ensure that staff are aware of and understand the compliance policies. General training should be provided to all staff, with additional specific training provided to relevant staff as appropriate - for example, staff more likely to encounter state aid issues should receive specific training. Refresher training should also be organised on a regular basis. An on-line compliance policy, including case studies and training questions, may be a useful tool.
for training purposes, particularly where staff are based in diverse locations and are likely to appreciate the flexibility of being able to complete training at their own convenience.

**Audit**

An optimal compliance policy should include a credible audit procedure to evaluate its implementation. The audit may be carried out internally or an external auditor may be used.

As with traditional air carriers, in order to be efficient and uncover the undocumented part of an airline’s commercial life (which is likely to raise the most risks), the auditing procedure would also require the use of techniques that are not part of the traditional audit repertoire, such as surprise audit visits, review of a team’s full electronic and hard copy archives and detailed staff interviews.

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**Islamic Sharia and its impact upon passenger settlements**

Islamic Sharia law features heavily in the legal systems of most countries in the Middle East and indeed the greater MENA region. One often associates Sharia as impacting upon banking transactions but the implications of Sharia upon dispute resolution and, in particular in an aviation context, in relation to passenger settlements, can be just as profound. In recent months, there has been a spate of air accidents in this region and elements of Sharia law will feature from the initial identification of persons entitled to claim compensation through to settling claims with minors. This article seeks to identify some of the more common features of Sharia in this context and to address some regular misconceptions.

When disaster strikes, it is both urgent and extremely important to identify the victim’s next of kin. When a man is survived by a single spouse, that task is rather easier than where, as is not uncommon in this region, he has up to four wives. It is a common misconception that all wives are not equal and that the first wife is the ‘real’ spouse. In fact, Sharia recognises all wives as equal, each having a first degree kindred relationship to her husband. It is therefore imperative that any advance payments as may be paid pursuant to article 28 of the Montreal Convention recognise this.

Whilst Sharia does not normally apply to payments of compensation (although there are exceptions, beyond the scope of this article), it does apply to inheritance. It is the writer’s experience in dealing with the families of deceased victims that even when this is explained to them, many, particularly the more devoutly religious, will demand that any compensation payments made to the family be treated as payments to ‘heirs’ and apportioned in line with Sharia inheritance apportionment. Such apportionment is calculated by reference to rather complex mathematical formulae and may result in male relatives receiving significantly more, often double, that of female relatives bearing the same relationship to the deceased. Siblings are sometimes excluded altogether. It should be noted that the rules surrounding inheritance vary between the different branches of Islam. Where, as is often the case, legal proceedings have been issued in foreign courts, such Sharia concepts will often require explanation to the court.

Settlements concerning minors raise many other issues. In the MENA region, minors are generally persons under the age of 21, rather than 18. In many cases, the guardian will not necessarily be a surviving parent. Where the surviving parent is the mother, if there is a surviving paternal grandparent, he will often be the ‘natural’ guardian, assuming rights superior to those of the biological mother, often irrespective of where the child lives. Moreover, a natural guardian (father or paternal grandfather) has rights far in excess of those ordinarily granted by the court to a ‘legal’ (court appointed) guardian and may even extend to almost unfettered access rights to the financial bounty (including settlements) belonging to that minor child.

Whilst the international liability conventions (Warsaw and Montreal) may provide limits of liability in relation to passenger death or injury claims, precise levels of compensation within such limits are determined by reference to domestic law in each country. Unless legislation otherwise provides, levels of compensation are calculated by reference to the Dieh (often referred to as ‘blood money’). A Dieh is paid to the families of a deceased victim by the person responsible for his or her death. The value of the Dieh can vary greatly, being worth as little as $10,000 in one country, or in excess of $200,000 in another. Its value can vary further depending upon the victim’s gender and additional compensation may be ordered by the Court where the Dieh is considered insufficient compensation. Where the victim is merely injured, again, the Dieh is often used to calculate personal injury compensation: a leg being valued at a quarter Dieh, a finger one tenth of a Dieh and so on. Multiple injuries may attract significantly more than a single Dieh.
The foregoing is by no means an exhaustive examination of the application of Sharia to passenger settlements. However, the writer hopes to have demonstrated that in addition to important cultural and political considerations, an awareness of Sharia is vital when handling claims in the MENA region.

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**Update on possible changes to the UK VAT exemption for aircraft**

In the Summer edition of the *Legalflyer* we alerted readers to a possible change in the UK VAT zero-rating for aircraft. This article provides an update on developments since July.

The UK has traditionally been a jurisdiction of choice for the transfer of title to aircraft and aircraft engines. This is largely due to the UK’s more practical interpretation of the EU VAT directive. However, the European Commission has recently challenged this interpretation and formally requested the UK to change its national rules.

The directive exempts supplies of aircraft and parts that are “used by airlines operating for reward chiefly on international routes”. In addition, the ECJ has ruled that, even if a specific aircraft is used chiefly on domestic routes, this does not matter for the VAT exemption so long as the airline itself is chiefly international.

The UK has implemented the relevant provisions of the directive in a more practical way. Under UK domestic law, the VAT exemption (i.e. zero rating) applies to any aircraft with a take off weight over 8000kg and neither designed nor adapted for use for recreation or pleasure. So in the UK, no aircraft under 8000kg is exempt from VAT even where it is used by an airline meeting the relevant conditions of the directive. Conversely, an aircraft of a weight exceeding 8000kg and neither designed nor adapted for private pleasure flying is exempt, regardless of whether or not the aircraft is used by an airline operating for reward chiefly on international routes.

On 25 June 2009, the European Commission announced that it had sent a reasoned opinion to the UK, setting out how the UK’s implementation of the VAT directive in relation to the aircraft exemption infringes the directive and formally requesting that changes be made to align the implementing legislation with the VAT directive. A reasoned opinion is the second step of the infringement procedure provided for in the EC Treaty. Under this procedure, the European Commission may refer a matter to the European Court of Justice if the relevant national rules are not amended to comply with the reasoned opinion within two months. This time limit has already passed for the UK.

We have been informed that the UK has agreed to amend the infringing provisions and that HM Revenue & Customs (HMRC) will be conducting a consultation with a limited group of interested parties on the changes to be made in the near future. If the amended domestic exemption were in exactly the same terms as the EU directive exemption, one would expect there to be increased instances of uncertainty as to its application. For example, where an aircraft is temporarily out of use, should the availability of the exemption on a sale of that aircraft be based on the historic or proposed future use of that aircraft? Would the sale of an aircraft from one lessor to another fall within the exemption notwithstanding that neither party is an airline? It is hoped that the UK will continue to take a pragmatic approach to the interpretation of the exemption and, if necessary, that HMRC will publish clear and specific guidance on the appropriate interpretation. At least for now (and until such time as the current UK domestic law is amended), airlines will be able to continue to rely on the provisions of the domestic exemption, notwithstanding the European Commission’s challenge.

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**A small step forward in large civil aircraft subsidies dispute**

At the beginning of September, the World Trade Organisation (WTO) handed down an interim ruling on a complaint by the US government that support from European governments to Airbus constitutes illegal subsidies.

The US complaint was made in October 2004 regarding the support given by European governments to Airbus in developing new large aircraft; the complaint was aimed in particular at launch aid, but also preferential infrastructure projects, research and development aid and loans from the European Investment Bank. The complaint was made after the US had withdrawn from the 1992 EU-US bilateral agreement limiting direct and indirect government support for aircraft.

The EC responded immediately by filing its own counter-complaint with the WTO regarding support given to Boeing in various forms (including research and development aid and tax advantages) by the US government and its agencies, including NASA and the Department of Defense. The two complaints have since continued in parallel.
Although the interim ruling in the US complaint was confidential, it has been widely reported that the WTO found that some, although not all, elements of EU government support for Airbus constituted subsidies. However, even if this is correct, it is difficult to assess the significance of this interim ruling until the WTO releases its counterpart equivalent interim ruling in the parallel EC complaint against the US, which is not expected for some months. It is quite possible that the WTO could find that both complaints contain some well-founded elements.

The two cases are the largest disputes the Geneva-based WTO dispute settlement process has ever handled, far exceeding already its usual one-year timetable - and the cases are likely to continue for a number of years yet. If the complaints proceed to a final ruling, the WTO has no power to impose penalties for non-compliance, but can permit the governments concerned to impose targeted sanctions in order to achieve compliance with the ruling.

However, only around a third of WTO disputes ever reach the final panel process - most are settled out of court or remain in a prolonged consultation phase. Indeed, in this case some sort of negotiated settlement between the EU and US to replace the 1992 bilateral agreement still seems the most likely outcome; this solution may become even more attractive in light of the changed economic circumstances since the complaints were first filed.

To muddy the waters further, the airlines’ recently announced proposal for the Copenhagen climate change summit suggests they will cut emissions 50% by 2050 - something that can only be achieved through development of significantly less polluting aircraft. The EU and US will be keen to ensure Airbus and Boeing respectively are well placed to meet this demand, and will likely be seeking new justifications for the aid and loans that will be needed to spur such development. Against this background, a clear international framework for future support for research and development of aircraft looks even more desirable.

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