

Cross-Border Aircraft Foreclosure: Viable Mechanisms and Associated Risks



Kateryna Y. SAFRONENKO
is a senior associate
with KPMG in Ukraine

Cross-border financing of the aviation sector is a crucial aspect of industry development. Bank loans for purchase of an aircraft, in practice, are pledged by a mortgage over the aircraft. Herewith, security of a debt by specific collateral might help a creditor to protect its interests as well as minimize potential risks within the process of asset foreclosure. Recent economic destabilization in Ukraine affects proper fulfilment of obligations by local debtors *vis-à-vis* foreign creditors, resulted in numerous requests with regard to validity of a collateral as well as aircraft repossession process.

In this article, we focus on legal and practical aspects of cross-border aircraft foreclosure, aimed at settling outstanding indebtedness between a debtor (a mortgagor) and a creditor (a mortgagee), provided that the mortgagee is a foreign entity. Our findings are limited to the secured aircraft foreclosure only.

Legal framework

The mortgagee is able, subject to certain conditions, to recover the pledged aircraft either pursuant to the local law, i.e., *On Mortgage Act of Ukraine* (hereinafter — the Act) or supranational acts, in particular, *Cape Town Convention* and *Aircraft Protocol* (hereinafter — the Convention, the Protocol accordingly, collectively the Cape Town Convention). Prior to adhering to the Convention and the Protocol Ukraine has declared that the provisions of the Convention will not apply to internal transactions (i.e., in case the centre of main interests of all of the parties to such transaction is situated, and relevant aircraft object is located in the same contracting state

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at the time of the conclusion of the respective contract).

Pursuant to the Act, a conventional mortgage may secure obligations of any kind, including future obligations (e.g., principal debt, interest, fees, penalties, etc.). To be enforceable in Ukraine, the mortgage agreement shall be notarized and include mandatory terms, in particular: (i) details of the mortgagor and the mortgagee (name, legal address and ID code); (ii) principal secured obligation, its term and amount; (iii) details of an asset subject to security; as well as (iv) indication if the mortgage note is issued or not.

In its turn, the Cape Town Convention provides for the constitution and effects of an international interest in certain categories of movable equipment and associated rights. Hence, certain prerequisites shall be met to constitute international interest and, thus, apply the provision of the Cape Town Convention in order to foreclose the aircraft. In particular, such interest shall be a) related to the aircraft and b) granted under the security/equipment lease/reservation agreement or contract of sale. Herewith, the mentioned agreements/contract shall formally comply with certain requirements (e.g., written form, description of the aircraft, availability of power to dispose, etc.). It is worth noting that the Cape Town Convention does not apply retrospectively with regard to pre-existing rights/interests or their priorities.

Pursuant to the Cape Town Convention, a registered interest has a priority over all other subsequently registered interests and over unregistered interests, even if the one, who registered the interest, knows that an unregistered right exists. In this regard, to ensure effective

protection and enjoyment of rights/legal means under the Cape Town Convention, it is highly advisable to register an international interest within the International Registry (hereinafter — the Registry), as supervised by the International Civil Aviation Organization.

Foreclosure mechanisms

Both the Act and the Cape Town Convention provide similar legal mechanisms for protecting a creditor's rights under loan/equipment lease agreements. Nevertheless, foreign creditors raise certain doubts with regard to efficient protection of their rights against any debtors' breaches through legal means, envisaged by the Cape Town Convention, in Ukraine or transboundary.

In contrast to the national Act, the provisions of the Cape Town Convention provide for more flexible and efficient procedure of aircraft foreclosure, *inter alia*, the reduced terms of stakeholder notification. Additionally, there is an argument that the creditor is entitled to request the recognition of a title in the aircraft even though the mortgage agreement does not provide for such a mechanism.

Foreclosure under the Cape Town Convention

The Convention establishes certain mechanisms of creditor's rights protection, which (mechanisms) might be implemented either in court or out of court procedures. In particular, the creditor is entitled to: (1) acquire title in the aircraft, (2) sale the aircraft to any third party, (3) lease out the aircraft, (4) collect or receive any income or profits arising from the management or use of the aircraft. Furthermore, under the Protocol the mortgagee has certain

remedies in the context of a default. Namely, the right to (a) de-register the aircraft in the Civil Aircraft Registry, and (b) ensure export and physical transfer of the aircraft out of its location. Mentioned actions are carried out based on an irrevocable delegation of authority to deregister aircraft (IDERA) by the registered owner to the third party. By virtue of the IDERA, the authorized person is entitled to procure de-registration and export of the aircraft.

Therefore, in contrast to four legal mechanisms, envisaged by the Convention and similar to the Ukrainian means of protection, de-registration and export of the aircraft under respective IDERA are considered the most flexible and efficient way to foreclose the aircraft. Hence, the relevant aviation authority (e.g. State Aviation Service of Ukraine) is obliged to enforce the mentioned remedies at the first request of the authorized person without any court order.

Risks and complications

Given relatively scanty practice with regard to applicability of mechanisms/remedies under the Cape Town Convention in Ukraine, the creditor might not be able to effectively implement them, considering the following:

1. **Non-applicability.** The Convention provides that the creditor and the debtor, on the basis of written consent, are entitled to derogate from or vary the effect of any of the Convention's provisions, except certain clauses. Thus, subject to mutual agreement, relevant parties might exclude the applicability of the Cape Town Convention to relations between the parties.

2. **Absence of Practice.** Despite the fact that Ukraine has adhered to the Cape Town Convention, as of today there is still no established practice (either court or business) with regard to protection of the creditors' rights under the Cape Town Convention as well as its correlation with local legislation.

3. **Absence of the IDERA.** Having in mind the mentioned above, to procure with remedies, envisaged by the Protocol (i.e., de-registration and export of the aircraft), the creditor should be authorized by the debtor to be able to carry out the actual re-

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possession of the aircraft. Therefore, if no IDERA is issued in favour of the creditor, the latter might not be able to foreclose a vehicle.

Foreclosure under the law

The Act provides for three principal options of mortgage foreclosure, in particular: (1) out of court procedure by either (a) acquisition of title in the aircraft by the mortgagee, or (b) sale of the aircraft by the mortgagee to any third party, or (c) leasing out the aircraft, or (d) collect or receipt any income or profit, arising from aircraft management/use; (2) sale of the aircraft at public auction based on the notary writ; and (3) in court proceedings by means of either (a) subsequent sale of the aircraft at public auction, or (b) acquisition of title in the aircraft by the mortgagee for further sale to any third party, or (c) leasing out the aircraft, or (d) recovery or receipt of any income or profits arising from aircraft management/use.

From the practical perspective, the most effective and quickest way to foreclose the aircraft under the Act is option 1 (b). It is worth noting that, such legal mechanism might be exercised subject to the following conditions:

- mortgage agreement, executed between the creditor and the debtor, includes mentioned reservation on aircraft foreclosure within out of court order, or

- based on a separate notarized agreement on satisfaction of the

mortgagee's claims, executed between the mortgagor and the mortgagee.

Risks and complications

1. **Potential Compensation.** Pursuant to the Act, after implementing of out of court foreclosure, the creditor is not entitled to raise any subsequent claims with regard to the mortgage. Hence, in case the creditor fails to settle the pending debt with the proceeds from the aircraft sale, it is not feasible to further recover the outstanding funds from the debtor (neither in state court, nor in arbitration).

2. **Potential Damages.** In case the actual sale price of the aircraft is less than its value, identified by respective evaluation, the creditor will be obliged to compensate price difference to certain interested parties (if any) as well as the debtor.

3. **Currency issues.** In case the buyer of the aircraft is a resident of Ukraine, it might face certain complications, associated with an inability to purchase / transfer of foreign currency abroad due to misregulating of foreign exchange regime of the mentioned transaction. In particular, from currency exchange perspective, there is no clarity whether the transaction at hand is a simple trade operation or so-called return of foreign investment.

Alternatively, the creditor might procure with foreclosure of the aircraft in court, provided in the mort-

gage agreement. For efficiency purposes, prior to deciding on respective competent jurisdiction over the foreclosure claim, the creditor should first assess all the pros and cons of each option (e.g., whether the state Ukrainian court or arbitration should resolve potential dispute). Otherwise, in the worst-case scenario, the procedure of aircraft foreclosure might take up to 3 years until the creditor will be able to recover its material (and devalued) asset. In any case, if the aircraft subject to foreclosure is located in Ukraine, the target jurisdiction of the creditor for enforcement of any debt collection judgments would be Ukraine.

From a practical perspective, filing a claim for aircraft foreclosure with a competent Ukrainian commercial court seems to be the fastest judicial option in contrast to arbitration. It may allow shortening the litigation timing to a period of 9-18 months. Under the mentioned scenario, the creditor

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might be entitled by the court to sell the aircraft to any prospective buyer found by the creditor. This solution may significantly speed up the enforcement and settlement process. Concurrently, the Ukrainian judicial system is rather bureaucratic and politically dependant. Hence, if the creditor is convinced or assumes that the debtor may intentionally delay the local court trial or affect the final decision, arbitration is more preferable.

Recognition and enforcement of arbitral awards in Ukraine

In order to be enforceable in Ukraine, the arbitral award, issued either by the International Commercial Arbitration Court at the Ukrainian Chamber of Commerce and Industry (hereinafter — the ICAC) or other arbitration, shall be recognized under the New York Convention by a Ukrainian state court. The crucial drawback of the ICAC award is that it might be challenged on its merits

in a Ukrainian state court.

Given cross-border nature of foreclosure (i.e., the creditor is a foreign entity and the debtor is a local entity) certain complications may arise within the notification procedure. Thus, it might take up to 2 years to obtain a binding and enforceable ruling of the Ukrainian court in the matter.

Each of the above-mentioned mechanisms, either under the Act or under the Cape Town Convention, has its advantages and disadvantages. Meanwhile, due to the lack of established practice with regard to cross-border aircraft foreclosure, aimed at debt settlement, it is crucial for the creditor to consider each option cautiously and take into account all available factors and pitfalls prior to implementing the contemplated foreclosure.

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