



HAN KUN LAW OFFICES

# Legal Commentary



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## Banking & Finance Law

### Repossession of Aircraft in China: Legal Issues and Options for Lessors

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While the aviation industry continues to expand quickly in the PRC market, it is still possible that things can go wrong and an individual lessee may default under a lease when it faces tough times due to various reasons. For all lessors, whether they are financial lessors or operating lessors, it is essential to have a good knowledge of their enforcement rights in the worst scenario and the actions that they can do to recover their aircraft when all other remedies have failed.

This article intends to provide an overview of the major legal and practical issues involved if a lessor seeks to repossess an aircraft leased to a Chinese operator/airline (the “**PRC Lessee**”). Considering the complexity of the repossession of aircraft, it should be noted that this article does not intend to give a detailed analysis of all issues that may come up during any aircraft repossession.

#### Lessor's Repossession Rights under the PRC Law

From PRC law perspective, a lessor's rights to repossess an aircraft may depend on the following facts:

- a. Whether the underlying lease is a financial lease or an operating lease. Under the PRC law, both a financial lessor and an operating lessor are entitled to repossess aircraft upon the PRC Lessee's default; however, due to the nature of a financial lease being financing, their rights differ in some aspects. For example, a financial lessor is required to return the residual value of the aircraft back to the PRC Lessee after it disposes of the aircraft and pay off the debt owned by the PRC Lessee to it.
- b. Whether the lease is a cross border lease or a domestic lease. A cross border lease is

usually governed by the laws of a foreign jurisdiction (such as the laws of England, New York); therefore, in addition to the statutory remedies provided by the PRC law to the lessor, the lessor may be entitled to claim the relevant rights and remedies under the governing law of the cross border lease.

- c. Whether the lease is entered into before or after 1 June 2009. The Cape Town Convention and its Aircraft Protocol (collectively, the “**Convention**”) took effect in mainland China from 1 June 2009; therefore, for those cross border leases entered into after 1 June 2009, the lessor would be entitled to claim the rights and remedies under the Convention.

### **Self-help Remedies in Repossession**

The PRC law does not expressly accept “self-help” remedies or equivalent concepts and, when approving the Convention, China has declared that “any remedy available to the creditor under any provision of the Convention which is not there expressed to require application to the court may be exercised only with leave of the court of the PRC”. Therefore, although lessor is permitted to exercise its rights to repossess the aircraft according to the lease and the applicable law, if the PRC Lessee does not cooperate in this respect or refuse to return the aircraft, it would be difficult for lessor to enforce the repossession right by directly taking physical possession of the aircraft.

Without the PRC Lessee’s cooperation, lessor may have to resort to the court for a judgment or verdict in favor of repossession of aircraft.

### **Application of Security Deposit or Money Drawn From the Security Deposit L/C or Bank Guarantee**

For an aircraft operating lease, it is normal that performance of the PRC Lessee’s liabilities and obligations under the lease is secured by a cash security deposit (the “**Security Deposit**”) or a standby letter of credit (the “**Standby L/C**”) or on demand guarantee (the “**Bank Guarantee**”) issued by a commercial bank. When the PRC Lessee defaults on its payment obligations under the lease, the lessor is entitled to apply the cash Security Deposit or make drawdown under the Standby L/C or the Bank Guarantee and apply the money drawn towards any outstanding amounts under the lease.

Although the lease may provide for the conditions and the way of using the cash Security Deposit, it is worth to note that application of the cash Security Deposit or the money drawn from the Standby L/C or the Bank Guarantee may constitute a set-off of debt and would require notice from lessor to the PRC Lessee (according to the Contract Law of the PRC, a set-off is effective from the moment when a debtor was notified about the set-off), regardless of the provisions of

the lease.

The PRC law also permits lessor to exercise its rights to set-off against the PRC Lessee's bankruptcy administrator after the PRC Lessee commences bankruptcy procedures, subject to satisfaction of certain conditions.

### **Bankruptcy of the PRC Lessee and Its Effect on the Repossession**

If the PRC Lessee's financial condition continue to deteriorate, it is possible that the relevant court may commence bankruptcy procedures against the PRC Lessee, on voluntary or involuntary basis.

On the one hand, in accordance with the PRC Law, the PRC Lessee may file a voluntary petition for bankruptcy only if the following two conditions have been met: first, the PRC Lessee is unable to pay its debts when due; and second, the PRC Lessee lacks sufficient assets to pay the debts or it becomes apparent that the PRC Lessee has no capacity to discharge its debts. On the other hand, a creditor of the PRC Lessee may file an involuntary petition when the PRC Lessee is unable to pay its debts when due. For the involuntary petition filed by the creditor of the PRC Lessee, whether the court would require a comprehensive review of the PRC Lessee's assets and liabilities or a non-payment in one transaction would trigger the bankruptcy procedures is more subject to the court's discretion.

Commencement of bankruptcy procedures will have profound legal implications to lessor's rights to repossess the aircraft, including:

- a. The PRC law imposes an automatic stay during the pendency of the bankruptcy procedure of the PRC Lessee, which means that:
  - i. the PRC Lessee is not allowed to pay rent and other amounts to an individual lessor under the lease;
  - ii. any lawsuit against the PRC Lessee can only be commenced in the same people's court that accepts the bankruptcy petition;
  - iii. any civil lawsuits or arbitration proceedings or enforcement procedures initiated prior to the commencement of the bankruptcy case are suspended;
  - iv. interest on unmatured debts (including default interests on unpaid rent) stop accruing as of the date the court grants the bankruptcy petition;
  - v. the PRC Lessee's creditor is prohibited from enforcing its rights against the property of the PRC Lessee after the bankruptcy petition is accepted by the court.
- b. The PRC law authorizes the court to avoid, upon request of the bankruptcy administrator,

certain fraudulent conveyances of the PRC Lessee's property within one (1) year prior to the date the court accepts the bankruptcy petition, and any payment made for the benefit of a creditor within the six (6) months period prior to the date the court accepts the bankruptcy petition if the debtor was insolvent at the time, which means that the court may scrutinize the payments made by the PRC Lessee to the lessor within the above period.

- c. The bankruptcy administrator of the PRC Lessee is authorized to terminate or continue to perform pre-bankruptcy contracts if there are obligations to be performed by each contracting party, which means that the bankruptcy administrator of the PRC Lessee may terminate the lease with the lessor.

If bankruptcy proceedings have commenced with respect to the PRC Lessee, and the lease has not been terminated either by the PRC Lessee's bankruptcy administrator or the lessor, then the rights of the lessor under the lease will continue as against the PRC Lessee's bankruptcy estate. The aircraft on lease shall not be included in the PRC Lessee's bankruptcy estate.

China has made a declaration to the Convention that the entirety of Alternative A of article XI of the Protocol shall apply. This means that, for those leases that the Convention applies, the PRC Lessee's bankruptcy administrator is obliged to return possession of the aircraft to the lessor within sixty (60) calendar days.

### **Interim Measures**

Under the PRC law, the aircraft may be arrested in China before or after a case is filed to the PRC court, if the lessor can convince the PRC court that the arrest meets statutory criteria for a property preservation measure. When the lessor applies for property preservation measure against the aircraft, the court has the power to demand counter-security from lessor in the form of cash or bank guarantee depending on the court's discretion.

If the Convention applies to the lease, lessor is entitled to the interim reliefs under the Convention from a PRC court pending final judgment of its claim and to the extent that the PRC Lessee has at any time so agreed, including: (a) preservation of the aircraft and its value; (b) possession, control or custody of the aircraft; (c) immobilization of the aircraft; (d) lease or management of the aircraft and the income therefrom; (e) sale of the aircraft and application of the income therefrom. In accordance with the declarations made by China at the time of accession to the Convention, for the remedies specified in subparagraph (a), (b) or (c), the PRC Court shall giving a ruling within ten (10) days after receiving an application and immediately enforce it; for the remedy specified in subparagraph (d) or (e), the PRC Court shall giving a ruling within thirty (30) days after receiving an application and immediately enforce it.

## **Enforcement of Repossession Judgment/Award in Favor of Lessor Made by Foreign Court or Arbitral Tribunal in China**

To date, it is still difficult in practice for a foreign lessor to enforce a foreign court interim order or an arbitral award to arrest and repossess aircraft leased to a PRC Lessee.

If a foreign lessor has obtained a final and conclusive foreign court judgment in respect of its repossession of the aircraft, it may apply to enforce such judgment before a PRC court without re-examination or re-litigation, provided that China and the country of the court have concluded a judicial assistance treaty or judgments of courts of the PRC receive reciprocal treatment in the courts of such foreign country. To date, there is no bilateral treaty between China and the U.S. or the England on recognition and enforcement of foreign court judgments. In June 2017, there has been a case that a court in Wuhan, Hubei Province issued a court order (Order No.: 2015 E Wuhan Zhong Min Shang Wai Chu Zi Di 00026 Hao) which recognized and enforced a judgment made by an U.S. court. This is the first court order ever in China that confirms the existence of “reciprocal treatment” relationship between China and U.S. However, as China does not have the legal principle of *stare decisis*, it remains to be seen whether the other PRC courts will follow this view.

In the event that a final arbitral award in respect of foreign lessor’s repossession of the aircraft is obtained from an arbitral tribunal, such award would be recognized and enforced in the PRC by the People’s Courts according to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“**New York Convention**”) if the award is made in a contracting state of the New York Convention (or if the arbitral award is rendered in Hong Kong, according to the Arrangement of Supreme People’s Court on Mutual Enforcement of Arbitration Awards between the Mainland and the Hong Kong Special Administration Region).

## **Deregistration of the Aircraft**

China maintains an operator-based aircraft registry, which means the operator of the aircraft is entitled to apply for the registration of the aircraft. In order for the PRC Lessee to operate the aircraft in China, the aircraft must be registered with the Civil Aviation Administration of China (the “**CAAC**”). For purpose of remarketing the aircraft in international aviation market and facilitating the next lessee’s registration of the aircraft in other relevant jurisdiction after repossession of the aircraft, the lessor needs to ensure that the aircraft will be deregistered from the aircraft registry maintained by CAAC upon its repossession of the aircraft.

According to the rules of CAAC, normally CAAC only accepts the deregistration application filed by the PRC Lessee of the aircraft in the capacity of “operator”. CAAC’s rules do not expressly permit a lessor being owner of the aircraft to deregister an aircraft by virtue of a deregistration

power of attorney issued by the PRC Lessee in advance upon leasing of the aircraft.

For those leases that the Convention applies, the lessor may rely on an Irrevocable De-Registration and Export Request Authorisation (the “**IDERA**”) recorded with CAAC to deregister the aircraft. It should be noted that even if the PRC Lessee has a duly recorded IDERA, it still needs to present “a document issued by a PRC court confirming that the Authorized Party is entitled to possession of the aircraft under the Convention” to CAAC in the deregistration application.

### **Export of the Aircraft**

After the aircraft is repossessed, the lessor may have to deal with export of the aircraft, obtaining permission to ferry flight the aircraft out of China and tax/customs clearance.

To export the aircraft out of China, the lessor will have to file a customs declaration and other necessary documents. As the customs authority normally only deals with the PRC Lessee for import and export of the aircraft, lessor may not be familiar with the relevant customs procedures and may need assistance from an experienced customs declaration agency if the lessor wants to export the aircraft by itself. To date, the PRC customs authority has not issued any special rules on export of an aircraft by using an IDERA.

The lessor may lease the repossessed aircraft to another operator in the PRC. In such case, if the PRC Lessee is still cooperative, the aircraft may be possibly transferred to the new operator by way of lease novation, which may not necessarily cause physical export of the aircraft (necessary procedures still need to be done with the customs authority to reflect the change of lessee).

The ferry flight of the aircraft would be subject to the confirmation of the Airworthiness Department of CAAC as a matter of procedure as to the airworthiness of the aircraft.

According to the rules of CAAC, the authorized party under a duly recorded IDERA is entitled to apply to the airworthiness certification department of CAAC to obtain export certificate of airworthiness before its application to deregister the aircraft.

### **Other Practical Issues**

To our experience in precedent repossession cases, in addition to the above legal issues, lessor is very likely to encounter the following practical issues in repossession of aircraft from the PRC Lessee:

- Other third parties with competing claims in respect of the aircraft and/or the PRC Lessee, including airports, fuel and other suppliers, maintenance facilities and etc.

- Airports and maintenance facilities who may claim possessory lien over the aircraft
- Status of ownership registration of the aircraft with CAAC
- Priority of the international interests and other registrable interests in respect of the aircraft on the International Registry
- CAAC's order to ground the aircraft
- Airport to grant access to aircraft
- Translation of the lease documents written in English into Chinese in order to be used in the relevant procedures in the PRC Court
- Experienced technical team readily available to inspect the aircraft and ensure airworthiness
- Qualified crew to operate and fly the aircraft
- Insurance arrangement after repossession of the aircraft
- The lessor's capability of remarketing the aircraft

According to our experience in the previous aircraft repossessions, it usually take a substantial long period of time to liaise with the relevant parties (including airport, fuel supplier, MRO, air traffic control, local CAAC agency, court, bankruptcy administrator, potential lessee) to coordinate the whole repossession process. This will be challenging to lessor, and to complete a successful and efficient repossession, lessor would need strong and timely support from its business, technical, remarketing and legal teams.

## ● **Important Announcement**

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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