

## Aviation - USA

### Perfecting a security interest in a lease of a registered aircraft

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An aircraft lease is a contract that provides for the conveyance of the use and possession of aircraft for a term in exchange for the payment of rent by the lessee. In order to create and perfect a security interest in a lease of a US-registered aircraft, or any related collateral, or to protect the economic ownership of the lessor as a true lessor, parties must take certain actions under state, federal and international law.

#### Lease types

A lease can take the form of an operating or 'true' lease or a 'finance' lease. An operating or true lease is a contract for the use and possession of an aircraft for a specified duration; such duration is less than the useful life of the aircraft. The lessee has no expectation that it will acquire ownership of the aircraft simply by making the scheduled lease payments. The lease payments are structured so that the arrangement is not a disguised financing for the benefit of the lessee. By contrast, a 'finance' lease (excluding as defined by Article 2A-103(1)(g) of the Uniform Commercial Code (UCC)) is generally known as a long-term lease in which the lease rentals return all or most of the lessor's outlay to acquire the leased aircraft. The duration of the lease is often for a significant portion of the aircraft's useful life. Furthermore, a finance lease can provide for the transfer of title to the aircraft to the lessee after the lessee makes all scheduled payments. The Federal Aviation Administration (FAA) may, under certain circumstances, treat the lessee of a finance lease as the owner of the aircraft and the lessor as a secured party. The characterisation of a lease as either a 'true' lease or a 'finance' lease affects the manner in which a lessor's interest in the aircraft – subject to such lease – is perfected.

Aircraft leases often require that the lessee provide additional collateral to the lessor in order to secure the lessee's lease obligations. Collateral is often in the form of a cash security deposit or letter of credit. Under the lease, the lessee is required to ensure that the aircraft is maintained in a certain condition and that maintenance is performed when required. Lessees may also be required to provide additional security for such maintenance in the form of cash payments reserved to cover such maintenance events. The UCC – a uniform body of commercial law adopted with some state-by-state variations – and other applicable state laws govern the attachment and perfection of any such additional collateral and are not pre-empted by federal or international law.

#### Security interests

Under state law, the UCC governs – subject to certain exceptions – the creation and perfection of security interests. The UCC, however, is subject to federal pre-emption, and where federal and state law conflict, federal law prevails. In addition, because the bundle of rights inherent in a lease includes aircraft and non-aircraft property, the federal aircraft registration system only partially pre-empts the state-law system to register security interests in the non-aircraft property that is often used as collateral in an aircraft lease.

Title 49 of the United States Code (Transportation Code) provides for the FAA to establish a system for recording title to, and conveyances (including leases) of, US-registered aircraft. The Transportation Code pre-empts many aspects of state law in regard to the perfection of interests in aircraft. The Transportation Code mandates that the FAA assume responsibility for, among other things, establishing a registry and

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protocol for the registration of aircraft and related security interests, including in aircraft leases. The United States is also party to the Cape Town Convention on International Interests in Mobile Equipment and the protocol thereto – an international treaty that governs, among other things, the perfection of 'international interests' in leases of US-registered aircraft. The Cape Town Convention applies to, among other things, leases of US-registered fixed-wing aircraft certified to transport at least eight persons or more than 6,050 pounds that were entered into (or materially amended or novated) after March 1 2006. The Cape Town Convention provided for the creation of the [international registry](#) for purpose of publicly recording international interests in aircraft, including the interests of a lessor under an eligible lease.

The failure to record properly a security interest in a lease or any related additional collateral could result in a loss of lien priority and, if a lease were to be characterised as a finance lease, the aircraft itself. Therefore, it is imperative that an interest in a lease of a US-registered aircraft be properly perfected under the FAA, the Cape Town Convention and the UCC.

Below is a summary as to how to perfect one's interest in a lease and related collateral with the FAA, the international registry and the UCC.

### **Federal law – perfection by filing with FAA**

All types of aircraft lease for US-registered aircraft may be filed and recorded with the FAA. The secured party initiates the recordation process by submitting to the FAA a conveyance recordation notice. In order to be in due form for filing the lease and a security assignment, both parties must sign the lease in blue ink. On acceptance of the filing, the FAA will return the original instruments to the lessor stamped with the filing information.

### **International law – Perfection by filing with international registry**

Under the Cape Town Convention, an international interest in a lease may be created if the lease:

- is in writing;
- relates to an aircraft object which the debtor or lessor has the power to dispose;
- enables the aircraft object to be identified; and
- in case of a security agreement, enables the secured obligations to be determined

In order to record an interest in a lease with the international registry, the lessor, the lessee and any applicable security assignee must be registered as a 'transaction user entity' with the international registry. A party may become a transaction user entity by completing the registration requirements with the international registry. Once all relevant parties are established as transaction user entities, the lessor must first submit an FAA Entry Point Filing Form AC 135 to the FAA in order to obtain an approval number to international interests over the subject aircraft with the international registry. On submission, the FAA will provide an authorisation code for the recordation with the international registry. Once received, a debtor may log on to the international registry and record an international interest in the lease together with any applicable security assignment thereof. Registration of an interest in a lease may be done on a prospective basis, up to 60 days before the filing of the lease with the FAA.

### **State law – perfection by complying with UCC**

Under the UCC, there are two alternate ways in which to perfect a security interest in a lease:

- file a UCC-1 financing statement; or
- take actual possession of the lease by creating and taking physical possession of an original chattel-paper counterpart to the lease.

A UCC-1 financing statement should always be filed against the lessee as 'debtor' and specify the aircraft as collateral in order to protect a lessor's interest in its aircraft in the event that the lease is construed to be a finance lease. A UCC-1 filing is valid for five years from the date of filing and may be renewed if a request is made before the expiration of such period. Chattel paper is a specially marked original copy of the lease that contains the right to rental and other payments thereunder. It creates a super-priority security interest over such items in favour of the party in possession of such original. Even though one can take a security interest over a lease under the UCC simply by filing a UCC-1 financing statement, a prudent aircraft financier would also take possession of the chattel-paper original because a good-faith possessor of such chattel paper original takes priority over all other creditors, so long as it, in good faith, had no knowledge of existing senior liens. A lessor (and in turn a security-interest holder) can perfect a security interest in any cash collateral provided by a lessee under a lease by filing a UCC-1 financing statement. However, a secured party with possession or control of any such collateral would have priority over any other secured

party. Therefore, a lessor should take possession or control over such collateral by depositing any cash in an account in the name of the lessor and any letter of credit issued in the name of, and held by, the lessor.

## Comment

Because state law is pre-empted by federal and international law, it would be fatal to a financier's priority in an aircraft lease if the financier perfected solely under the UCC without complying with the requirements of the Transportation Code and the Cape Town Convention. Furthermore, perfecting under the UCC is essential in order to perfect interests in leases and related collateral not covered by the Transportation Code or the Cape Town Convention.

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