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LEGAL ASPECTS OF AIRCRAFT FINANCE

By DAVID I. JOHNSTON†

PART I

I. INTRODUCTION

AIRLINES in the United States of America and Canada desiring to purchase commercial aircraft are confronted today with important legal and financial considerations. The financial considerations must take into account the relatively high cost of new equipment in comparison to airline earnings. In the face of technological advances, the airlines have, in recent years, been forced to re-equip their piston fleets with jet and turbo-prop aircraft in order to remain competitive. The high cost of new equipment is largely responsible for an estimated three hundred per cent increase in airline investment from 1952 to 1962.¹ Until the end of World War II, the relatively low unit cost of equipment enabled the airlines to finance purchases through retained earnings, the sale of equity securities and short-term bank borrowings.² However, since 1947 the unstable earnings record of the carriers has caused airline stocks to be classified as highly speculative by conservative financial institutions. While the improvements in traffic and revenue enabled United States domestic trunk airlines to recover from their substantial loss position recorded in 1961 and to show a modest profit after taxes,³ it is apparent that the available seat miles offered continue to outstrip total revenue passenger miles as the industry load factor continues to drop.⁴ Airline management may be encouraged to note that the operating economies of new type equipment have enabled these carriers to show a profit with a break-even load factor of 53.3 per cent, but may not be encouraged on

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¹ Although a DC-3 passenger aircraft cost \$100,000 in 1938 in comparison to a modern jet passenger aircraft costing \$6 million in 1962, the 1962 Annual Report of the Air Transport Association of America recorded that the average airline revenue per passenger mile was only 23.7% higher in 1962 than in 1938 while the general consumer price index had increased 115.9% during the same period of time.

² Brown and Ashby, *Airline Financing*, 16 J. Air L. & Com. 460 (1947); Hines, *Legal Difficulties in Secured Airline Equipment Financing*, 15 J. Air L. & Com. 11 (1948); Donahue and Perry, *Airline Financing and Operational Problems*, 23 J. Air L. & Com. 151 (1956); Adkins and Billyou, *Developments in Aircraft Equipment Financing*, 13 Bus. Law. 199 (1958).

³ In 1962, although revenues exceeded \$2.2 billion, a modest profit of \$11.2 million after taxes and debt servicing was achieved. A net loss of \$34.7 million was experienced in 1961 and the earnings deficiency for the 1956-1961 period was reported by the Air Transport Association to be \$457.2 million.

⁴ Refer to *Aviation Week & Space Technology*, March 11, 1963, at 159. Over-all load factors for United States trunk airlines are shown as follows:

1955	64.1%	1959	61.4%
1956	64.1%	1960	59.5%
1957	61.5%	1961	56.2%
1958	60.0%	1962	53.3%

the other hand by the trend of coach revenue passenger miles to steadily increase at the sacrifice of higher yield first-class revenue passenger miles. Thus, it may still be some time before United States airlines can count upon equity securities as a source of potential funds;⁵ and until that time arrives the airline industry, like the railroad industry, must continue to finance its equipment requirements through borrowing from financial institutions and purchasing such equipment on credit terms from the manufacturers.⁶

However, before present equipment programmes could be completed, technology had already taken a further step forward by placing upon the drafting boards the supersonic transport aircraft. Under the terms of an inter-governmental arrangement, the British and French aircraft industries have undertaken to produce an operational Mach 2.2 supersonic transport aircraft by 1970 with development costs estimated in excess of \$500 million to be borne equally by the two governments. The British-French supersonic transport is to be known as the "Concorde" and has been ordered by British Overseas Airways Corporation, Air France and Pan American World Airways and may be ordered by Continental Airlines. In the United States, consideration has been given for several years to the development of a Mach 3 aircraft having an average block speed of 1500 m.p.h., carrying 150 passengers and flying 3000 hours per year to do the work of four subsonic jets.⁷ There is considerable controversy within industry and governmental circles in the United States at the present time as to whether a Mach 3 steel titanium aircraft requiring new manufacturing techniques or a Mach 2.2 aluminum aircraft involving known manufacturing techniques, should be manufactured within the United States. According to a report recently released by the Federal Aviation Agency, the cost of a Mach 3 steel titanium aircraft would be \$22.6 million each in comparison to the cost of a Mach 2 aircraft of between \$13 and \$15 million.⁸ Current estimates of the cost of the SST programme range somewhere between \$900 million and \$1.5 billion. It is obvious that supersonic transport aircraft can only be made available to United States airlines if substantial governmental support can be found for their development.

In view of the financial climate which prevails in the industry today, it is important to examine the legal problems that surround aircraft financing in the United States and in Canada in order to ascertain what the law has done and what it can do to develop a more favorable climate for investment by financial institutions. The machinery provided by the law must be simple, it must provide security for the investor, and it must not unduly restrict the airline in its operations or dealings.

⁵ Barber, *Airline Mergers, Monopoly and the CAB*, 28 J. Air L. & Com. 189 (1962). Professor Barber sees cause for some improvement in the economic health of United States airlines and his recommendations, especially with reference to matters of government policy, warrant careful study.

⁶ United States airlines have acquired jet equipment from manufacturers on extremely favorable credit terms and at prices below cost. Neither Boeing, Convair, Douglas nor Lockheed have reached the break-even point in their current commercial aircraft programmes. In the *Aviation Daily*, Jan. 4, 1963, it was reported that the Boeing break-even point on its Model 727 programme was estimated at more than 180 aircraft although firm orders received to that date amounted to only 131 aircraft.

⁷ *Study on Supersonic Transport* prepared for the Federal Aviation Agency by United Research, Inc., Oct. 1960.

⁸ *Aviation Daily*, June 24, 1963, at 326.

The treatment of the subject matter will be confined to considerations of aircraft finance in the United States and in Canada since the situation outside America is largely influenced by the extent to which financing arrangements are determined by governments rather than by airline management.⁹ The laws of the United States and Canada relating to finance in general and aircraft finance in particular will be treated comprehensively but, where useful, reference will also be made to the laws of other countries.

In the international forum, consideration will be given to the International Convention on Rights in Aircraft, 1948, often referred to as the Geneva Convention. The major airlines of the United States and Canada have international routes, the maintenance of which requires that a certain proportion of the airlines' equipment be continuously in foreign countries. Such equipment includes spare engines and parts dispersed in depots at various international centers in addition to aircraft. This situation poses a serious problem to the financial institutions concerned since it is usually difficult to predict the extent to which property rights and security interests in such equipment will be recognized by foreign courts.

Since security is the basic consideration for a financial institution which is contemplating the advance of funds, various types of security instruments have been discussed and the uses and relative merits of each considered at length.¹⁰ In this connection, it is useful to study the credit arrangements developed by the railroads during the last half of the nineteenth century since commercial aircraft financing has borrowed from precedents established in the field of railroad equipment financing although there are many basic differences in the problems involved and their possible solution.¹¹ Implicit in any discussion of security rights is the matter of notice by recording. In Canada there is no central registry where such security rights may be recorded and it is the author's view that the establishment of such a registry by legislation of the Government of Canada is highly desirable and would be a valid exercise of the powers of that Government under the British North America Act.

During the present transitional period, while the airlines are endeavouring to raise funds to meet their new equipment commitments, it is both timely and important that the legal problems affecting finance be examined to ensure that future development of the industry will be attractive to investors and to ensure that an industry which is vital to the national economy and to national defence is not hindered by unsuitable or inadequate legislation.

II. CONDITIONAL SALE CONTRACT AND PLEDGE

A. Object Of Security

As an introduction to the subject of security instruments utilized in aircraft finance, it is first necessary to consider the nature of the security

⁹ Oates, *Financing The Jets*, *Aeroplane*, April 24, 1959:

The preservation of a satisfactory ratio between loan capital and equity capital is of little importance in the case of carriers such as B.O.A.C., B.E.A., Air France and Sabena which have for many years been largely capitalized through the issue of fixed interest-bearing stocks or loans.

¹⁰ Shawcross and Beaumont, *Air Law* (2d ed.), *Commercial Dealings in Aircraft*.

¹¹ Adkins and Billyou, *Current Developments in Railroad Financing*, 12 *Bus. Law*, 207 (1957); Duncan, *Equipment Obligations* (1924).

which an airline could make available to those having a financial interest to be protected. Since an aircraft itself may be encumbered with a security lien, it must be properly identified or identifiable. Changes in the basic characteristics of an aircraft involving major and sometimes minor modifications are a matter of concern to the secured creditor. In some countries the law expressly prohibits modifications on the aircraft without the consent of creditors having a security interest therein.¹² In Canada and the United States restrictions on the aircraft operator in this regard are the subject of contractual negotiations. Therefore, the validity of security given on engines and other component parts of aircraft will be determined by the provisions of provincial and state laws respectively.

The opinion has been expressed¹³ that a mortgage in the United States on component parts of an operational aircraft such as propellers, radio or radar (other than engines) cannot be recorded with the Federal Aviation Agency since the Act¹⁴ provides for the recording only of mortgages in "any aircraft engines, propellers, or appliances maintained . . . for installation or use in aircraft," *i.e.*, provided they may be classified as spare parts. Such parts may however be encumbered if the controlling law of the state so permits.

Apart from the aircraft, spare parts are available for security as independent assets. However the identity of spare parts can present a difficult problem. Spare parts are more numerous, varied and widely dispersed at parts depots located along the carriers' routes. Such parts are put into service by being taken from stock and incorporated into the aircraft, hence losing their identity. These characteristics of spare parts and their handling has presented its problems from a legal point of view. In addition to considering aircraft and spare parts as objects of security, a later chapter deals with the possibility of offering the complete aviation enterprise as security. The enterprise of course would include the fleet of aircraft, spare parts, handling equipment, special tools, office equipment, and generally all moveables and immoveables, corporeal and incorporeal.

B. Protection Of Conditional Vendor Of Aircraft

The usual conditional sale contract for aircraft and spare parts will contain covenants in favor of the vendor to the following effect, such covenants to be binding upon the purchaser until the purchase price shall have been paid in full:

(1) The purchaser will operate, control and maintain the aircraft and parts in conformity with all applicable laws, rules and regulations, and will be solely responsible for any fines, penalties or forfeitures occasioned by any violation thereof.

(2) The purchaser will indemnify and save harmless the vendor from any and all claims, loss, damage, costs and expenses which the vendor may suffer and incur by reason of any personal injury, including death, or any damage to or loss of property, arising out of or in connection with the operation, maintenance or control of the aircraft and parts. The purchaser will procure and maintain at its own expense insurance satisfactory to the vendor insuring and covering the vendor against liability

¹² Ley general de aviacion civil art. 250 (El Salvador 1955); Ley de aeronautica civil art. 212 (Honduras 1957);Codigo de aviacion civil art. 205 (Nicaragua 1956).

¹³ Bayitch, *Aircraft Mortgage*, 13 U. Miami L. Rev. 152 (1958-1959).

¹⁴ Federal Aviation Act, § 503(a)(2), 72 Stat. 731 (1958), 49 U.S.C. § 1403(a)(2) (Supp. 1958).

for loss, injury, damages or claims caused or arising out of or in connection with the operation or maintenance of the aircraft and parts, including injuries to or deaths of passengers, injuries to or deaths of third persons and damage to or destruction of property, public or private within certain specified minimum limits.

(3) The purchaser will, at its own expense, procure and maintain all risks hull insurance on the aircraft and fire and broad extended coverage insurance on parts when not attached to the aircraft in amounts not less than the full insurable value of the aircraft and parts.

(4) In the event that the purchaser becomes a party to any litigation involving the aircraft or parts, the purchaser shall immediately give notice and details thereof to the vendor.

(5) The purchaser will pay all license fees, permit fees, taxes or other charges in connection with or against the aircraft and parts, including personal property, sales, use or similar taxes imposed upon the vendor by reason of its ownership thereof.

(6) Any repairs or improvements made upon the aircraft and parts by the purchaser will be at the purchaser's expense, and will become a component part thereof, and the property of the vendor.

(7) The purchaser will have the right to paint or print its name or any symbols it may desire on the aircraft, but will at all times maintain on the aircraft a notice containing language to the following effect: "This aircraft is operated by (name of purchaser), under Conditional Sales Agreement from (name of vendor and its address)."

(8) The purchaser may operate the aircraft and use the parts within or without the limits of (territory) provided, however, that the purchaser may not permit the aircraft or parts to be taken into any of the so-called "iron curtain" countries, including without limitation USSR, Albania, Lithuania, Hungary, Czechoslovakia, Bulgaria, Poland, Viet Minh, East Germany (exclusive of the Western Sector of Berlin and the approach corridors thereto), Romania, Latvia, Esthonia, China and North Korea.

(9) The purchaser will not create or permit to be created any lien or charge upon the aircraft or parts. Neither the purchaser nor anyone claiming by, through or under the purchaser, will have any right to file, place or claim any mechanic's liens upon the aircraft or parts, and notice is given that no person who may furnish any materials, services or labor for any improvements, alterations or repairs to the aircraft or parts shall be entitled to any lien thereon.

(10) The purchaser will maintain and keep the aircraft and parts and all components thereof in good order and repair, subject to the maintenance requirements of the applicable government authority, the vendor and the manufacturer of any component thereof, and will replace, in or on the aircraft and parts of its components, any and all parts, equipment, appliances, instruments or accessories which may be worn out, lost, destroyed, confiscated, or otherwise rendered unfit for use and beyond repair, so that each of such items will: (a) be in good operating condition and will have a value and utility at least equal to that of the property replaced, and (b) be owned by the purchaser, free and clear of all liens and encumbrances. The purchaser will be obligated to perform at its own expense (i) such overhauls of the airframe of the aircraft and its com-

ponents, (ii) such engine overhauls and all inspection and maintenance service of the engines and of the aircraft, including its engines, propellers, instruments, accessories and equipment, and (iii) all other repairs required by such aircraft, engines and their components, including the replacement or addition of parts when necessary, all of which overhauls, services and repairs will be in accordance with the vendor's maintenance procedures and those of the applicable government authority. The purchaser will also accomplish all airworthiness directives of the applicable government authority and will accomplish the annual licensing and re-licensing of the aircraft and engines if required by the governmental authority at any time, so as to maintain such license in full force and effect.

(11) The vendor will have the right to inspect the aircraft and parts, whether on the ground or in the air, and to inspect all documents and records pertaining thereto.

(12) In the event that the vendor retakes possession of the aircraft and parts, the purchaser will pay to the vendor an amount which would be required as the cost to the vendor for overhaul, repairs and replacements of any and all parts, equipment, instruments and accessories, in order to restore the aircraft and parts and their components to the same overhaul hours and condition as at the time of delivery of the same to the purchaser.

(13) The purchaser will maintain all records pertaining to the aircraft, its engines and propellers in accordance with the rules and regulations of the government authority, and will deliver the same to the vendor upon any repossession.

(14) The purchaser will preserve and maintain its corporate existence and all its rights, privileges and franchises.

(15) The purchaser will keep all its properties, useful or necessary in its business, in good working order and condition.

(16) The purchaser will furnish to the vendor at regular intervals certain financial statements and other information relating to the financial condition of the purchaser.

(17) The purchaser will not, without the prior written consent of the vendor sell, lease, assign, transfer or otherwise dispose of the aircraft or parts or of all or substantially all of its assets; make any loans to or investments in non-aviation enterprises or aviation enterprises; or declare or pay any dividend.

The foregoing restrictive covenants have been set forth at length since their provisions are typical of covenants contained in all security instruments employed in aircraft finance. The nature and scope of these covenants is indicative of the degree of control which the vendor may expect to retain over his property and the debtor. It is also usual to find other more specialized covenants of a financial nature included in the list of events of default, such covenants being closely tailored to the terms of the transaction in question and directly reflecting the bargaining strength of the parties in the negotiation.

III. EQUIPMENT TRUST AGREEMENT

A. *Development From Railroad Finance*

Since commercial aircraft financing has borrowed to a considerable extent from precedents established in the field of railroad equipment

financing, it is appropriate at this point to consider the historical development of railroad finance. Two general forms of equipment trusts have been used by the railroads in the United States and Canada in purchasing railroad equipment on credit.¹⁵

Until about twenty years ago the greatest part of railroad equipment financing was handled under the Philadelphia Plan which first evolved about 1870.¹⁶ The essence of this plan is that the equipment is leased to the railroad, and the railroad pays for it through rental payments to the trustee. The rentals are then applied to the corresponding maturities of principal and dividends of certificates issued under the plan and held by the investors. The reason for the adoption of the Philadelphia Plan was the state of the law in Pennsylvania in regard to conditional sales. The Pennsylvania courts had uniformly refused to sustain the title of a conditional vendor who had surrendered possession to his vendee, as against the claims of creditors of, and purchasers from, the vendee without notice of the conditional vendor's claims. Pennsylvania, in the days when the above decisions were made, had no general system for recording or filing chattel mortgages. Investors and their counsel thus arranged to have the equipment not sold but leased with the privilege to the lessee of purchasing at the expiration of his lease. The lessor's title not having passed, the presumption in favor of creditors of the railroad that the railroad owned the equipment was not available to them.¹⁷ Another attraction of former times was that equipment trust certificates in Pennsylvania, and perhaps in other States as well, had certain tax advantages for the holders over other corporate obligations.

The second form of equipment trust used by railroads is known as the Conditional Sale Plan.¹⁸ Under this arrangement, an investment banking house, acting on behalf of the railroad, finds an institutional investor or a group of such investors who are willing to advance the funds to purchase equipment. The manufacturer of the equipment enters into a conditional sale contract with the railroad and assigns its rights thereunder to the investor or, if there is more than one investor, to a bank or trust company (the agent) which distributes the participation certificates issue registered in the names of the investors. Under the conditional sale, the purchase price of the equipment is usually paid in equal installments of principal and interest with title to the equipment becoming vested in the railroad upon payment of the last such installment. Upon delivery of the equipment, title is transferred by the manufacturer to the investor who usually is represented by the agent. The agent receives the payments which have been made by the railroad and distributes them among the holders of its participation certificates. It is interesting to note that the investor normally has no direct right of action against the railroad under the conditional sale plan, but must rely upon the agent to enforce the debtor's obligations. Under the Philadelphia Plan, the equipment trust certificates on their face represent an obligation of the trustee with the guarantee of the railroad company as lessee for payment of principal and

¹⁵ Adkins and Billyou, *supra* note 11, at 210.

¹⁶ Duncan, *op. cit. supra* note 11.

¹⁷ Page and Gates, *Work of Corporate Trust Departments* (1927).

¹⁸ Also referred to as the "New York Plan."

dividends.¹⁹ The specific purpose of the endorsed guarantee was to provide the certificate holder a direct right of action against the railroad.²⁰

Having reviewed the development of equipment trusts in railroad financing, it can be concluded that there is a current trend towards the conditional sales plan. It is a variant of this plan that forms the basis of most airline equipment trusts today. For all practical purposes the traditional Philadelphia lease arrangement under which title passes to the railroad upon payment of the final rental installment, produces the same legal effects as a conditional sale. The tax implications of leases are discussed in a subsequent chapter, but the advantages of a lease with an option to purchase may, under certain circumstances, be illusory with the transaction being regarded by the taxing authority as a conditional sale.²¹ However, certain investment banks still appear to favor the Philadelphia Plan in the belief that it is easier to sell to the public certificates issued thereunder, and thus, it can be expected that vestigial aspects of the lease feature are likely to be retained in railroad equipment finance for the sake of public acceptance.

The Philadelphia Plan equipment trust is still usually in the historical form involving the use of vendors and two documents called "Agreements" and "Lease." The vendors no longer serve any useful function, since the equipment is transferred directly to the trustee and the two separate documents also have outlived their usefulness. Recently there has been prepared a modified form of Philadelphia Plan equipment trust which eliminates the vendors and combines in one Equipment Trust Agreement the important provisions of both the agreement and lease. The result is a substantially simplified document without change in substantive rights. The recent Series UU Equipment Trust of the Southern Railway Company was created under an agreement in the new form and it is anticipated that other railroads will adopt it shortly.²²

B. Equipment Trust For Aircraft Purchases

The problems which faced the railroads in the field of equipment purchases are in many respects similar to the problems facing the airlines. However, there are also significant differences in the two fields of finance which can in part be attributed to the nature of the airplane itself and to the nature of airline operations.

From the point of view of security, the equipment trust has been use-

¹⁹ Interest on equipment trust certificates issued under the Philadelphia Plan are customarily referred to as "dividends."

²⁰ Adkins and Billyou, *supra* note 11, at 212. They point out that this right of action is now of no practical importance since, in the event of default under the lease, the trustee will protect the rights of certificate holders by selling the equipment and/or by filing a claim under the lease in the reorganization proceedings.

²¹ Adkins and Billyou, *supra* note 11, at 209:

From the point of view of the railroad the advantage of the lease arrangement is that (a) no cash down payment is required by the railroad and (b) the railroad should be entitled to deduct from its income for federal income tax purposes the entire rent paid, which is a larger amount than the interest, plus depreciation allowed for tax purposes which would be deductible in the same period under the ordinary Philadelphia Plan arrangement. There is still some controversy with the Bureau of Internal Revenue as to the right of the railroads to make the full deduction. However, since the railroad never acquires any title to the equipment and since the lessor retains a valuable asset after the expiration of the lease, it would seem that the transaction is a true lease rather than a disguised conditional sale, and that the railroad's right to deduct rent should ultimately be sustained.

²² Adkins and Billyou, *supra* note 11, at 212.

ful in railroad financing in times of prosperity as well as in times of adversity. The loan was secured by specific items of equipment, the equity in that equipment building up in value more rapidly than it decreased and not being subject to dilution by the claims made by other creditors of the railroad. With rare exceptions, the holders of equipment obligations were paid in full in spite of the receivership of the issuing railroad for the obvious reason that a receiver could not normally afford to give up the use of the equipment and was forced to continue payments in order to retain it.²³

However, a financial institution holding equipment trust certificates secured by aircraft may not enjoy the same degree of security for practical, rather than legal considerations, as the holder of certificates secured by railroad equipment. The down payment made by the airline is often in the form of trade-ins which cannot readily be disposed of on the used aircraft market. This consideration combined with a payment schedule which in some cases may correspond to nearly the expected useful life of the aircraft, can only be interpreted as meaning that the equity of the airline in its aircraft may not build up in value as rapidly as in the case of railroad equipment. In addition, the resale possibilities are limited although the aircraft may be practically new. Aircraft are frequently designed to perform special tasks, to operate on certain specific routes under certain specific conditions and are, in other words, tailored to the needs of a particular airline. This may make the aircraft difficult to resell as the result of a bankruptcy or reorganization, without the incorporation of costly modifications. The resale value of aircraft is also subject to fluctuation as the result of technological advance which can, notwithstanding the fact that the equipment in question is only a few years old, render it uneconomical to operate. Thus, the vicissitudes of the used aircraft market are a factor which must be taken into account by a financial institution purchasing aircraft equipment obligations.²⁴

1. *Nature and Application*

Under the typical equipment trust used in financing the manufacture and purchase of aircraft by a commercial carrier, the airline makes a contract with the aircraft manufacturer for the equipment which the airline wants. The contract and the proceeds receivable thereunder are then assigned to the trustee. The manufacturer transfers the aircraft to the trustee upon delivery and, under the usual conditional sale arrangement, the trustee retains legal title to the aircraft for the benefit of the holders of the equipment trust certificates until the purchase price and interest thereon are paid in full by the airline. Possession of the equipment is granted by the trustee to the airline.

Each equipment trust certificate issued by the trustee represents an

²³ Duncan, *op. cit. supra* note 11, at 146.

²⁴ Adkins and Billyou, *supra* note 11, at 216:

The resale of aircraft that has been repossessed because of default under a security instrument may not be nearly as successful. Not only is the number of purchasers severely limited (there are only thirteen major carriers and thirteen local service lines in the United States) but, since aircraft deteriorate rapidly if not constantly attended, protected and used, the problems of repossession and resale are far from simple. If the earnings of one airline that has borrowed money through equipment financing should, for reasons other than bad management, fall off so drastically as to result in default, other airlines might be affected by the same conditions so as to make any satisfactory sale difficult.

obligation of the trustee with the guarantee of the airline to pay the holder the amount of principal and interest shown on the face of the certificate. The financing may be carried out by the manufacturer itself or by others. If the financing is carried out by the manufacturer, the trustee issues certificates to the manufacturer as representing the price of the equipment. The manufacturer will then place the certificates with financial institutions who purchase these equipment obligations at a negotiated discount. In this manner, the manufacturer will realize the sales prices. Depending upon the credit facilities available to the manufacturer, it may choose to hold the certificates itself and pledge the same as collateral for bank or other credit. Alternatively, if the manufacturer does not arrange the financing, the trustee places the equipment trust certificates and pays the manufacturer out of the money put up by the purchasers of the certificates.²⁵

2. *Substantive Provisions of the Trust*

The trust is usually referred to in the conditional sale contract between the aircraft manufacturer and the carrier, and is executed prior to the equipment being delivered to the carrier and often is executed prior to start of production of the aircraft. The equipment trust being an instrument of security will always provide for the payment of the balance of the purchase price and interest thereon falling due in installments at regular intervals after delivery of the aircraft, and of course, depending upon the extent to which the purchase contract and the trust are correlated as a matter of drafting, the trust may contain complete payment terms.

Depending upon whether the trust comes into effect before or after delivery, the agreement may provide for the appointment of inspectors to inspect the equipment on delivery and, if satisfactory, to accept it on behalf of the carrier and so certify to the trustee. In the event that the trustee places the equipment trust certificates and pays the manufacturer, the agreement may provide for payment of the manufacturer by the trustee for the equipment upon receipt by the trustee of: (1) a proper invoice from the manufacturer specifying the equipment and its price (which must correspond to the prices stipulated in the equipment trust agreement or the purchase contract); (2) a bill of sale in favor of the trustee; (3) the inspector's certificates; and (4) the opinion of counsel satisfactory to the trustee that the bills of sale and purchase contract are valid and effective to vest title to the equipment in the trustee, free of all liens and encumbrances. In the industry today, it is usual for the manufacturer to receive equipment trust certificates from the trustee reflecting the indebtedness of the purchaser for the balance of the price of the aircraft. In such circumstances, the foregoing formalities of delivery are altered accordingly.

Under a typical equipment trust with an airline as purchaser, the airline would, among other things, undertake: (1) to pay at their respective maturities, the equipment obligations, the interest thereon and taxes in connection therewith; (2) to maintain its corporate existence and all its

²⁵ Under a typical conditional sale contract used today, the manufacturer will have received a down payment (or its equivalent in trade-ins) upon execution of the purchase contract from the carrier.

rights, privileges and permanent franchises; (3) to maintain, at its own expense, in good order and repair the trust equipment, and to replace at its expense any equipment destroyed; (4) to satisfy and discharge all claims which might become a lien or charge upon the trust equipment equal or superior to the title of the holders of the trust certificates or the trustee; (5) to indemnify and save harmless the manufacturer and the trustee for all losses, damages and claims arising out of the use or operation of the trust equipment while title thereto remains vested in the manufacturer or the trustee; (6) to maintain in respect of the trust equipment, hull, passenger legal liability, public legal liability and property damage legal liability and excess insurance payable to the purchaser and the trustee as co-insured; (7) to fasten and to keep on each piece of equipment a metal plate showing that the trustee is the owner of the equipment, although the airline also may letter the equipment with its name or other marking to indicate its interest therein; (8) to file periodically with the trustee certified financial statements, insurance statements and reports of the location and condition of all equipment; and (9) to maintain certain specified minimum working capital and net worth requirements.²⁶

The trust agreement also binds the purchaser to certain negative covenants which, subject to such exceptions as may be agreed upon in each case, usually include the following: (1) not to sell, lease or assign all or substantially all of its assets; (2) not to declare dividends or make loans or investments; (3) not to merge into or consolidate with any other corporation; (4) not to make payment for fixed or capital assets; and (5) not to lease the trust equipment.

The equipment trust also provides for the recording of the equipment trust agreement and supplemental equipment trust agreements under the Federal Aviation Act of 1958. Upon delivery of any aircraft or space part, the purchaser is obligated to cause the aircraft and space parts to be registered in the name of the purchaser with the Federal Aviation Agency and to enter into supplemental trust with the manufacturer and the trustee subjecting such aircraft and spare parts to the terms of the principal equipment trust. These formalities are observed to conform with the recording requirements of the Federal Aviation Act concerning security interests in aircraft.

The equipment trust agreement also contains the customary provisions concerning the duties and responsibilities of the trustee, and generally protecting the trustee for claims arising in connection with things done by the trustee in discharging its obligations.

3. *Advantages and Disadvantages*

The principal advantage of the equipment trust agreement is the facility of financing where participation is divisible into as many parts as there are holders of trust certificates. These certificates are transferable in the hands of the holders. However, it is usual for the majority of the certificates to be placed in large blocks with two or three financial institutions.

In the chapter entitled "Chattel Mortgage" which follows, the relative advantages and disadvantages of the chattel mortgage and conditional sale are outlined. Since the equipment trust arrangement in aircraft finance

²⁶ Page and Gates, *op. cit. supra* note 17, at 167.

is usually a conditional sale, reference should be made to that chapter.

However, a change made by Congress to the United States Bankruptcy Act in September 1957, favors conditional sale and lease agreements over chattel mortgages. This apparently has had the effect of making equipment trust financing more popular in recent years. The amendment to Section 116 of the Bankruptcy Act is discussed in the section which follows.²⁷

C. Bankruptcy Act Amendment (U.S.)

Under legislation relating to bankruptcy in the United States, bankruptcy reorganization courts are vested with extensive powers over companies and their properties which are subject to reorganization.²⁸ The rights of conditional sale vendors and of chattel mortgagees in reorganizations have been curtailed in many instances. In the case of chattel mortgagees, the court has ordered participation in the reorganization and prevented the mortgagees from exercising their right of repossession. In the case of conditional sale vendors, reclamation orders of the court have allowed debtors liberal periods of time in which to satisfy the vendor's claim.

In 1935, Section 77 of the Bankruptcy Act was revised to preserve from interference in bankruptcy reorganization the right to repossess rolling stock pursuant to the terms of a railroad equipment trust or conditional sale agreement.²⁹ It was maintained for some years that comparable protection should be extended to the field of aircraft finance to assure financial institutions with investments secured by airline equipment that the injunctive power of the bankruptcy court would not be brought to bear if the airline was subjected to proceedings for reorganization under Chapter X of the Bankruptcy Act. The repossession of airline equipment would have had a serious effect upon the public by disrupting passenger and mail services and thus, it was felt that the power of repossession was somewhat illusory.³⁰ In addition under Chapter X, a secured creditor of an air carrier could in case of default be confronted with, at the minimum, a lengthy delay before he could exercise his right to repossess and sell the airline equipment subject to his claim since the court usually has the power to enjoin creditors from enforcing their rights against the bankrupt for such time as may be required to permit the reorganization to be effected.³¹ This delay could deprive the creditors of a very valuable and important right since the market for second-hand aircraft fluctuates considerably as has been seen.

²⁷ Hines, *Legal Difficulties in Secured Airline Equipment Financing*, 15 J. Air L. & Com. 11 (1948).

²⁸ Adkins and Billyou, *supra* note 2, at 208. Cited is *Continental Bank & Trust Company v. Chicago R.I. & Pac. Ry.*, 294 U.S. 648 (1935). In this United States Supreme Court judgment, it was held, "that a court charged with the reorganization of a railroad under Section 77 of the U.S. Bankruptcy Act could issue an injunction restraining creditors from exercising a power to sell collateral owned by the bankrupt and pledged as security for a loan to the debtor." The sale was considered to be prejudicial to the reorganization and limitation of the pledgee's power of sale was warranted in the circumstances.

²⁹ *Zirn v. Hanover Bank*, 215 F.2d 63 (2d Cir. 1954).

³⁰ Adkins and Billyou, *supra* note 2, at 209. The authors point out that the recalculation of aircraft, engines and spare parts would be so serious that "it would expose the carrier to the danger that the CAB might exercise its power under § 401(h) of the Civil Aeronautics Act to revoke the carrier's certificate of public convenience." It is not likely that a bankruptcy court would have risked such a serious result affecting the public interest.

³¹ *Id.* at 210.

Thus it was that in September, 1957, the United States Congress amended the Bankruptcy Act by adding subdivision (5) to Section 116 thereof reading as follows:

Notwithstanding any other provisions of Chapter X, the title of any owner, whether as trustee or otherwise, to aircraft, aircraft engines, propellers, appliances, and spare parts (as any of such are defined in the Civil Aeronautics Act of 1938, as now in effect or hereafter amended) leased, subleased, or conditionally sold to any air carrier which is operating pursuant to a certificate of convenience and necessity issued by the Civil Aeronautics Board, and any right of such owner or of any other lessor to such air carrier to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of Chapter X if the terms of such lease or conditional sale so provide.

Congressional reports covering the amendment describe the purpose of the legislation as that of facilitating financing, especially as regards investment in local carriers.³² The amendment should materially aid the air carriers in obtaining financing by improving the position of the secured creditors, but unfortunately the legislators failed to confer the benefits of the legislation upon chattel mortgagees. It will be seen that the chattel mortgage is the most common type of security used in aircraft finance and its omission from subdivision (5) of Section 116 of the Act may have the effect of increasing the popularity and use of equipment trust and conditional sale financing.

Adkins and Billyou are of the view that the omission of the chattel mortgage from the provisions of the legislation may have been an oversight in drafting the amendment. The language used was taken directly from the language added in 1935 to Section 77(j) of the Act to cover railroads which are concerned with equipment trusts and conditional sales. Chattel mortgages are only rarely used in railroad financing because of problems created by the after-acquired property clauses of broad system mortgages. This difference in financing techniques should have been taken into account by the legislators who amended Section 116, but the apparent oversight can be easily corrected by a further amendment extending the protection of subdivision (5) to the chattel mortgagee.³³ There does not appear to be any valid reason why the legislation should not be extended to include the chattel mortgage.

The affect of the existing legislation on the chattel mortgagee and the action to be taken by the chattel mortgagee to protect his interests pending the enactment of corrective legislation are discussed in the next chapter.

IV. CHATTEL MORTGAGE

A. Nature And Recordation

A chattel mortgage is generally considered in the common law to be "an agreement vesting in the creditor the title to the chattel, defeasable by performance on the part of the debtor of the obligation for which title to the chattel is conveyed as security."³⁴ Apart from performance, the

³² H.R. Rep. No. 944 and S. Rep. No. 1032, 85th Cong., 1st Sess. (1957).

³³ Adkins and Billyou, *supra* note 2, at 211. The writers believe that duplication of the language of similar legislation relating to railroads was at least in part the reason for the omission of the chattel mortgage.

³⁴ Bayitch, *supra* note 13, at 158.

title to the chattel is redeemable only in equity or by virtue of specific legislative enactment having application.³⁵

In principle the security interest must attach to a specific chattel. In Canada and in the United States the conveyance creating an interest in aircraft or in chattels connected with aircraft must meet the requirements of provincial or, as the case may be, state laws having application. For registration under the Federal Aviation Act of 1958 the conveyance must describe the aircraft by make, manufacturer's serial number and Civil Aeronautics registration number, or any other detail sufficient to enable identification.³⁶ In instances in which an engine is encumbered, the conveyance must specifically identify it by make, model and manufacturer's serial number;³⁷ in instances in which spare parts including engines are encumbered, specific identification must be made in the conveyance of the air carrier by name and the conveyance must describe generally the types of the spare parts covered thereby,³⁸ and in addition must specifically describe their location or locations.³⁹

Although it is not possible to record a fleet mortgage under the Federal Aviation Act unless the aircraft are specifically identified, it will be seen that the Geneva Convention (Art. VII, Para. 5) makes provision for circumstances in which several aircraft of a fleet are encumbered for a single debt. It is also interesting to note that in Canada and the United States aircraft may be used as security regardless of the origin or nature of the debt. Registration requirements may however provide that certain minimum information on the debt be shown in the conveyance. The chattel mortgage is in the form of a formal instrument suitable for recording. In common law jurisdictions, the law of property usually makes it mandatory to record the chattel mortgage, subject to certain exceptions in which the chattel be delivered to the mortgagee and continue to remain in his actual possession. To qualify for recordation under the Federal Aeronautics Act, the conveyance must be acknowledged by the signer or signers before a notary public or other officer authorized by the law of the United States, or of a State, territory or possession thereof, or the District of Columbia, to take acknowledgements of deeds.⁴⁰

The foregoing comments concerning recordation apply, of course, to all types of security instruments and conveyances. Under the laws of the United States and Canada registration has only the function of giving notice to third persons without affecting the instrument's intrinsic validity either as to parties or third persons. In general, recording statutes in force in common law jurisdictions put persons on notice of the existence of the instrument recorded, which effect can also be achieved by factual knowledge alone. Under the Federal Aviation Act, recording of a conveyance involving ownership shall not be evidence of ownership of aircraft in any proceeding in which such ownership by a particular person is, or may

³⁵ *Ibid.*

³⁶ Federal Aviation Act, § 503(a), 72 Stat. 731 (1958), 49 U.S.C. § 1403(a) (Supp. 1958).

³⁷ Federal Aviation Act, § 503(a)(2), 72 Stat. 731 (1958), 49 U.S.C. § 1403(a)(2) (Supp. 1958).

³⁸ Federal Aviation Act, § 503(a)(3), 72 Stat. 731 (1958), 49 U.S.C. § 1403(a)(3) (Supp. 1958).

³⁹ Federal Aviation Act, § 503(a)(3), 72 Stat. 731 (1958), 49 U.S.C. § 1403(a)(3) (Supp. 1958).

⁴⁰ Federal Aviation Act, § 503(e), 72 Stat. 731 (1958), 49 U.S.C. § 1403(e) (Supp. 1958).

be, in issue.⁴¹ Bayitch notes that such a reservation in favor of the otherwise applicable state law is not expressed with regard to the recording of lesser interests in aircraft, for example, of the mortgage type, but the Act has not been interpreted as an attempt to encroach upon the legislative jurisdiction of the states in this area.⁴²

B. *Advantages And Disadvantages*

The chattel mortgage is the most commonly used security instrument in aircraft finance, although in recent years the conditional sale and lease have also been widely employed. There are a number of features of a chattel mortgage which contribute to its popularity and suit its application to aircraft and aircraft parts.

1. *After-Acquired Accessories*

An advantage to the chattel mortgage is that after-acquired accessories not sold by the conditional vendor can be made subject to the mortgage. This is important where the customer purchases and installs costly equipment after the aircraft has been delivered by the manufacturer. The regulations of the CAB and the Department of Transport concerning the installation of expensive radar and flight recorder equipment in aircraft would materially increase the equity of the secured investor who was a mortgagee under an instrument drafted to cover after-acquired accessories.

2. *Replacement Parts*

In regular servicing and maintenance of aircraft, parts are continually being replaced. In some cases the replacement is made as a result of a routine periodic inspection and in other cases, parts are replaced at periodic intervals on the instructions of the manufacturer or at the direction of the governmental authority having jurisdiction. In consequence a large inventory of expensive spare engines and spare parts must continually be available to the operator. Such a stock is often worth twenty percent of the original price of the aircraft, and is dispersed at depots around the world in the case of an international airline. A chattel mortgage, by its broad terms, can cover any generally described and identified property irrespective of its origin or location subject, of course, to compliance with applicable recording requirements.⁴³

3. *Interchangeability of Liens*

Provision may be made in a security instrument for the interchangeability of liens in circumstances in which there are different mortgages or conditional sale agreements covering different aircraft operated by the same carrier.⁴⁴ It is essential that at the time of default all components and parts physically attached to a particular aircraft be subject to the same lien as the aircraft and thus, it may be provided that the lien of the particular mortgage on any particular spare part which becomes attached to an aircraft subject to another mortgage will be deferred to the lien of the other mortgage so long as the spare part remains so attached.

⁴¹ Federal Aviation Act, § 501(f), 72 Stat. 731 (1958), 49 U.S.C. § 1401(f) (Supp. 1958).

⁴² Bayitch, *supra* note 13, at 170.

⁴³ Adkins and Billyou, *supra* note 2, at 201.

⁴⁴ *Id.* at 203.

4. *Additional Assets*

Another advantage of a chattel mortgage as compared with a conditional sale agreement or lease-purchase agreement, is that property other than that already owned by the airline can be subjected to the mortgage, the lender obtaining a first mortgage or junior lien on such other property. Thus, office equipment, maintenance shops, passenger and cargo loading equipment and other assets could be included in the chattel mortgage as added security either at the time of the purchase or subsequently at a time when the lender considers the original security to be no longer adequate.

5. *Tort Liability*

The problem of tort liability of the aircraft owner can arise in certain jurisdictions in instances where a conditional sale agreement or a lease-purchase arrangement has been employed under which the lender is the title owner of an aircraft, and the aircraft is registered in the name of the operator. Such a problem probably would not arise where the security instrument is a chattel mortgage.⁴⁵

6. *Section 116(5) of Bankruptcy Act (U.S.)*

Reference has been made in the previous chapter to the fact that in adding subdivision (5) to Section 116 of the Act⁴⁶ the legislators failed to take into account the chattel mortgagee. The amendment provided in effect that the title of a lessor or of a conditional vendor of aircraft should not be impaired by any proceeding under Chapter X, *i.e.*, reorganization. Adkins and Billyou suggest that the combination of a conditional sale or lease with a chattel mortgage so that:

the vendor would have protection in a Chapter X proceeding in respect of the property which he had sold, and would have as additional security a chattel mortgage covering spare parts and possibly other aircraft, which would be effective to improve his position relative to other creditors even though the property subject to the chattel mortgage could not be immediately repossessed in Chapter X proceedings.⁴⁷

If Section 116(5) of the Act is amended to cover the interests of the chattel mortgagee as recommended herein, the mortgage would have a further advantage over conditional sale and lease agreements in the sense that provision could be made for the repossession of newly acquired equipment as well as the older equipment. The authors⁴⁸ recommended that at the present time the chattel mortgagee should endeavour to neutralize the advantage that Section 116(5) now gives to the lessor or conditional vendor. The chattel mortgage could be drafted to provide that the very act of entering into a lease or conditional sale which provides, in accordance with Section 116(5), that the lessor or conditional vendor may repossess the equipment in the event of bankruptcy, shall be a default under the chattel mortgage. It certainly would be prudent to

⁴⁵ Until 1948, when § 524 of the Civil Aeronautics Act was enacted, secured transactions in the United States relating to aircraft were unsatisfactory because a lessor, conditional vendor or assignee was exposed to the risk that as owner, regardless of negligence, he could be held by a court to be absolutely liable under the laws of some states for damage to persons or property.

⁴⁶ 71 Stat. 617 (1957).

⁴⁷ Adkins and Billyou, *supra* note 2, at 211.

⁴⁸ *Id.* at 212.

include such a provision in every aircraft chattel mortgage to ensure that the airline could not enter into security instruments that would permit other creditors more extensive practical rights than those of the chattel mortgagee.⁴⁹

C. *The Basket Lien*

Prior to 1948 there was no security device which would enable airlines in the United States to borrow against their stock of spare engines and parts which is normally used to maintain the aircraft in operation. The spares inventory will be located at various depots along routes on which the airline operates. When the need arises spares are taken from the stock and installed on the aircraft of which they become part. The inventory of spares is continually in the process of being depleted and replenished and thus has an ever-changing identity.⁵⁰

The so-called basket lien amendment to Section 503 of the Civil Aeronautics Act in 1948 enabled the airlines to subject their floating inventories of spare parts to liens, one appropriate security instrument being the chattel mortgage. Under Section 503 as amended, liens on aircraft and engines over 750 horsepower could be recorded by including in the chattel mortgage an appropriate description of such aircraft and engines. Engine numbers must also be listed. Liens or charges on other engines and spare parts can be perfected by recording an instrument which provides in substance that there shall be a lien on all engines and spare parts covered by a general description and situated at specified locations.⁵¹

V. FLOATING CHARGE AND FIXED CHARGE

A. *Enterprise As Security*

The legal system of different countries have approached the problem of using the complete enterprise of an airline as security in a variety of ways. The legal problems relate to the nature of the enterprise which includes moveables and immoveables both corporeal and incorporeal. In common law jurisdictions there are no specific statutory provisions which regulate mortgages on aviation enterprises. However, in Canada both the fixed charge and floating charge are available in the mortgage of corporate assets, and they are frequently combined in the same trust deed.⁵² In the United States on the other hand the security device used to mortgage an enterprise is a fixed charge known as the corporate mortgage.⁵³ Such a mortgage is generally non-statutory and results from private agreement. The floating charge which developed in the law of England has not

⁴⁹ *Ibid.* Adkins and Billyou also suggest that the chattel mortgagee will have the benefit of § 116(5) if it should later be amended to give rights to a chattel mortgagee.

⁵⁰ Adkins and Billyou, *A Proposed New Form of Security for the Senior Debt of Our Airlines and Railroads: Floating Charges*, 12 Bus. Law. 378, 382 (1957).

⁵¹ Adkins and Billyou, *supra* note 2, at 203.

⁵² Fraser, *Reorganization of Companies in Canada*, 27 Colum. L. Rev. 932, 934 (1927):

It is the almost invariable practice to include in a well drawn Canadian bond mortgage a floating charge upon the assets and undertaking of the company. Most bond mortgages contain a specific charge of a company's real estate and buildings or other fixed assets in addition to the floating charge, although sometimes there is no fixed charge and the floating charge is the only security for the bonds.

Also see Gower, *Some Contrasts Between British and American Corporation Law*, 69 Harv. L. Rev. 1369, 1397 (1956).

⁵³ Bayitch, *supra* note 13, at 178. Reference is made to Fletcher, *Cyclopedia of the Law of Private Corporations* (Supp. 1957) p. 177; Dewing, *The Financial Policy of Corporations* (1953) p. 195; Lyon, *Corporations and Their Financing* (1938) p. 244.

found acceptance in the United States and is generally not recognized there today.⁵⁴

B. Nature And Application

1. Floating Charge

In establishing a floating charge on its assets, the corporation effectively pledges all its assets as security for payment of the bonds while at the same time retaining the right to continue to deal with such assets in the normal course of business. In the advent of a receivership under the security instrument, the assets become frozen and are available to the trustee in bankruptcy or receiver for the benefit of the bondholders. The charge is usually drawn in favor of a trustee whose responsibility it is, in the event of default and upon application of the bondholders, to appoint the receiver. The receiver in turn, acting in the interest of the bondholders, will endeavor to realize upon the assets and discharge their secured claim. It is customary for the floating charge to attach to all the assets of the corporation, moveable and immovable, corporeal and incorporeal, including sums owing by debtors, uncalled capital, proprietary rights under license agreements and so forth.⁵⁵

The floating charge has been described by Lord Macnaghten in the following terms:

A specific charge, I think, is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.⁵⁶

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 a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes. His right to intervene may of course be suspended by agreement. But if there is no agreement for suspension, he may exercise his right whenever he pleases after default.⁵⁷

The legal profession in England gave birth to the floating charge about 1870. In the first case to determine the validity of the charge, the court held that debenture holders secured by a floating charge were entitled to the proceeds of the sale of ships in priority to general creditors.⁵⁸ In England and in Canada the floating charge is available to incorporated companies.⁵⁹ In England where, because of the "reputed ownership" clause of the Bankruptcy Act and certain other provisions of the Bills of Sale Acts of 1872 and 1882, the floating charge is only available to incorporated companies, it is quite common to incorporate solely because of the

⁵⁴ *The Availability of the Floating Charge as a Security Device in the United States*, 28 Colum. L. Rev. 360 (1928).

⁵⁵ Cole, Morley and Scott, *Corporate Financing In Great Britain*, 12 Bus. Law. 324 (1957).

⁵⁶ Illingworth v. Houldsworth, A.C. 358 (1904).

⁵⁷ The Governments Stock and Other Securities Investment Co. v. Manila Ry., A.C. 86 (1897).

⁵⁸ *In re Panama*, New Zealand and Australian Royal Mail Company, L.R. 5 Ch. 318 (1870).

⁵⁹ Gower, *supra* note 52, at 1396.

greater facilities for borrowing which flow from the ability to grant an effective floating charge.⁶⁰

The law does not require any special wording to create a floating charge but the intention must be shown to impose a charge on property present and future and to permit the company to continue to deal with that property in the ordinary course of business.⁶¹ The floating charge is also equitable by nature, being junior to a legal mortgage created at a later date if the mortgagee had no notice of the floating charge. However, laws of England and of Canada require that the charge be registered as notice as a condition precedent. The trust deed may itself place some limitation on the company's power to create additional charges in priority to or *pari passu* to the charge which is its subject. There appears to be a trend in England which favors the floating charge over the fixed charge, but it would seem likely that the two security devices will continue to co-exist, frequently under the same trust deed.

2. Fixed Charge

The fixed charge is a specific charge or mortgage on certain definite assets such as land or buildings. The fixed charge differs from the floating charge in the sense that the assets subject to the charge cannot be disposed of without the charge continuing to bind the mortgagor in possession. This form of mortgage is appropriate for a company with much of its property in tangible fixed assets. The assets are valued on a "going concern" basis since this is the most realistic appraisal that could be relied upon in the event the security would have to be enforced for the benefit of the bondholders. The corporate mortgage employed in the United States is of the nature of a fixed charge and consequently does not provide the mortgagor with the same freedom of disposition in his business dealings as the floating charge.

A parent company which is itself a holding company and which operates subsidiary companies owning most or all of the fixed assets of the group, may nevertheless issue debentures which are secured. The only security available to the holding company itself are the shares of the subsidiary companies which are of little value since the parent would rank after the creditors of the subsidiaries. Thus the parent, in order to issue secured debentures, must obtain the concurrence of the subsidiary companies in the provisions of the trust deed. The subsidiaries must grant a fixed or floating charge on their assets in favor of the trustee as security for the parent company's debentures. It would be necessary in such circumstances to ensure that the subsidiary companies were so empowered to pledge their assets and that in return some consideration was received under the debenture issue.

3. Trust Deed

It is customary for the trustee to be a corporation which has been expressly organized for and is experienced in carrying out the work of a trustee. The conditions which attach to the debentures are set out in detail in the trust deed and include covenants by the company in favor of the trustee on behalf of the bondholders to pay principal and interest

⁶⁰ *Id.* at 1397.

⁶¹ Adkins and Billyou, *supra* note 50, at 388.

when due, to carry on business in a proper manner and set out circumstances in which the bond becomes enforceable. The trust deed usually contains provisions for meetings of the bondholders to agree to any modification of their rights.

Generally the debentures are in registered form upon issuance. A register is maintained by the company containing the names and addresses of bondholders who have certifications indicating that they are entered on the register. The persons so entered on the register are the only persons recognized by the company as having any title to the security. Debentures are usually issued in acknowledgement of long term debt which implies a term of twenty years or more. During the last five or ten years of the term, the company usually has the optional right to redeem the whole issue or portions thereof at a premium above the final redemption price. The right of prepayment is negotiated but may be difficult to obtain when interest rates are high. The interest rate and the price at which the debentures are issued depend upon the money market and the bond market respectively. Debentures can be issued at a price below par or above par, but the redemption price is usually at par or the issuance price, whichever is higher.

The trust deed often will contain provisions to the effect that the issue is "open-ended." This means that within certain specified limits determined by a formula the company may issue further bonds ranking *pari passu* with the existing bonds and having the same or different interest rate and sinking fund provisions. From the point of view of security, such new bonds would rank equally with those previously issued.

The formula governing the issue of any further stock is usually on the basis that the value of the net assets of the company based on the last audited accounts must amount to not less than, say, two and a half or three times the total amount of stock outstanding (including the new stock to be issued) and that the audited earnings of the company for the last three years must show that the amount required to pay the interest on the stock (including the new stock) is covered, say, not less than two and a half or three times. A formula on these lines is chosen to protect the existing stockholders and, at the same time, to provide a proper method for the company to obtain further loan money as its business expands.⁶²

C. Advantages Of Floating Charge For Airlines

The advantages of the floating charge to an airline is readily apparent to the observer. This unique security device furnishes an airline as mortgagor with a wide latitude of flexibility in its dealings. The investor would have a valid and binding instrument to enforce while the operator would be able to pool, lease, loan, transfer and sell aircraft, engines and spare parts freely in the normal course of business. In discussing the merits of the so-called "basket-lien" under a previous chapter heading, the special nature of an airline's business was discussed and it was concluded that an airline should, where possible, have reasonable freedom of acquisition and disposition in respect of its fleet and the spare parts, handling equipment and special tools for its support.

While the floating charge is available to airlines in Canada and in England, an airline in the United States is not so fortunate. Adkins and

⁶² Cole, Morley and Scott, *supra* note 55, at 339.

Billyou in an article entitled "A Proposed New Form of Security for the Senior Debt of Our Airlines and Railroads: Floating Charges" recommend that the Civil Aeronautics Act be amended authorizing United States airlines to enter into agreements creating floating charges to secure debt and providing that purported conveyances made, or liens created by the obligor, in violation of any restrictive covenants entered into to protect such floating charges would be void.⁶³

Under the Federal Aviation Act, only those parts of the corporate mortgage dealing with specific chattels are recordable. Thus, the entire corporate mortgage as such will not qualify.⁶⁴ Adkins and Billyou support the constitutionality of their proposed amendment by quoting instances of the use in the United States of federal law to add to or to alter the state-created rights of interstate carriers. The floating charge is proposed as a security device which would appeal to a large number of investors. At the moment investors are obliged to rely upon the "basket-lien" provisions of Section 503 (a) (3) covering the spares inventory and this underlines the need of United States airlines of a floating charge to cover spare parts, engines and propellers in particular. In addition, the airlines have many other assets that might be employed as security to increase their borrowing power. Assets not covered by the terms of Section 503 would include office equipment, maintenance shops, passenger and cargo loading equipment, underground fueling systems and accounts receivable. The remarks of Messrs. Adkins and Billyou with respect to the floating charge as a security device for United States airlines are worthy of serious consideration by the legislators.

(EDITOR'S NOTE: This concludes Part I of a two part article. Part II, which will appear in the next issue of this Journal, will include the chapters on "Leasing," "The Geneva Convention," and "Priorities of Liens and Privileges.")

⁶³ Adkins and Billyou, *supra* note 50.

⁶⁴ Bayitch, *supra* note 13, at 178.