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The Rise of Aircraft Leasing

In recent times, we have seen that commercial airlines prefer to lease their aircraft rather than to use their own resources to finance the purchase of their fleet. Over the last two years, AirAsia, Malaysia's leading low-cost carrier, sold a majority of their aircraft portfolio in two transactions -- first to firms managed by BBAM Limited Partnership in 2018[1] and secondly, to private investment firm, Castlelake LP in 2019[2]. These aircraft were then leased back to airlines within the AirAsia group. With the rise of leasing companies in this region, the increased availability of leased aircraft and competitive rental rates, it is no wonder that many commercial airlines chose to lease their aircraft and conserve their cash resources to expand their business in other ways. The leasing of aircraft also allowed operators to quickly fill gaps for shortages of aircraft due to special circumstances such fleet grounding or to cater for the seasonal higher flying volume.

Occurrence of a Global Crisis

The aviation industry has been devastated by the Covid-19 pandemic. The pandemic has struck fear in relation to health concerns worldwide and together with the numerous travel restrictions imposed by many countries, there has been a drastic decline in passenger bookings. This in turn caused many commercial airlines to ground a majority of their fleet. Airlines have resorted to drastic measures in the likes of implementing pay cuts, cancellation of flight routes and offering unpaid leave to staff in an effort to conserve their cash resources. With uncertainty as to when the industry can recover, airlines are now faced with difficult decisions as to how their remaining reserves should be allocated. Airlines who have leased aircraft would have significant rental payment obligations to lessors which they may not be able to keep up with whilst their fleet is grounded. If lessees cannot fulfil their payment obligations under their lease agreements, this would in turn make it difficult for leasing companies to fulfil their financial commitments to their investors and financiers.

[1] Circular to Shareholders of AirAsia Group Berhad dated 27 April 2018 as available on www.bursamalaysia.com.
[2] Circular to Shareholders of AirAsia Group Berhad dated 1 April 2019 as available on www.bursamalaysia.com.
[3] http://cccovid19.mot.gov.my/

The growing concerns faced by airlines and leasing companies in the light of this pandemic have raised interesting issues as to whether the existing law and the "standard" terms and conditions in a typical aircraft lease agreement addresses the rights of the parties in unexpected situations and more particularly, which party is better protected. In this article, we will examine the general legal position and the relevant clauses in a market-standard aircraft lease agreement to consider whether leasing companies have an unfettered right to demand for the lease rentals to be paid or to terminate their lease agreements due to defaults by the lessee or whether a lessee can claim indulgences under the lease agreement for circumstances which are beyond their control.

"Hell or High Water" Clause

Leasing companies will most likely look first to the "hell or high water" clause, which is a standard clause in aircraft lease agreements. The "hell or high water" clause, also known as the "net lease" clause, sets out the lessee's obligation to pay rent on an unconditional basis throughout the duration of the lease, regardless of the circumstances.

The "hell or high water" clause is extremely important to lessors as it ensures that a steady cash flow is generated from the rent payable by the lessee under the lease agreement. This in turn guarantees the lessor's ability to repay its debt for the aircraft if it is being financed. This fundamental clause is unlikely to be given up by any lessor.

There are very few exceptions to the net lease clause which lessors are agreeable to. During better times, airlines with stronger bargaining positions may be able to obtain a carve-out where the lessor has itself breached its obligations under the lease agreement causing the lessee to be unable to operate the aircraft during the quiet enjoyment period. In the absence of any limited carve-outs applying, it is likely that lessees will be subject to the "hell or high water" clause and will need to continue making the rental payments under the lease even in the midst of this global pandemic.

Force Majeure

"*Force majeure*" is a contractual provision that allows both parties to be free from the contractual obligations that could not be performed due to the occurrence of certain triggering events beyond their control, such as war, acts of God, strikes and riots. If any of the triggering events occur, the contracting party relying on the *force majeure* clause must prove the occurrence of such event referred to in the clause and that such event has prevented, hindered or delayed the performance of the contract. Furthermore, the party relying on the clause must prove that non-fulfilment of its contractual obligations was due to the circumstances which are beyond its control and that reasonable steps have been taken to avoid or mitigate such event or its consequence.

In general, the courts will look into the construction of the *force majeure* clause to determine whether such clause is wide enough to cover the triggering event and whether it has affected the performance of the parties' contractual obligations under the contract. In addition, the contracting party relying upon the *force majeure* clause must comply with the requirements provided in the force majeure clause to invoke the clause, e.g. if notice is required to be given to the counterparty, such notice requirements must be complied with.

Assuming that the aircraft lease agreement contains a *force majeure* clause, whether or not such clause could be invoked as a result of the Covid-19 pandemic will depend on whether an "epidemic" is listed as the triggering event in the lease agreement. Although the occurrence of the Covid-19 pandemic is beyond the reasonable control of the lessee, it would be

rare to find a *force majeure* clause in a standard aircraft lease agreement that allows the lessee to avoid rental payments in a situation where the lessee is forced to cancel its flights and ground its fleet.

Statutory Rights under the Contracts Act 1950

In Malaysia, an agreement to do an act afterwards becoming impossible or unlawful could be deemed frustrated and void under section 57(2) of the Contracts Act 1950 (the "Contracts Act"), which provides as follows:

"A contract to do an act which, after the contract is made, becomes impossible, or by reason of some event which the promisor could not prevent, unlawful, becomes void when the act becomes impossible or unlawful."

In order to rely on section 57 (2) of the Contracts Act 1950, the contracting party must fulfil the following requirements[2]:

1. The event upon which the promisor relies as having frustrated the contract must have been one for which no provision has been made in the contract. If provision has been made, then the parties must be taken to have allocated the risk between them.

2. The event relied upon by the promisor must be one for which he or she is not responsible. In other words, self-induced frustration is ineffective.

3. The event which is said to discharge the promise must be such that renders it radically different from that which was undertaken by the contract. The court must find it practically unjust to enforce the original promise.

In ***Pacific Forest Industries Sdn Bhd & Anor v Lin Wen-Chih & Anor*** [2009] 6 CLJ 430, the Federal Court held, inter alia, that a contract does not become frustrated merely because it becomes difficult to perform. The doctrine of frustration is only a special case to discharge a contract by an impossibility of performance after the contract was entered into. A contract is frustrated when, subsequent to its formation, a change of circumstances rendered such contract legally or physically impossible to be performed.

It should be noted that not all contracts would be deemed automatically frustrated and void due to the travel restrictions imposed by the Malaysian Government in light of the Covid-19 pandemic. If a lessee wants to rely on Section 57(2) of the Contracts Act, such lessee must prove that it has struggled to perform its contractual obligations or that there has been a change of circumstances rendering the contract legally or physically impossible to be performed.

The majority of aircraft lease agreements are governed by English law or New York law and whether or not frustration applies will depend on the governing law of the lease agreement. The English courts have been cautious in deciding whether or not frustration could be invoked as the application and effect of the doctrine of frustration could be very draconian. Once the doctrine of frustration applies, the contract becomes void due to the impossibility of performance and parties will be permanently discharged from their respective contractual obligations.
From a Malaysian law perspective, frustration is unlikely to apply because it is not impossible for the lessees to perform its obligations under the aircraft lease agreement - it is just not commercially viable for them to do so during this time. The courts are also likely to find that it will be unfair to release the parties from their obligations under the aircraft lease agreement merely because aircraft operations are temporarily halted.

Illegality; Change in Law

It is common for an aircraft lease agreement to include an "illegality event" clause in which the "illegality event" occurs due to a change in law and is or will become illegal, unlawful or impossible for the lessee to carry out its obligations under the lease agreement.

Whilst it may not be commercially feasible for an airline to operate the aircraft amidst the pandemic, it is not illegal for the lessee to meet its obligations arising from the leasing of the aircraft. At the time of writing, the Movement Control Order ("**MCO**") imposed by the Malaysian Government does not contain restrictions on both international and domestic flight operations3 although there are various travel restrictions imposed on individuals. At this point in time, the Malaysian Government has not made it illegal to operate flights and it is important to note that the decision to cancel flights are made by the respective airlines. Accordingly, this pandemic is therefore unlikely to fall under the definition of an "illegality event" or constitute a "change in law".

Material Adverse Change ("MAC"); Material Adverse Effect ("MAE")

Standard lease and financing agreements would normally allow a creditor (i.e. the lessor or financier) to declare that an event of default has occurred if there has been a "material adverse change" in the financial condition of the debtor (i.e. the lessee or borrower) or if circumstances have occurred which would have a "material adverse effect" on the obligations of the debtor to carry out its obligations under the lease or financing agreement.

MAC/MAE are usually defined in broad terms and this can potentially give creditors wide discretion in exercising their right to declare that an event of default has occurred. However, it is interesting to note that whilst most creditors would generally insist on retaining the MAC/MAE clause in their agreements, creditors are reluctant to rely on the MAC/MAE clause in declaring an event of default – preferring to rely on specific events of default instead. This is rightfully so as a declaration that an event of default has occurred would have a serious chain reaction triggering cross defaults in the lessee's other agreements and potential reputational damage to the lessee. A creditor would therefore need to be very certain that an MAC/MAE event has occurred if it wants to rely on this provision in declaring an event of default under the agreement. If a lessee is able to continue performing its contractual obligations, then it would be difficult for a creditor to claim that the MAC/MAE clause has been triggered.

The MAC/MAE clause can be a useful provision for creditors to begin negotiations with debtors without waiting for a payment default. However, at this point in time, it remains to be seen whether creditors will rely on the MAC/MAE clause in calling an event of default following the effects on the debtor due to the Covid-19 pandemic.

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Moving Forward

Whilst it is interesting to consider the legal position of the parties under an aircraft lease agreement, perhaps the pertinent issue is not a legal one, but rather what is the best way forward for all the parties involved. In the current climate where few airlines are entering into new leases, terminating an existing lease and re-possessing the aircraft presents its own set of problems for the lessor. Perhaps the best way to weather this storm would be for the parties to restructure the existing lease agreements rather than for the lessors to terminate them and risk a slew of similar actions by the rest of the creditors of the airline. This would be more desirable in the long run to ensure the airline's survival and its ability to bounce back once the world recovers from the effects of the Covid-19 pandemic.

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