

Parking Aircraft When They Are No Longer Flying – Consider The Labuan Option by Datin Shelina Razaly Wahi



Although domestic flights have resumed faster than initially anticipated, the fact that many international borders remain closed (both from the perspective of restricting residents and citizens from exiting a country; and the restriction on the entry of non-citizens / non-residents into a country), has meant that international flights have a long way to go, to hit their pre-COVID-19 levels.

Latest International Civil Aviation Organisation (ICAO) estimates indicate that the possible COVID-19 impact on world scheduled passenger traffic (compared to business as usual) would be (i) an overall reduction of 1,815 to 3,213 million passengers; and (ii) approximately USD236 to USD419 billion of potential loss in the gross operating revenues of airlines.

Many airlines have already announced rationalisations of their fleet – including retiring entire aircraft types, and streamlining or harmonising their existing fleets. These rationalisations have been effected in various forms – delayed or cancelled deliveries for new aircraft; early termination and return of aircraft in existing leases and in extreme cases, pure default in leases – all in an attempt to cut costs and capacity, in order to better cope with some of the economic fallout of the COVID-19 pandemic. With most airlines having a fleet that consists of both owned, albeit financed aircraft, as well as leased aircraft, both finance lessors and operating lessors are already seeing the negative impact of COVID-19 on their businesses.

With a few airlines having already announced insolvency and/or restructuring of some sort (for eg. Flybe (the United Kingdom) having gone into administration in March 2020; Virgin Australia having entered voluntary administration in April; Avianca (Colombo) filed for chapter 11 bankruptcy protection in May), and many other operators showing serious signs of distress around the world, the industry faces the prospect of many aircraft coming into the market over the immediate and short-term.

Lenders and lessors are facing similar scenarios across multiple markets. A forcible repossession is not the preferred option, with lessors preferring to work with and support their airline lessees, particularly if the airlines are being reasonable. Also, depending on the jurisdiction concerned, the cost of a forcible repossession, usually predicated by some sort of injunctive order, could end up being substantive. Hence what is most likely to happen is a mutual termination whereby certain provisions are made for the benefit of both lessor and airline. However sometimes a mutual position may not be possible, for example in the event of a liquidation event on the part of the airline. In either event - the lessor is then faced with a dilemma – how to deal with the aircraft once it has been returned or repossessed?

Labuan is already host to several entities in the business of aircraft leasing. The current structures mostly reflect that the Labuan company (who is the aircraft owner) is a wholly-owned subsidiary of a parent company who is an airline operator in Malaysia. A plus point is the relative speed (24 hours) and low cost (USD300-USD1500) of incorporating a Labuan company.

In accordance with the provisions of the Labuan Business Activity Tax Act (“LBATA”), Labuan companies who own aircraft and/or leased aircraft for the purpose of sub-leasing those aircraft, are required to comply with certain conditions pertaining to economic substance. Prior to these provisions coming into effect (circa 2019), the preferred structure was for the Labuan entity (that owned the aircraft) to be a Special Purpose Vehicle (“SPV”) whose sole shareholder was a trust controlled by a corporate trustee, and for the lenders to hold a charge over the shares in that SPV. In the event the airline were to default on its performance of the sub-lease, the Secured Party (typically the Lender) could then call in the charge and gain ownership of the subject aircraft with minimal fuss and minimal time.

A similar structure, of an SPV owned by a trust, may well come in use today, for the purpose of holding aircraft assets that no longer have homes, whether due to mutual termination or due to repossession from airline operators. Having a Labuan trust hold an aircraft during the interim period while that aircraft is not being leased out and/or operated by the next operator, could be a more efficient process, and provides an alternative to the lessor holding the aircraft directly.

These kinds of structures therefore see a Labuan trust owning aircraft, through the ownership of all the shares in an SPV that is the legal owner of the aircraft. So long as the Aircraft is not physically situated in Malaysia, the Aircraft may be the property of the Trust. In addition, utilising the Trust as the ultimate beneficial owner of the SPV protects the SPV structure from any insolvency risk on the part of the lessor / owner. Such a Trust is usually set up as a Labuan purpose trust - controlled by a corporate trustee, and the directors of the SPV are often independent professional directors provided by a dedicated corporate services provider (who would be the corporate trustee). The constitutional documents and trust documents governing the SPV or to which the SPV is subject, provide an effective means of limiting the roles of the directors. The deed settling the purpose trust (Trust Deed) can be drafted to clearly set out the purpose of the Trust and the duties of the Trustee, and any restrictions or obligations on the exercise of shareholder powers in relation to the SPV.

The Labuan Purpose Trust

The Labuan Purpose Trust provides flexibility because it can be set up without the need to stipulate a beneficiary, for the benefit of a group of individuals, or for any number of purposes — charitable or non-charitable, or a combination of both. Under this trust structure, the settlor may appoint a personal representative in the form of an enforcer, to ensure that the trustee carries out his/her duties accordingly. The Trust Deed can also enhance the bankruptcy remoteness of the SPV by providing that the trustee will not take any action to wind-up the SPV without the express consent of the enforcer.

The Labuan Special Purpose Trust

An alternative to the “orphan trust” structure that arises when the SPV (set up as a Labuan Holding Company) is owned by a Trust that is controlled by a corporate trustee, is the Labuan Special Purpose Trust. The Special Trust requires the trustee to retain designated shares of an underlying Labuan company as assets of the trust while ensuring that the management of the Company may be carried out without the intervention by the trustees. In this structure, there is a separation of economic benefit to beneficiaries from the voting control of the trustees, which is carried out in accordance with pre-set rules. Arrangements can be made to allow representatives of the settlor to play an active role in management.

The Special Trust therefore allows the settlor to be in control of the day-to-day management of the assets, yet protects the assets from unforeseen challenges that may arise. The special trust allows the settlor to be in control of the assets, which can then be used for investment or other purposes. The proceeds (of such an investment) are then placed with a trustee for protection. A major benefit of the Special Trust is that it can be structured for long-term asset protection, including for example as a result of changes in political and/or economic policy in the settlor’s original jurisdictions. Unlike the Labuan Purpose Trust, the Labuan Special Trust does not have provisions for an enforcer.

Setting up an SPV and a Trust Structure in Labuan offers multiple benefits:

- ✧ Labuan (and Malaysia) has a strong legal system, based on English common law
- ✧ The establishment and maintenance of a Labuan company is straightforward
- ✧ An SPV whose only purpose and activity is to hold assets will not be subject to the licensing or regulation applicable to entities involved in “Labuan Business Activities”
- ✧ If the SPV is carrying out a Labuan Non-trading Activity (which includes holding property), the SPV will be exempt from tax in Labuan
- ✧ There are no minimum capital requirements for a Labuan company
- ✧ Labuan companies are not required to have locally resident directors

- ✧ The Labuan Trust Act provides asset protection without reference to the laws of any country or jurisdiction (ie protection against a foreign law claim or enforcement of a foreign law judgment)
- ✧ When a Labuan trust is established, then there will be no taxes applicable to the assets and income of the trust
- ✧ There is a high degree of confidentiality protection with Labuan trusts
- ✧ Labuan legislation specifically provides for Purpose Trusts as well as Special Trusts

In addition, the process of setting up a Labuan trust is fairly straightforward – all submissions for the registration of a Labuan Trust to the Labuan Financial Services Authority, are filed through the Labuan Trust Company (ie the corporate trustee); a Labuan Trust may be registered within 7 working days (or 2 days with a fast track process); and the registration fee is only USD200.

Once the SPV is set up under either the Purpose Trust or Special Trust structure, title to an aircraft could then be transferred to that SPV. If a lessor, in the event where the lessor/creditor has provided financing for the purchase of the aircraft, already holds a charge over the shares of the SPV, the creditor could then transfer those shares to a trustee. Once the aircraft is either sold or leased again, the lessor could then choose whether to transfer the ownership of the aircraft from the SPV to the seller; or to transfer the ownership of the shares of the SPV from the corporate trustee.

Malaysia is party to the Capetown Convention on International Interests in Mobile Equipment (“the Capetown Convention”). As Labuan is part of the territory of Malaysia, notwithstanding that Labuan has its own LBATA and Labuan Companies Act, stakeholders in the aircraft (whether security parties or even owners of engines, for example) would also be able to take comfort from the fact that their interests could similarly be protected in Labuan as in any other Capetown Convention jurisdiction.

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