The Turkish aircraft market: ready to turn the autopilot off?

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A very large percentage of all aircraft-related transactions in Turkey are regulated by the Financial Leasing Law and relevant ancillary legislation. However, neither the legislation nor the institutions involved are fully equipped to accommodate market players at the level of internationally acknowledged standards. This article seeks to pinpoint some of the issues hindering efficient and uniform practice in the market such as the inadequacy of the regulatory framework, incompatibility of the institutions and procedural loopholes that have mostly been neglected until recently. Also covered are the practical resolutions addressing these issues.

A. Introduction

In 1933, the first commercial aeroplane in Turkey flew with less than five passengers. Since then, the aviation industry has expanded on an almost unimaginable scale, both globally and domestically. Before the multi-player, competition-driven market structure obliged the Civil Aviation Authority (CAA) to amend its legislation, Turkish Airlines (THY) had been the sole provider of commercial aviation services in Turkey. Following the partial privatisation of THY and legislative restructuring, there now exist over 20 airlines registered in Turkey and almost all of them operate internationally. However, aircraft leasing formed only 2 per cent of total asset leases in 2008,[1] and the value of aircraft imported was approximately US$1.5 bn, in comparison with total imports of approximately US$200 bn.[2]

One could read such figures in one of two ways. Firstly, the volume of aircraft-related transactions has increased dramatically in the past few years due to the increasing level of competition and the introduction of new players. As the number of aircraft-related transactions increases, disputes and loopholes of an entirely distinct nature are regularly encountered. Although there had been efforts to achieve harmonisation with regard to aircraft finance transactions globally, through international conventions such as the Cape Town Convention, these remain inadequate on their own to address the problems at hand. Turkey, for instance, signed the Cape Town Convention in 2001, but has not yet ratified it. Even if the Convention comes into force, a sustainable solution will not be possible unless the domestic legislation and authorities are restructured in a way that allows them to liaise with each other more efficiently. A second way to make sense of the current market is to argue that there is still a lot of room for expansion. In view of this fact, the vulnerability of the industry to the risk of speculative practices becomes even more evident. Since an aircraft financing deal requires the co-operation of many government authorities acting in different sectors, and the provisions regulating aircraft deals are spread over all kinds of laws, it becomes even more challenging to sustain a stable and harmonious relationship between these authorities. This article aims to set out some of the issues arising out of the incompatibility of different legislative sources and government authorities' lack of proactivity with respect to the market practice in Turkey.

B. The Financial Leasing Law and the regulatory framework

A very large number of Turkish cross-border aircraft-related transactions are governed by the Financial Leasing Law No 3226 ("the FLL"). This is because some very intriguing tax advantages are provided for transactions governed by the FLL, especially in relation to aircraft. Those transactions that do not come within the scope of the FLL are governed by the general provisions of the Code of Obligations, be it a sale or lease transaction. However, it should be noted that lease transactions benefit from a considerably larger number of tax incentives when compared to sale transactions, which explains the popularity of aircraft leases in Turkey. The FLL, however, is clearly not drafted in consideration of the unique nature of aircraft transactions. Most provisions of the FLL are intended for the protection of small and medium-sized enterprises, ordinarily leasing machinery and similar equipment. Hence, it is only natural to anticipate the emergence of loopholes over the years both in terms of redundancy in policymaking and actual application of the law, when such provisions are applied to large airline corporations against their original intended scope of application. Some internationally recognised structures that are ordinarily used in cross-border aircraft leases are prohibited by the FLL. For instance, subleasing and sale and lease-back transactions are not allowed under Turkish law, and the underlying agreements need to reflect such restrictions. A strictly grammatical interpretation would imply that operating leases do not fall within the scope of the FLL. Market practice, on the other hand, has produced *sui generis* agreements governing a relationship that evokes an operating lease struc-

ture, which are also respected by the government authorities. Another important drawback of the FLL is the monitoring structure it provides in relation to cross-border leasing transactions. Article 8 states that lease agreements shall be registered with the Banking Regulation and Supervision Agency ("the BDDK"). Although this provision may seem like a logical outcome of the objective of the BDDK as defined in the Banking Law No 5411, it is clearly not tailored with aircraft transactions in mind. This is the basis of the inconsistency inherent in the legal framework governing aircraft deals. Involving a number of government authorities to monitor different aspects of a transaction without a solid regulatory background results in contradicting implementation of laws. This results in a high-risk market for the lessors, which in turn leads to higher leasing costs and stricter security demands for the lessees, making the situation difficult for all parties involved. Fortunately, there is a new draft FLL pending before the Turkish Parliament which is expected to be enacted in 2009.[3] The draft FLL aims to sort out some of the issues impeding efficient performance of agreements at the moment, allowing both subleases and sale and lease-back transactions, which clearly demonstrate the lawmaker's appreciation of current market practice.

C. The Civil Aviation Authority

A significant number of problems in relation to the inconsistent application of law by official bodies stems from a single government body: the CAA. The CAA is the key government authority regulating and monitoring every aspect of aircraft-related transactions in Turkey. Although there are secondary legislative sources, the operations of the CAA are mainly regulated by the Civil Aviation Act No 2920 ("the Act"). The Act fails to provide in-depth solutions to some practical issues that arise as a result of escalating market activity. The fact that it has not been amended except for a few minor corrections since the day of its enactment in 1983 demonstrates how the lawmakers have failed to keep up with market needs and global trends. As an inevitable consequence of such failure, the number of precedents that reveal the incompatibility of certain CAA policies with market procedures increases every day. An example that demonstrates how the CAA legislation lacks legal infrastructure is the concept of temporary registration. As stipulated by the CAA, the aim of including such a provision in the Act is to ensure that aircraft and rights *in rem* are registered with the CAA. This is usually the case for short-term leases where the conditions set out in the law for a permanent registration are not met and is intended to encourage international trade and acknowledges the global features of aircraft deals. However, the CAA has created another condition in practice that has no legal basis. Namely, the temporary registration will not be operative unless the lessor is a foreign entity. This means that a company registered in Turkey will not be considered as eligible for temporary registration in spite of the fact that the owner of such company is a foreign entity. This approach contradicts the main purpose of the temporary registration concept and impairs the vast potential of transactions that could take place under this Article.[4]

Probably the most striking example of the incompatibility of the two authorities that govern cross-border aircraft transactions manifests itself when a used aircraft is being imported into Turkey. Both domestic and international legislation require that all aircraft periodically undergo a series of maintenance procedures depending on their flight hours. A C-Check is only one of these numerous maintenance procedures. The BDDK needs to approve and register the underlying leasing agreement in order for the import to take place. In practice, this approval will not be granted until the CAA issues a letter of technical appropriateness addressed to the BDDK. Keeping these facts in mind, there are a few details breaking this chain of formalities. Firstly, there is a BDDK communiqué which calls for the relevant party to file its application with the BDDK at least seven days prior to the importation of the aircraft into Turkey. Secondly, the CAA will not issue a technical appropriateness letter unless presented with evidence of a fresh C-Check maintenance. This all appears to be very straightforward, but if the aircraft has not undergone a fresh C-Check prior to its actual import into Turkey, the procedure turns into a deadlock. By way of demonstration, the aircraft needs to be in Turkey to go through the C-Check maintenance, which is the only way the CAA will issue and send the technical appropriateness letter to the BDDK for the agreements to be registered and to gain effectiveness. However, the BDDK does not allow the aircraft to land in Turkey (and hence undergo a C-Check) until seven days before the application is made, which translates as "until it receives the technical appropriateness letter from the CAA".

Whether a fresh C-Check is actually required, or one performed "recently" suffices, is not clear. The CAA, at this point, demands a fresh C-Check to be done before issuing the acceptance letter even if it is not yet due (ie required) under national or international maintenance regulations. In short, imposing such a requirement appears to be at the sole discretion of the CAA officials, and lacks any sort of legal basis. The only practicable solution under the current legislative structure is to perform the C-Check prior to the importation of the aircraft into Turkey so that the CAA issues the technical appropriateness letter and the BDDK application can be finalised in accordance with the anticipated timeline. Nonetheless, it is imperative to note that the preference of most airlines is not to perform the C-Check outside Turkey, considering their discounted arrangements with local maintenance companies, because of obvious cost issues involved.

Unless the idiosyncrasies inherent in aircraft transactions are acknowledged in an effort to enhance the CAA legislation, the problems that are faced at the moment because of the ambiguity of the law cannot be settled competently. One can only hope that an organisational rearrangement similar to the provisional and structural reform made in relation to the FLL is initiated with regard to the CAA operations as well, effectively influencing and advancing the market practice in the long run.

D. Banking Regulation and Supervision Agency

The BDDK plays an important role in numerous stages of aircraft deals as previously demonstrated. In addition, it is also involved in almost every aspect of banking and finance regulation and practice in Turkey. Authorising this body to deal with transactions of such a specific nature (ie aircraft) inevitably cripples the compatibility amongst different authorities and the efficiency the market seeks. For instance, while registering the agreements, the BDDK checks the form and content of the agreement as well as the parties' legal capacities. One would presume that such investigation should be conducted by relying upon certain predefined criteria developed in parallel to the unique procedures involved in financing an aircraft. However the BDDK fails to apply uniform assessment standards for these kinds of agreements, partly due to its lack of industry-specific expertise. When it comes to the application of law, the BDDK usually chooses to pursue a conservative course of action and assesses the agreements in comparison to previous transactions in the same industry. As a result, precedent agreements attain a *de facto* binding effect that has no legal grounds. In simple terms, the BDDK specifically requests that certain phrases in an agreement are amended to conform to the exact wording that the authorities are accustomed to, even though the suggested amendment proves to have no real implication on the meaning or application of the agreement. In a recent example, the BDDK did not register an agreement unless the word "may" was replaced with "shall". Such a hurdle costs a considerable amount of time and money as the amendment needs to be notarised first and then submitted to the BDDK by way of a separate application. In practice, this conservative approach by the BDDK has at times almost disabled the freedom of contract principle, enslaving the entire market to a standard form agreement. A more feasible attitude would have been to establish basic standards that each agreement should comply with, and registering the agreements accordingly. The draft FLL comes to the rescue one more time, foreseeing a new structure that transfers the BDDK's current duty to monitor leasing transactions to a body specifically intended for this purpose named the Financial Leasing Companies Association ("the Association"), hence eliminating the procedure before the BDDK. If the objects of the Association are regulated in a sensible manner, parties acting in the aircraft market would know the limits of their freedom with respect to the agreements and could act accordingly. As a result, the credibility of the authorities would not be compromised and the procedures before government authorities would be conducted more efficiently, with room for new and diversified transaction structures which are in accordance with the law.

E. Requirements as to the form and enforceability issues

The final point that practitioners need to note is the vagueness with regard to various enforcement issues that typically arise in aircraft transactions. Especially in a time when financial markets all over the world are affected by the current credit crunch, it is not unreasonable to predict a rising trend in enforcement-related disputes and the legal consequences thereof. The inconsistencies commence with the perfection of the lease agreements. In accordance with Article 70 of the Act, any security agreement in relation to an underlying lease agreement should be notarised in order to have legal and binding effect.

However, the number of exemptions and incentives, especially for transactions with foreign elements, makes it almost impossible for the public notary to remain up to date and eventually leads to discrepancies even amongst public notaries. A lessee, for instance, may get a lease and mortgage agreement notarised side by side, without having to bear any stamp duty. It is not impossible, on the other hand, for another, unlucky, lessee to be required to bear a considerable amount of stamp duty on his mortgage simply because another notary public is unaware of the legislation providing for such exemption.

Similarly, the deregistration powers of attorney that allow for the lessor to deregister an aircraft from the CAA registry were typically drafted in a way that rendered them unenforceable under Turkish law. For instance, it is prohibited under Turkish law to issue an irrevocable power of attorney. Therefore a power of attorney including the word "irrevocable" would not be acceptable when presented before an official body. In practice, parties typically use a notarised translation of the English irrevocable deregistration powers of attorney instead of a properly notarised Turkish power of attorney. In such a case, there is an English irrevocable power of attorney that is unenforceable because of the fact that it is "irrevocable" and there is a notarised translation of the same, which is also unenforceable due to the mere fact that it is a only a translation and not a separate power of attorney. No government authority would act upon a power of attorney, let alone a translation, which includes the word "irrevocable" or any other word indicating irrevocability irrespective of whether it is in English, in Turkish, notarised or translated. Overall, the frequency of the "irrevocable" deregistration powers of attorney that are in circulation in the market whose enforceability is untested is quite discomforting.

Another question of reliability stems from the enforcement of foreign arbitral awards. As there are several agreements that either include an arbitration clause or are governed by foreign law, enforceability of foreign awards becomes an important issue. Although the conditions for enforcement of an award are set out in the law, the precedents are still quite inconsistent. This trend can be traced back to the condition of "compliance with public order" for enforcement of an award. As the term is vaguely defined, judges have an extremely wide space for interpretation and happen to use such discretion harshly. Both the lack of a ruling precedent and experience in the relevant field of law causes the result of an enforcement proceeding to be "unpredictable". As enforcement proceedings of such nature increase in number and the courts gain more experience, there is no doubt that most of the existing ambiguities will diminish in time.

F. Outlook

In conclusion, the current market situation is predicted to reveal many more inconsistencies and much more unsound practice in the market as the number of disputes increases. This points to the need for a closer look at the regulatory framework in Turkey for aircraft deals and consideration of reform into a more organised and coherent structure to ensure that the law and the actual market practice are in accordance with each other. Thanks to the unique characteristics of the aviation industry, and the technical complexities attached to it, such as the regulatory and tax framework, operational and perfection issues for each jurisdiction, practitioners already realise the diverse scope of application and that the legislative uncertainties are causing inconsistent practice in the market. Hopefully, these problems stemming from the unique jurisdictional restrictions inherent in the aircraft industry will be recognised a lot more clearly due to their rate of recurrence. The aftermath of the credit crisis will present opportunities to repair the structural and legal flaws and restore the credibility of the authorities. This will only be possible through acknowledging the global trends that influence market practice in Turkey and embracing the essentials of implementing the same efficiently. ■

1 Financial Leasing Association (www.fider.org.tr).
2 Turkish Statistical Institute (www.turkstat.gov.tr).
3 H Gülelçe, "Mevzuat¹m¹zda Leasing" [Leasing under Turkish Legislation] [2008] *Leasing World Bulletin* September, 10.
4 I Kaner, *Hava Hukuku (Hususi Kısım)* [Aviation Law (Private Law Section)] (Istanbul, Filiz Kitabevi, 2004), 29.