

THE TRANSPORT
FINANCE LAW
REVIEW

SIXTH EDITION

Editor
Harry Theochari

THE LAWREVIEWS

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For further information please contact Nick.Barette@thelawreviews.co.uk

Editor
Harry Theochari

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PUBLISHER

Tom Barnes

SENIOR BUSINESS DEVELOPMENT MANAGER

Nick Barette

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Nick Brailey

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PREFACE

The Transport Finance Law Review is intended to provide the industry with a guide to transport finance today, in each of the key jurisdictions globally in which aircraft, rolling stock and ships are financed.

The transformation of the asset finance industry triggered by the global financial crisis has been well-documented. Before the crisis, traditional asset finance, in the form of bank debt, had been the mainstay of the transport sector.

Now, regulation introduced with the intention of preventing future crises, such as Basel III and Basel IV, has made long-term lending to the transport sector significantly less attractive. This has, in part, led certain banks to exit the asset finance market altogether, by selling all or part of their loan books to help them to meet their capital requirements.

At the same time, the aviation, rail and cruise industries have required a steady stream of finance to acquire additional assets to help them to meet growing demand from passengers, particularly in developing economies. This, coupled with the desire, and in many cases the requirement, for more environmentally friendly and sustainable transport, the advent of new and disruptive technologies (such as autonomy, blockchain and artificial intelligence) and the introduction of increasingly sophisticated technology (such as high-speed rail and high-specification ships) is leading to increased funding requirements in many areas of the transport sector.

Asset finance in its traditional form is now available from relatively few banks, who in turn are prepared to lend to relatively few names, which are usually leaders in their relevant sectors and have green credentials, which satisfy new environmental standards set out in, for example, the Equator Principles or the Poseidon Principles. Tenors tend to be shorter, and borrowing more expensive. It is clear that debt finance alone is no longer sufficient to meet the needs of the global aviation, rail and shipping industries. Other financiers and investors have recognised this and have identified significant opportunities to secure returns, using innovative new funding structures, and often in collaboration with traditional lenders who have remained in the market.

These developments have meant that legal advisers to the transport finance sector are now required to provide a far broader set of legal skills and market knowledge than has previously been required.

At the time of writing, capital is readily available to much of the aviation industry, which is benefiting from rising demand for air travel and industry forecasts anticipating a doubling of passenger numbers in the next 20 years. The capital markets are also open for business for the aviation industry, and there is a flow of equity investments from both hedge funds and private equity as well as large-scale investments from Asia (and China in particular).

In the rail market, passenger demand is also increasing and significant investment is being made in new and existing rail assets globally. Increased appetite for high-speed rail and light rail transit is encouraging rail market participants to look outside of their traditional markets in search of new opportunities in developing countries, including those forming part of China's Belt & Road Initiative.

Attitudes towards the shipping industry are generally more cautious. The amount of debt finance available to shipping has fallen dramatically, and alternative sources of finance, such as private equity, hedge funds, bond markets and capital markets, have also reduced. This is not surprising to many as shipping gradually emerges from possibly the worst recession it has ever experienced in modern times, impacting across the entire spectrum of the industry. Shipping is still a hugely entrepreneurial business with more than its fair share of dynamic owner principals who are still making sizeable commercial bets as to where the industry is heading and this has led, in a number of sectors, to an over ordering of ships in recent times, which has kept the market depressed.

Today, capital markets, private equity structures and leasing account for a substantial proportion of the transport finance market. A number of private equity players are buying loans from traditional banks at a large discount to see immediate returns. Others have invested directly in shipping in the belief that the cyclical nature of shipping will result in returns in the medium to long term. In the aviation industry, leasing firms, which are frequently supported by private equity players, now account for about 40 per cent of the major aircraft manufacturers' sales. In the case of rail, new investors are being attracted to the industry by the commitments made by governments worldwide to improve existing infrastructure and invest in new, sophisticated rail links.

Against this evolving financing landscape, new environmental regulation and disruptive technology is bringing about further changes. Artificial intelligence, distributed ledger technology such as blockchain, and low carbon technology are creating new funding requirements, as well as bringing new participants into the transport sector, with new ideas for raising finance.

The aviation, rail and shipping industries each have their own unique characteristics and need lawyers with a deep understanding of how each of these complex industries operates. A detailed knowledge of the principles of asset finance is now also required, combined with the ability to advise on new capital markets, leasing and corporate structures. In addition, while the majority of asset financings in the transport sector tend to be governed by English or New York law, an understanding of the principles of local law in the key jurisdictions in which transport assets are registered is also of great importance.

We have sought contributions from jurisdictions that play a leading role in the financing of transport assets. Each chapter provides an overview of the transport finance industry in these jurisdictions, with an analysis of how key lenders have changed over the past five years and how the financing of assets has developed as a result. Contributors have provided an overview of the legislative framework for transport finance and financial regulation affecting lenders to the transport sector. Authors have also been asked to review any significant innovations and notable recent and pending financings and cases, and to provide assessments of how the transport sector is likely to continue to develop in their markets.

I would like to thank the contributors to this volume. Their efforts are deeply appreciated and represent a substantial contribution to the transport law library as the sector continues its transformation.

Each contribution reflects the significance of the transport sector today, and the need for readily available funding for industries that underpin the global economy by transporting people and commodities around the world every day.

Lawyers have had to become increasingly nimble as clients require advice on developing intricate joint-venture agreements and complex capital market products, and increasingly on the opportunities and threats presented by environmental challenges and disruptive change throughout the transport sector. It is an incredibly exciting time to be a lawyer in this field, as our contributors demonstrate in the following chapters.

Harry Theochari

Norton Rose Fulbright

London

April 2020

CANADA

Damon Chisholm, Joanna Dawson, Ryan Gallagher and Lucia Stuhldreier¹

I INTRODUCTION

Canadian transportation policy is continuously evolving as a response to provide a more competitive regime to attract new business while balancing other interests, such as environmental issues. Although Canada is bordered by three oceans, the majority of trade moves by rail and not by sea. Canada's ports and harbours, railways and airports provide integral transportation to domestic and international economic activities. Canada's marine industry comprises a number of domestic marine service operators that provide shipping services both domestically and internationally.

II LEGISLATIVE FRAMEWORK

Domestic and international law and regulation

Aviation

Civil aircraft in Canada are registered under Part II of the Canadian Aviation Regulations, under the laws of a member state of the International Civil Aviation Organization, or under the laws of a state with a bilateral agreement allowing for flights into Canada. Canada's civil aircraft registry does not keep track of title to aircraft, but instead involves registration based on custody and control of aircraft. Basing registration on custody and control means that Canadian aircraft may be registered to a lessee who is responsible for ongoing operation and maintenance, even though the lessor holds title to the aircraft. This can lead to problems for the registration of security interests in aircraft, as there is no registry for title of or liens registered against aircraft. For these reasons, aircraft security interests in Canada are governed by provincial personal property security legislation.

Canada signed the Cape Town Convention on International Interests in Mobile Equipment and the Protocol thereto on Matters specific to Aircraft Equipment (the Cape Town Convention) in 2004, and passed federal legislation in 2013² ratifying the Cape Town Convention. The Cape Town Convention facilitates asset-based financing by creating an international legal framework concerning the creation and enforcement of security interests in aircraft equipment, thus alleviating the previous concerns with the Canadian regulatory regime.

1 Damon Chisholm, Joanna Dawson, Ryan Gallagher and Lucia Stuhldreier are partners at McMillan LLP.

2 The International Interests in Mobile Equipment (Aircraft Equipment) Act.

The Cape Town Convention establishes uniform criteria for creating international interests (such as security agreements) in aircraft equipment, an electronic international registry with first-to-file priority, a system of default remedies available to creditors, and possession rights for debtors. During the process of ratification, a country can make certain declarations that outline, inter alia, specific remedies and insolvency rights.

Marine

Because of the division of powers set out in the Canadian Constitution, maritime law is subject to both provincial and federal legislation. The federal government has been granted exclusive jurisdiction over navigation and shipping and various other related marine matters. However, each province has been granted jurisdiction over property in the province. International maritime conventions are also recognised as a source of law and are effected in both case law and statute. The provincial superior courts have inherent jurisdiction over all matters, unless such jurisdiction is expressly excluded, and the Federal Court of Canada has concurrent jurisdiction to hear specific matters granted in respect of Canadian maritime law.

Vessel financing may be secured by the registration of a statutory mortgage governed by the federal Canada Shipping Act 2001 (CSA), by provincial personal property security legislation, or by both, depending on the type of vessel and the security to be taken. However, many of the provinces have legislation that specifically provides that mortgages under the CSA are exempt from the provincial personal property security regime.

The CSA statutory system of registration for ship mortgages applies only to vessels that are registered or recorded in the Canadian Register. The CSA mandates that a vessel, unless it qualifies for an exemption under the regulations, must be registered under the CSA if it is not a pleasure craft; is wholly owned by qualified persons; and is not registered, listed or otherwise recorded in a foreign state. While registration of pleasure craft is optional, it may be advisable as vessel financing security provided under the CSA does not extend to non-registered vessels. A vessel that is under construction in Canada may be temporarily recorded as a vessel being built in Canada.

Rail

As a general rule, under the constitutional division of powers, railways that cross provincial borders or international boundaries are subject to federal jurisdiction; those located entirely within a province are provincially regulated. Financial transactions involving federally regulated railway companies,³ such as mortgages and financings of rolling stock,⁴ are governed by the Canada Transportation Act (CTA). Part III, Division 3 of the CTA creates a regime governing the registration of financing documents by both railway companies and owners of rolling stock. Additionally, provincial real and personal property legislation can apply to railway assets, so many parties elect to make registrations in provincial personal property registries and real property title offices in conjunction with their CTA registration.

3 A 'railway company' is defined in Section 87 to refer to: a person who holds a certificate of fitness under Section 92, a partnership of such persons or a person who is mentioned in Subsection 90(2).

4 Definition of 'rolling stock' in the Canada Transportation Act, Section 6, is as follows: a locomotive, engine, motor car, tender, snow-plough, flanger and any car or railway equipment that is designed for movement on its wheels on the rails of a railway.

III FINANCIAL REGULATION

i Regulatory capital and liquidity

The Bank Act (Canada), and the numerous corresponding regulations, provide the primary framework over all banking activity in Canada. Pursuant to the Bank Act, banks must maintain adequate and appropriate forms of liquidity. In addition, the Office of the Superintendent of Financial Institutions (OSFI) may make guidelines respecting adequate and appropriate forms of liquidity.

In July 2018, the OSFI issued a discussion paper setting out the OSFI's proposed policy direction and timelines for implementing the final Basel III reforms in Canada, which include changes to the credit risk, operational risk, leverage ratio and credit valuation adjustment frameworks as well as to the capital floor. The OSFI has noted its support for the changes proposed in the final Basel III reforms and intends to implement them domestically while also being guided by the unique characteristics of the Canadian market. Although, given the substantial amount of revisions to the capital framework that are required to reflect the final Basel III reforms, the OSFI is considering staggering the implementation of certain standards over a period of time. Industry feedback on these changes is being sought through a separate consultation process.

ii Supervisory regime

Canada has a shared system of financial regulation and supervision between the Minister of Finance and the federal and provincial governing bodies. However, the Minister of Finance has ultimate responsibility for the oversight of Canada's financial system.

The supervision of all banks in Canada, federally registered trust and loan companies, insurance companies, cooperative credit associations and private pension plans is conducted by the OSFI, which is an independent government agency responsible for the administration of the Bank Act (Canada) and overseeing banks under the supervision of the Minister of Finance. The Financial Transactions and Reports Analysis Centre of Canada is responsible for anti-money laundering and anti-terrorist-financing monitoring. The Financial Consumer Agency of Canada administers the consumer provisions of the Bank Act, which include disclosure requirements respecting borrowing costs and deposit account terms. The activities of banks in Canada are also subject to the federal system of deposit insurance operated by the Canada Deposit Insurance Corporation.

At the provincial level, authorities regulate credit unions and *caisses populaires* (in Quebec), and securities commissions administer and enforce securities legislation and regulate all securities-related activities within the province.

The Bank of Canada is the nation's central bank. The Bank of Canada regulates the nation's credit and currency and generally promotes the economic and financial welfare of Canada.

IV SECURITY AND ENFORCEMENT

i Financing of contracts

Aircraft

Aircraft objects are primarily financed through leases, secured loans, chattel mortgages, and conditional or instalment sales. Those who have legal custody and control over an aircraft, as opposed to the registered owner, have complete responsibility for the operation and

maintenance of the aircraft and must file evidence of this responsibility with Transport Canada in the Canadian Civil Aircraft Register (CCAR). Lease interests must also be registered with the CCAR, although the register is not a register of title or liens related to aircraft. An aircraft registered in the CCAR may be removed through a process known as deregistration in the event that legal custody and control over the relevant aircraft is transferred.

Security interests in aircraft are governed by provincial laws as opposed to those at the federal level. A movable hypothec will be required to create a security interest over an aircraft in Quebec, while in other Canadian provinces a security agreement will typically be sufficient for the purposes of creating and registering a security interest. To perfect a security interest after 1 April 2013 for aircraft meeting the requirements of the Cape Town Convention, security interests must be registered in the International Registry. It remains common practice to also register a security interest in the relevant provincial register for personal property security. An International Registry registration of a fully and properly constituted international interest in an aircraft object will have priority over all provincial registrations made after 1 April 2013. There are, however, limited exceptions to preserve the priority of non-consensual rights of third parties in Canada.

Marine

The most common method of financing vessels is through a mortgage pursuant to the CSA. However, as movable personal property, vessels are also subject to provincial personal property security legislation. The appropriate statutory regime is determined by the vessel category and the nature of collateral. When there is direct conflict between federal and provincial legislation, the doctrine of paramountcy dictates that federal regulation will take primacy. The interaction between provincial personal property regimes and federal jurisdiction over vessels has not been definitely resolved, and thus care must be taken to determine which statutory scheme governs.

The CSA allows the registered owner of a registered vessel to grant a mortgage against a vessel, or any share of it, as security for any financing. In addition to the statutory form, parties usually elect to enter into a collateral agreement outlining the full obligations and rights and remedies of the mortgage. The mortgagor will generally be required to, *inter alia*, pay the principal and interest on schedule, maintain and operate the vessel appropriately, and maintain insurance for the vessel. In the case where a mortgagee is entering into a subsequent mortgage, the loan may also involve higher interest to offset the increased risk associated with being a subordinate mortgagee. Mortgagors have a multitude of rights under the mortgage, including the right to sell the ship (assuming this is not explicitly excluded as a possibility in the agreement); however, the mortgagor must not materially impair the mortgage security.

As there are no provisions for taking a mortgage under the CSA over a licensed pleasure craft or a vessel registered in the small vessel register, the vessel is treated as 'personal property' and may be charged by any methods recognised by law for the taking of security in chattel or personal property (i.e., provincial personal property security legislation). In general, lenders (particularly financial institutions) are reluctant to provide financing unless the vessel is registered under the CSA.

The CSA also allows for the registration of a mortgage against a vessel in the process of being built. A builder's mortgage operates in a similar manner as if it were a mortgage of a registered vessel, although it is common practice that this is discharged upon completion of the construction and subsequently replaced with a standard mortgage.

The CSA augments the security of a mortgage to the extent that it provides a statutory scheme of registration whereby the mortgagee can give notice that it has an interest in and over a particular vessel. However, a statutory mortgage does not afford creditors complete security for repayment of indebtedness, as vessels may move to jurisdictions or ports where courts do not enforce Canadian mortgages. In addition, other unregistered maritime or statutory liens may take priority over the registered mortgage, which leads creditors to seek additional protection, such as the right to proceeds of insurance policies or a charge on the vessel's freight.

Under the CSA, no charges other than a mortgage are registrable; thus, searches may be used to determine the owner and statutory mortgages registered against a particular ship but will fail to reveal any other encumbrances on the ship, particularly maritime liens that are not registrable. In addition, failure to register the mortgage under the CSA can result in a loss of priority.

The Bank Act also allows a bank to register security in fishing vessels and aquaculturists' vessels with the Bank of Canada. Under the Bank Act, the secured party only needs to provide notice of intention to take a security interest. In competition between a Bank Act security and a mortgage, priority will be determined based on the first to register under the CSA. To avoid this disadvantage, a fishing vessel (but not an aquaculturists' vessel) can be registered under both the CSA and the Bank Act, which allows banks to have the additional protection of the CSA in priority disputes.

Rail

Section 104 of the CTA allows any person to deposit in the office of the Registrar General of Canada (the Registrar) a mortgage or hypothec issued by a railway company, a security agreement entered by a railway company, an assignment or other document relating to the foregoing, or copies or summaries of any such documents. Similarly, Section 105 of the CTA allows any person to deposit in the office of the Registrar documents, or copies or summaries of security documents, relating to rolling stock, including those evidencing a lease, sale, mortgage, hypothec, security agreement, and various other types of transactions.

The office of the Registrar has established a registry system (the Registry) for security documents relating to railway assets under Sections 104 and 105 of the CTA. The Registry receives documents electronically and makes such documents available online in a publicly available and searchable database. The Registry is intended to provide public notice of the interests established in the documents deposited. Filings under Sections 104 and 105 of the CTA are optional. The Registry is not self-expunging; an interest will remain in the registry indefinitely, and therefore give notice to third parties, until it is expressly amended or discharged by filing of a subsequent document.

When searching the Registry, the searcher should input the name of the current owner or obligor, as well as previous owners or obligors (and any known predecessors to each), as applicable, of the property or rolling stock to be searched. When searching rolling stock, it may be advisable to also search by the rolling stock UMLER marks assigned by the Association of American Railroads. The Registry does not purport to be a title or ownership registry and no provincial or federal ownership registry exists for rolling stock.

Parties often choose to file memoranda or summaries of documents, so it may be necessary to attempt to contact one or more parties for further information. One may need to review many documents to assess the extent to which a particular asset is subject to a

security interest. Further, because there is no requirement to file a security interest in the Registry, subsequent documents that affect the interest may not be available in the Registry. Accordingly, the results of searches of the Registry may bear some risk.

Provincial legislation may also apply to certain railway assets. Parties may elect to file security interests in real and personal property registries established under provincial legislation in addition to the Registry, or instead of the Registry, depending on the asset. As a result, it is generally advisable for a party seeking to take a security interest in a railway asset to search the Registry as well as potentially applicable provincial registries.

ii Enforcement

Aircraft

With the adoption of the Cape Town Convention, repossession of an aircraft upon default may be conducted subject to the applicable lease or security agreement. This includes repossession pursuant to foreign law as chosen by parties to the contract, so long as the choice to implement this foreign law was made bona fide. Federally governed insolvency law, as outlined in the BIA and the CCAA, is also applicable to aircraft contracts.

A creditor can enforce its rights under a lease agreement even in the event that the lease has not yet been terminated, so long as an event of default occurs. The common law provinces of Canada allow for self-help remedies in events of default under a lease agreement. In Quebec, enforcement originally must have been authorised by a court; however, this requirement has been modified since the coming in force of the Cape Town Convention, which allows for self-help remedies in the event of default under a lease agreement. Although the Cape Town Convention allows for self-help remedies, they have yet to be judicially considered in Quebec.

Injunctions are another effective, albeit costly and time-consuming, enforcement mechanism. They are particularly useful in situations where delivery of the aircraft would be challenging.

Marine

Mortgages must be recorded in the order in which they are filed with the Vessel Registry. The priority of competing mortgages in respect of the same vessel or share in a vessel is determined by the sequence of the registration of the mortgages and not according to date of each mortgage, unless all of the mortgagees file their written consent with the Chief Registrar.

If seeking to enforce under a marine mortgage, the mortgagee has the right to take possession of and sell the vessel in circumstances of default or material impairment of the mortgagee's security by the mortgagor. Circumstances of default are generally defined in the loan agreement, in which case the mortgagee will often be able to take possession of the vessel in realisation of its security interest. Material impairment of the mortgagee's security is a question of fact, generally established when there is a material effect on the value of the vessel or the other property subject to the mortgage. Once material impairment is established, the mortgagee can take possession of the vessel and can treat the mortgage agreement as having been repudiated such that the contract is enforceable against the mortgagor for breach of contract but unenforceable against the mortgagee.

Possession by the mortgagee can take the form of actual possession or constructive possession, with constructive possession involving the establishment of a clear intention to

take ownership of the vessel. Once the mortgagee is in possession, the mortgagee has all of the rights and obligations of ownership, including expenses associated with the vessel, and can make use of the vessel subject to the terms of the mortgage.

Upon default by the mortgagor, the mortgagee obtains an absolute power of sale. Up to the point of sale, the mortgagee has an obligation to exercise appropriate care of the ship and sell the vessel in good faith and at the best price possible. Sale can be conducted as either a personal sale or a judicial sale. When conducting a personal sale, the mortgagee will generally issue a statutory bill of sale such that the purchaser can maintain the vessel on the registry. Personal sale is a less costly and more time-efficient method than court-administered sale; however, the mortgagee will only be able to transfer as much good title to the purchaser as the mortgagee has itself.

However, if there is more than one registered mortgage of the same vessel or share, a subsequent mortgagee may not, except under court order of competent jurisdiction, sell the vessel or share without the agreement of every prior mortgagee.

Under the Bank Act, a bank's security interest will grant it the statutory power of seizure and sale upon default. The bank's power of sale in circumstances of default grants it the ability to conduct a sale by public auction, while the right of sale in other circumstance will be subject to the terms of the agreement entered into with the borrower. The bank has an obligation to provide notice of sale, act with expediency, and act in a commercially reasonable manner.

iii Arrest and judicial sale

Aircraft

Regarding international interests, the Cape Town Convention provides multiple remedies that can be exercised with or without the intervention of courts, so long as they are exercised in a commercially reasonable manner. These remedies include allowing a creditor to: (1) take possession or control of the aircraft; (2) sell or lease the aircraft; or (3) collect or receive income or profit arising from the use of the aircraft. The enforcement of foreign judgments is determined at the provincial level, and Canadian courts will generally enforce a judgment of a foreign jurisdiction for a sum certain that is a final non-appealable judgment issued by a court of competent jurisdiction.

Under non-international security interests, a secured creditor will typically apply to the court to obtain repossession of the aircraft. Creditors can only exercise self-help remedies if they are provided for in the security agreement and do not involve the use of excessive force. An order of surrender can be obtained within a few weeks in the event that the repossession is not opposed. If the matter requires trial, it may take one or two years for the order of surrender to be obtained, and this may take even longer if the trial is appealed. When a repossession is opposed, the law allows for provisional grounding measures. For example, common-law provinces allow for an interim recovery judgment. Additional measures are also available; for instance, an interlocutory injunction may be awarded to a creditor pending trial, so long as there is a risk of unlawful removal of the aircraft from the province.

Canada's adoption of the Cape Town Convention allows a lessee or debtor who seeks protection from its creditors under Canadian insolvency law to be granted a stay of up to 60 days prior to the lessor or secured creditor being entitled to seize the aircraft. The lessee or debtor will not be able to avoid the seizure unless it remedies all prior defaults and agrees to continue performing its obligations both during and after the insolvency proceedings.

Marine

One method of sale available to marine mortgagees is to arrest the ship and conduct an *in rem* judicial sale. Unlike personal sale, this allows the mortgagee to clear title on the vessel, so this is the preferred method of sale if there are multiple charges on the vessel or when multiple parties hold an interest in the vessel. In conducting a judicial sale, the mortgagee also has the option to obtain an *in personam* judgment against the mortgagor's other assets. As is the case with personal sales, either the mortgagee or the marshal will issue a bill of sale to the purchaser such that the purchaser can maintain the vessel on the registry. When a vessel is subject to several security interests, maritime liens will have a priority ranking above statutory mortgages.

V CURRENT DEVELOPMENTS

i Developments in policy and legislation

Marine

The Canadian shipping industry is frequently subject to changing legislation and policy, domestically and internationally, which can affect compliance with vessel finance security, thus increasing the costs to the vessel owner. In Canada, many of the recent initiatives were focused on environmental issues. For example, the Arctic Shipping Safety and Pollution Prevention Regulations, which came into force in December 2017, incorporate the International Code for Ships Operating in Polar Waters and include several safety and pollution prevention measures relating to vessel design and equipment, vessel operations and crew training.

The Canada-European Union (EU) Comprehensive Economic and Trade Agreement (CETA) has brought about changes to coasting trade rules that apply to the use of eligible foreign vessels in Canadian waters. Specifically, under the Coasting Trade Act (Canada), certain EU owners who wish to use foreign vessels in Canada may provide a limited number of coasting trade services without a licence upon acceptance of advance notification by the Canada Border Services Agency and Transport Canada. However, eligible EU entities must take measures to meet any applicable requirements before using a foreign vessel to provide coasting trade services without a licence in Canada, including meeting prescribed notification requirements and providing supporting documentation. Failure to demonstrate eligibility could result in enforcement action taken against the vessel.

ii Trends and outlook for the future

Canada has contributed significant resources to the environmental assessment of its coastlines. Under the Oceans Protection Plan, the government is currently assessing the environmental impact on marine shipping, which includes numerous environmental and economic considerations.

ABOUT THE AUTHORS

DAMON CHISHOLM

McMillan LLP

Damon is a partner and co-chair of McMillan LLP's Commercial Real Estate Group. Damon's experience includes complex project financing and acquisitions, purchasers and vendors of large commercial developments, commercial lending matters including secured, unsecured and project financing. As a member of the firm's aviation group, Damon has experience in transactions involving the buying, selling, leasing and financing of aircraft, as well as advising on aircraft title and registration issues. Damon's experience extends to protecting clients' interests internationally under the Cape Town Convention through registration with the International Registry of Mobile Assets, and he is McMillan's administrator for all matters in relation to the Convention on International Interests in Mobile Equipment.

JOANNA DAWSON

McMillan LLP

Joanna Dawson is a partner in McMillan LLP's Vancouver office and is a member of the business law group and transportation group. Joanna practises in all areas of corporate and commercial law with a particular focus on the marine industry. Joanna routinely advises on wide range of marine transactional matters including registration and financing of ships, buying, selling and leasing of marine assets and vessels, ship construction, and importation/exportation of vessels. Joanna's experience also includes preparing and negotiating marine transportation agreements.

RYAN GALLAGHER

McMillan LLP

Ryan Gallagher is a partner and a member of McMillan LLP's transportation group and competition group. Ryan's practice focuses on transportation and logistics with a particular emphasis on the rail industry. Ryan has particular experience in counselling, negotiating and attending to regulatory and arbitration matters involving rates and conditions of service on and with Class I railways on behalf of some of the largest shippers and rail users in Canada. Ryan also has assisted the firm's clients with various commercial negotiations, regulatory submissions before the Canadian Transportation Agency, industrial property development issues as well as environmental permitting and approval issues.

LUCIA STUHLREIER

McMillan LLP

Lucia Stuhldreier is a partner and a member of McMillan LLP's transportation group. Lucia advises and represents rail shippers in negotiations of rail transportation agreements, including rate and service matters, and agreements for the construction, acquisition and shared use of rail trackage. She has extensive experience in rail regulatory proceedings before the Canadian Transportation Agency and arbitrations relating to rail freight rates, service issues, interswitching and railway line discontinuance, as well as related judicial review and appellate proceedings. Lucia also advises clients on rail transportation policy and regulatory matters relating to aviation and truck transportation.

MCMILLAN LLP

Royal Centre, Suite 1500
1055 West Georgia Street
PO Box 11117
Vancouver V6E 4N7
British Columbia
Canada
Tel: +1 604 689 9111
Fax: +1 604 685 7084
damon.chisholm@mcmillan.ca
joanna.dawson@mcmillan.ca
ryan.gallagher@mcmillan.ca
lucia.stuhldreier@mcmillan.ca
www.mcmillan.ca

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