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INTERNATIONAL RECOGNITION OF PROPERTY INTERESTS IN LEASED AIRCRAFT: THE NEW UNIDROIT CONVENTION ON MOBILE EQUIPMENT

by

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A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfillment of the requirements for the degree of MASTER OF LAW (LL.M.)

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ABSTRACT

The aviation industry is one characterized by its constant search for new methods to finance and acquire new equipment as international markets develop. In this search, multiple legal and financial frameworks have been created resulting in economic flexibility for carriers, through very complex transactions. Inside this trend of financial arrangements the most frequently used method is to lease the equipment they need.

The main concern related to these transactions is that aircrafts are highly movable assets that can travel to various jurisdictions. This faculty supposes a threat to lessors and owners' property interests over the aircraft because property law is encompassed into national laws and are not easily recognized in other countries in cases of controversies centered in a movable good.

Chapter I of this thesis will focus on the different types of financing methods used by carriers to procure new equipment. Chapter II discusses the current international conventions in force regulating international leases. Finally, Chapter III purports to analyze the Draft UNIDROIT Convention on International Interests in Mobile Equipment and the Protocol related to Aircraft Equipment.

RESUME

L'industrie aéronautique se caractérise par un besoin constant de nouveaux modes de financement et d'acquisition d'équipements. De nombreux cadres légaux et modes de financement furent imaginés dans le but de permettre aux transporteurs aériens de jouir d'une olus grande flexibilite économique malgré la complexite toujours croissante de ces opérations financières. Parmi ces modes de financement,la méthode la plus utilisée est le contrat de bail.

La difficulté rencontrée dans ce mode de financement réside dans le fait que les avions sont des biens mobiliers: ceux-ci peuvent donc aisemment passer d'une juridiction à une autre. Ce caractère de "res mobilis" peut être en soi une menace aux droits qu'ont bailleurs et propriétaires sur l'avion. En effet les caractéristiques du droit de propriété applicable sont déterminées par le droit national,ce qui peut susciter de nombreux problèmes en cas de litige, un droit national n'étant pas toujours aisemment reconnu et appliqué par une juridiction étrangère.

Le chapitre I de cette thèse portera sur les différents modes de financement utilisés par les transporteurs aériens dans l'acquisition de nouveaux équipements. Le chapitre II traitera des Conventions internationales en vigueur relatives aux contrats de baux internationaux. Enfin,le chapitre III analysera le "Draft UNIDROIT Convention on International Interests in Mobile Equipment" et le "Protocol related to Aircraft Equipment".

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Special thanks to my parents and grandparents for their unconditional support in the accomplishment of my studies and their love and trust in all the choices in my life.

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INTRODUCTION

Less than one hundred years after the Wrights' brothers took their first flight, breaking what was thought to be an infrangible barrier, more than 1.3 billion passengers took to the skies in aircrafts operated by scheduled airlines in 1997.

During the advent of the aviation industry air transportation companies relied on three methods to finance aircrafts and their equipment, being these: cash flow from their business, equity raised through public and private placements, and short-term borrowing. At that moment mostly all international and national airlines were owned and subsidized by their respective national governments which helped these carriers by assuming the risks in cases of default or poor management. Another important factor was that the costs to acquire aircrafts were much lower than today prices which today, in some cases, may exceed the amount of US$ 150 millions per unit.

After the end of the Second World War a new trend in the aviation industry began when it started to take advantage of the surplus of aircrafts available capable of flying more passengers with increased cargo loads in longer range routes. As technology evolved jet passenger aircrafts became a reality but prices for this new equipment also rose to levels where airlines were incapable of financing such investment through previously known sources. This technological development was followed by a marked process of privatization, deregulation, and liberalization of the aviation industry which deprived airlines of States' financial support.

Leasing was one of the new legal and economic figures that gained importance in the aviation industry in lieu of the tax benefits it gives to investors and the flexibility it adds to operators or lessees. In 1997, 106 airlines from 41 countries reported spending the equivalent of USD$ 10,679 millions on rental of flight equipment, an increase of 52 per cent compared to 1989 figures[1]. On the other hand, Airbus Industrie estimates an average passenger traffic increase of 5.9 per cent per year from 1999 to 2018 with the active passenger fleet of jets almost doubling in the same period adding nearly 10,000 new aircrafts. To couple with this increase in passengers, traffic, and cargo operations and to continue the process of fleet renewal necessary due to the age and inefficiency of the equipment, Airbus estimates that airlines and cargo operators will take delivery from 1999 to 2018 of some 15,500 new aircrafts worth approximately USD$ 1.29 trillion in 1999 prices.[2]

Leasing contracts are regulated by national or state laws depending on the jurisdiction where the contract is entered. This multiplicity of laws, requirements, duties, rights, and procedures create the perfect setting for risks and controversies associated with these kinds of transactions, specially when the main asset, the aircraft itself, is one of the most movable objects one can think off in terms of national and international border crossings. Even in countries like the United States one can find 50 different state jurisdictions with their applicable laws as to buying

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See ICAO *Study on Aircraft Leasing*. Attachment to State letter EC 2/82, LE 4/55-99/54, May 1999.

2

See Airbus Industrie Global Forecast for 1999-2018.

and selling of aircrafts with some involvement of federal law through the Uniform Commercial Code (UCC) which has served to unify states' commercial laws.[3]

These financial developments put pressure upon the international community prompting it to adopt various international documents with the purpose of recognizing property interests and to later unify the legal standards in the matter. The first treaty adopted was the 1933 Convention for the Unification of Certain Rules Relating to the Precautionary Arrest of Aircrafts. It was followed by the Convention on the International Recognition of Rights in Aircrafts of 1948, also known as the Geneva Convention[4] in the aviation industry.

Notwithstanding the adoption of the *Geneva Convention* in 1948, the big changes in fleet financing started with the emergence of jet aircrafts which were and still are more expensive if compared with previous and present propeller-driven models. Additionally, new technology brought up the concept of interchangeability of components, mainly engines and navigational instruments, increasing the risk to lessors. Under the Geneva Convention engines are considered components of aircrafts leaving engines lessors unprotected. These circumstances prompted lessors to look for ways to protect their investments and shield them from risks associated with these kinds of financial transactions.

In 1988 a new international convention on leasing was adopted sponsored

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See J.S. Hamilton, *Practical Aviation Law*, 2nd ed. (United States: Iowa State University Press, 1996) at 141.

4

See "Convention on the International Recognition of Rights in Aircraft" (1993) XVII-II Ann. Air & Sp. L. 517. [hereinafter Geneva Convention]

by the International Institute for the Unification of Private Law, also known as UNIDROIT. It is called the 1988 UNIDROIT Convention on International Financial Leasing.[5] This convention tried to unify various aspects of leasing as it became one of the biggest tools in international financing.

Many types of financial arrangements were brought up into the aviation industry as the asset based financing and the leveraged leasing. In the first lenders, knowing that airlines were not capable of completely securing their debts, began relying on the asset per se as the main guarantee for their investment. The second involves a plurality of players where ones take advantage of the aircraft's depreciation for taxation purposes while others receive the leased asset. One of the main concerns over leveraged leases is that sometimes they do not appear in airlines' balance sheets giving investors a hidden debt to equity ratio. This is also called off balance sheet financing.[6]

The latest developments in the field of international leasing are a draft Convention and Protocol on matters related to aircraft that are under discussion and analysis by joint commissions of UNIDROIT and ICAO (International Civil Aviation Organization). These are the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment and the Preliminary Draft Protocol to the Preliminary Draft UNIDROIT Convention on International Interests in Mobile

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See "UNIDROIT Convention on International Financial Leasing" (1988) Uniform Law Review 135. [hereinafter Leasing Convention]

6

See D.H. Bunker, *The Law of Aerospace Finance in Canada* (Canada: Institute and Centre of Air and Space Law, McGill University, 1988) at 341.

Equipment on Matters Specific to Aircraft Equipment. The convention covers from the creation to the effects of three kind of international interests: those granted under a security agreement, those held under a title of reservation, and those vested in a person who is the lessor under a leasing agreement[7] while the Protocol is directly focused upon international property interests over aircrafts and their components.

One of the innovations the Convention includes is the creation of an international registry of property interests in mobile equipment. Discussions are been held as to whether the registry of interests in aircraft shall be regulated by the Council of ICAO or whether it should be part of a new International Registry considered under the Convention.

It is our objective to conduct a review of both UNIDROIT's preliminary drafts, the Convention and the Protocol, and their implications in the creation, registration, and international recognition of property rights in aircrafts and their components. To accomplish this goal emphasis will be given to understand the different types and classifications of leasing from a comparative approach and the concepts of title reservation and security agreements as embodied in the drafts.

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7 See Art. 2(2) of the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment as Reviewed by the Drafting Committee, June 1999.

CHAPTER I - TYPES OF FINANCING

As the title of this chapter suggests, there are many financial options and methods for airlines to finance their fleet and get through a transaction to acquire or to "rent" an aircraft or one of its components. The word rent has been used deliberately to distinguish the concept of buying equipment, which can also be done through leasing, and leasing per se meaning a temporary transfer of the lessor's property to the lessee for his use.

Some of the options financiers and airlines may employ are the following: internal financing, equity financing, conditional sale agreements, debt financing, countertrade, and leasing, among others. The importance of encompassing the transaction into one of them is that it serves to establish the rights and duties of each party to the contract. It also helps by setting out the relationship both parties to the contract will have toward third parties and governments for taxation purposes.

The main characteristic of internal financing or self-financing is that airlines generate funds from their operations and are allowed to keep such funds by reinvesting them to finance the acquisition of aircrafts and more frequently, their components which are cheaper goods than airframes. It also is much cheaper than borrowing due to the absence of interest.[8]

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[8] Bunker, *supra*, note 6 at 608.

In addition, internal funds can be generated through the conversion of existing assets, namely (1) outright sale of equipment, (2) sale and leaseback[9] and/or (3) sale of residual values of the leased equipment.[10]

Equity financing is a financial mechanism used by corporations to generate funds through the investment of capital by particular persons in exchange of stock or shares becoming shareholders and therefore owners of such corporation. Shares can be divided into two kinds: (a) common shares and (b) preferred shares. It is the opposite to debt financing which is raising capital by issuing bonds or borrowing money.[11]

Common shareholders are considered the owners of the corporation and it is them who benefit from the growth of it by receiving part of the profits through the dividends paid.[12] Preferred shares commonly refers to a group of shares that have preferential rights and claims to income or assets after bondholders but before common stock. They puts investors in a middle position between that of a full equity shareholder and that of a creditor who becomes entitled to repayment of any capital

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9

For a detailed description of these kind of transactions refer to the leasing chapter in page 35.

10

P. Pompongsuk, *International Aircraft Leasing: Impact on International Air Law Treaties* (LL.M. Thesis, McGill University, 1997) at 4 citing D. Bunker, *supra* note 6 at 7.

11

Blacks Law Dictionary, 5th ed., "equity financing".

12

See R.K. Rosales, *Legal Aspects of Asset Based Aircraft Financing* (LL.M. Thesis, McGill University, 1990) at 33.

prior to any shareholder of any class.[13] Moreover, it is the corporation the one who decides what kind of preferential treatment these shares will receive over its common shares.

The importance of this kind of financial arrangement is that corporations are freed from paying interest over the debt and their only duty toward the shareholders is that of paying dividends when favorable conditions occur.

On the other hand, corporations which are not able or unwilling to use equity financing resort to debt financing through the legal figure of loans evidenced by a bond, a debenture, or a note which can be secured or unsecured. It is a common method of financing in the aviation industry due to the fact that airlines' equity is not enough to cover all expenses related to fleet and aircraft components acquisitions because of the high prices of such equipments. The main constraint this financial alternative presents to airlines is that it is based on their credit capacity which sometimes, specially in low yield industries as this, is committed to its limits. In addition, interests are charged to the loan increasing airlines' financial responsibility who has to pay the principal and the interests in scheduled installments.

Furthermore, the practice of issuing unsecured loans in the aviation industry is practically non-existent because of the amounts of money involved and lenders require airlines security assurances for their investment. The typical approach followed by the financial industry requires borrowers to secure such loans through

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13 Bunker, *supra*, note 6 at 11.

bonds, notes, and/or debentures.[14]

PART A COUNTERTRADE

Countertrade has always played an important role in international business transactions, specially in the aviation industry, due to the fact that some countries lack the cash flow or credit to guarantee such transactions. Others rely on this type of economic policy to promote the development of national or local industries which in some cases are nationalized monopolies or in others are the main economic resources generators for local economies.[15]

It implies a *quid-pro-quo*, two directional, supply contracts between parties which range from purely private enterprises to governmental sponsored policies and from one specific transaction to all foreign trade contracts involving that country. In recognition of the international importance of these economic transactions, the United Nations Commission on International Trade Law (UNCITRAL) published a Legal Guide on International Countertrade Transactions covering those transactions in which a party supplies goods, services, technology or other economic value to the second party, and, in return, the first party purchases from the second party an agreed amount of goods, services, technology or other economic value. The distinctive characteristic of these transactions is the existence of a link between the

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14 Bunker, *supra*, note 6 at 15.

15 R.H. Folsom et al, *International Business Transactions in a Nutshell*, 3rd ed. (United States, West Publishing Co., 1988) at 205.

supply contracts in both directions where the conclusion of the supply contract or contracts in one direction is conditioned upon the conclusion of the supply contract in the other direction.[16]

Countertrade takes several forms being "barter" and "counter-purchase" the basic ones. The term barter refers to a transaction involving the direct exchange of goods between two trading parties. No cash changes hands for the reciprocal exports which have counterbalancing values and which are usually governed by a single contract.[17] Where there is a difference in value in the supply of goods in the two directions, the settlement of the difference may be in money or in other economic value.[18]

Counter-purchase is a transaction under which the exporter agrees to sell goods to the importer, and simultaneously undertakes to purchase other products from the importer of a pre-determined nature and equal to an agreed percentage of the original contract value, during a particular time period.[19] It is distinguished from buy-back agreements in that the products sold under the first contract are not

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16

UNCITRAL, *Legal Guide on International Countertrade Transactions* (New York, United Nations, 1993) at 5.

17

J.H. Jackson and W.J. Davey, *Legal Problems of International Economic Relations, Cases, Materials, and Text*, 2nd ed. (United States, West Publishing Co., 1986) at 1196.

18

UNCITRAL, *supra*, note 16 at 8.

19

Bunker, *supra*, note 6 at 71.

used in the production of the items sold in return.[20]

Another classification of countertrade are the buy-back agreements in which one party supplies the other with an industrial facility and the supplier agrees to purchase the products therein produced or to be paid with such products.

The other type of countertrade is called offset. This type of countertrade is commonly used in highly sophisticated technology transactions and in those involving major civil procurements or goods of high value as commercial aircrafts or telecommunications systems. It takes various formats depending in the agreements between the parties. Some importing countries require domestic content in the acquired product, co-production, local subcontracting, and/or local investment by the exporter. This was the case in the agreement between McDonnell-Douglas and the government of the People's Republic of China to assemble 25 MD-82's in Chinese territory or the case of Air Canada buying DC-9's while negotiating the construction of the wings components for all DC-9's in Ontario. In some cases the goods covered by an offset transaction have no relationship between them and serves as a way to take as much advantage as possible of a multi-million dollar transaction as in the case of Saudi Arabia that in 1984 paid for 10 Boeing 747-300 aircrafts with oil worth USD $1 billion at the official government price.[21]

20

UNCITRAL, *supra*, note 16 at 8.

21

Bunker, *supra*, note 6 at 73.

PART B LEASING

Leasing of aircrafts is encompassed in the so called title-based financing transactions which includes conditional sales, hire purchasing, and leasing. Among all previously named and explained methods of aircraft financing used by airlines, leasing arrangements are the most popular ones allowing airlines to obtain the use of aircraft without making the substantial capital investments required to purchase them.[22]

During the last ten years the industry has seen a dramatic increase not only in the number of aircraft leased but also in the numbers of players getting involved in this booming business. Fifteen years ago the major financiers in the industry were the big United States banks while now there is a whole plethora of corporations, manufacturers, and finance subsidiaries willing and able to assume the risks inherent to these financial transactions. In 1989 McDonnell-Douglas Finance Corporation (MDFC), a wholly owned subsidiary of McDonnell-Douglas Corporation, reported having a financing portfolio exceeding USD $2.5 billions.

During a speech before the American Bar Association Forum on Air and Space Law Annual Conference, Mr. Charles I. Ledgerwood of MDFC stressed the impact aircraft mega-lessors were having in the industry and predicted that such

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22 See Hamilton, *supra*, note 3 at 157.

companies were going to play a important role in the future of airline's financial transactions. As of 1989, mega-lessors already controlled nearly thirty percent (30%) of the production of the three major manufacturers at that time.[23]

According to Ledgerwood, manufacturers continued to sell delivery positions to mega-lessors because they started to take over the role of providing financial support to airlines which normally did not receive much attention from the manufacturers. Furthermore, these lessors developed a considerable expertise in remarketing aircraft and financing operators with weak sheet balances. Lastly, he pointed out, orders from the operating lessors allowed manufacturers to fill out the production schedule with large orders instead of small ones.[24]

Manufacturers are also significant players in the business of aircraft financing by entering in multiple types of selling and financing agreements, specially those in which they become part of the risk-sharing partnership by bearing some responsibility for the future value of their product. The aviation industry has seen a growing trend of manufacturer's co-participation in the risk of the financial operation which also helps to ease lenders' concerns about the transaction. However, it should not be considered as a direct loan to the buyer but as a package to support, through indirect finance, the sale of their products and as a guarantee to the supplier of funds.

23

See C.I. Ledgerwood, *"Market Trends in Aircraft Financing"* (American Bar Association Forum on Air and Space Law Annual Conference, Law in Aviation: Looking Ahead, United State: 1989)

24

Ibid.

It is a guarantee different to those extended to the financial institution or leasing company by the buyer or operator. We refer to two figures that have become known as Deficiency Guarantees and Asset Value Support.[25] Asset value support is characterized as a manufacturer's guarantee, up to a limited amount, that supports the residual value of the asset at the time of a default or of a voluntarily termination of the financing. It is not widely favored by manufacturers in cases of airlines' voluntarily return or walk-away basis because it exposes the manufacturer to unilateral actions of the operator which sometimes are not related, at all, to the airline's ability to survive and make the payments.[26]

Deficiency guarantees are normally requested from the manufacturers only when the credit risk of the airline-debtor is of sufficient concern to the financier that, but for the manufacturer's agreement to reduce the financier's asset exposure to a level that he feels comfortable with and so provide him with an improved assurance of payment in full, finance could not be otherwise arranged. The key point to a deficiency guarantee is that the manufacturer will expect the financier to look to all its other sources of recourse prior to calling on the manufacturer to pay the outstanding amount for which it is liable.[27]

25

See B. Charlton, "An Understanding of Guarantees and Indemnities in Aircraft Finance" (1988) 16 I. B. L. 321 at 323.

26

See C. Thaine, "Role of Manufacturers in Aircraft Financing: Asset Value Support-I" (1989) 17 I. B. L. 212 at 214.

27

Ibid. Another article on the topic with considerable information and analysis of these transaction can be found in: M. Fingerhut, "Role of the Manufacturer in Aircraft

As of 1998 ICAO estimated that leasing companies controlled forty-nine percent (49%) of leased aircraft up from thirty-five percent (35%) in 1989 while banks and manufacturers controlled forty-three percent (43%) of leases, up only two percent (2%) as compared to 1989 figures.[28] On the other hand, aircrafts leased by airlines to others declined from twenty-three percent (23%) in 1989 to only eight percent (8%) in 1998 although it still is the main escape valve used by airlines to adjust their fleets in cases of economic slowdowns or seasonal changes in traffic patterns.

Today one of the dominant leasing corporations is the International Lease Finance Corporation, a/k/a ILFC, which owns a portfolio valued at more than USD $18 billions consisting of more than 400 jet aircraft. Per example, ILFC is committed to acquire 45 Airbus 330's some of which are already flying with multiple operators around the world, keeping up the trend of substantial aircrafts orders.

Confronted with these financial options and figures, lessors must decide which type of economic and legal arrangements will suit their objectives and suffice to protect their property interest in leased aircrafts and their components, including engines, avionics, in-flight entertainment equipment, seats, landing gears, etc. One must not forget that the best security somebody may have over any good is ownership.

There are two main options to choose from: title reservation over the aircraft

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Financing: Asset Value Support-II, The Airlines Perspective" (1989) 17 I. B. L. 219.

[28] See ICAO's Study on Aircraft Leasing, *supra*, note 1 at 7.

or its components and security interest agreements where the asset, meaning the aircraft, becomes the guarantee to secure the performance of the obligation of the chargor.

Several lessors or lenders require operators to register the leasing agreement or mortgage in all jurisdictions the lessee or borrower flies the aircraft, increasing costs to airlines. The rules on registering the security instrument or title reservation agreement varies from country to country, some of which do not require or do not allow it. In others, as in the United States, it is mandatory under the Unified Commercial Code which declares that where a federal statute provides a system for recording documents of ownership and security interests in a specific class of products, federal law prevails. Under these circumstances the Federal Government occupied all states' jurisdiction over the matter through the Federal Aviation Act of 1958 and established the Federal Aviation Administration Aircraft Registry in Oklahoma City. This registry maintains records showing the entire history of ownership and other legal interests in all aircrafts of U.S. registry.[29]The same happens with conditional sales agreements.

Nonetheless, many Civil Law jurisdictions do not have laws applying to movable assets mortgages and special statutes had been legislated to secure the recognition of property interests and the validity of such agreements over movable goods. In countries that follow the Common-Law legal tradition they are referred as to chattel mortgages.

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29 See Hamilton, *supra*, note 3 at 141.

For purposes of our endeavor let us suppose that the parties have agreed to regulate their relationship through a leasing contract.

PART C REASONS FOR LEASING

Why leasing has become the principal way to finance equipment acquisition or operation in the aviation industry? There are many factors prompting airlines to lease aircrafts and their components. The most important ones are accounting and taxation purposes. Leasing of aircraft reduces the costs inherent to owning the equipment and the lessee often has an option to acquire the asset at the end of the lease by paying the residual value of the equipment involved therefore retaining the appreciation of such good.

In terms of accounting, leasing serves to achieve off balance sheet financing by not increasing the debt to equity ratio, specially in the cases of sell and leaseback agreements, and by not affecting the existing credit lines. Over a medium to long period, leasing can be a hedge against inflation in that the lease payments are made by reference to the cost of the asset unadjusted for inflation and the payments are in current rather than in constant dollars. The opposite will happen in case of deflationary periods but that is not the usual scenario in the industry.[30]

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30 R.F. Selby, *Leasing in Canada: A Business Guide* (Canada: Butterworths, 1987) at 2.

However other important reasons for leasing follow:

- it provides the lessor with a security device by maintaining the ownership on its side reducing the risks and costs in cases of default by the lessee. In this way ownership is easier to prove by the creditor.
- it serves as an alternative to small and newly established air carriers to have access to aircrafts which in some cases are new equipment with lower maintenance costs.
- allows air carriers to meet seasonal demands for additional capacity without incurring in large capital outlays or debt from purchasing aircrafts. In the cases of lower traffic yields, it also lets air carriers to reduce their financial burden by leasing some excess or under-utilized aircrafts to other operators or competitors for fixed periods of time while economic conditions come back to normal.[31]
- allows air carriers, particularly smaller ones from developing countries, to operate unused traffic rights.[32]
- it helps, from the lessee's standpoint, to shift the burden of equipment obsolescence to the lessor because the lessee does not becomes involved in the difficulties of reselling or remarketing used and

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31

See ICAO's Study on Aircraft Leasing, *supra*, note 1 at 7. An example of the latest possibility may be the leasing arrangements Garuda Indonesia, Malaysia Airlines, and Phillippines Airlines entered with other carriers to lease part of their fleet during the Asian turmoil that affected the region in 1997 and 1998.

32

Ibid.

outmoded aircrafts.[33]

- leasing arrangements are much more flexible and leasing companies are generally more adaptable than banks and financial institutions with respect to contract structures.[34]
- some air carriers also use aircraft leasing as a way to familiarize with and to train crews on new type of equipment due to be introduced in their fleet.
- it enables the addition of delivery and installation costs, professional fees, insurance, and interim financing costs to the capital cost to be financed and amortized over the term of the lease.[35]

33

Fortier, J.M. *Real Rights in Aircraft* (LL.M. Thesis, Institute of Air & Space Law, McGill University, 1980) at 117.

34

Cohen, J. *The Challenge of Aircraft Financing and its Legal Implications* (LL.M. Thesis, Institute of Air & Space Law, McGill University, 1996) at 11.

35

See Bunker, *supra*, note 6 at 59.

PART D LEASING AGREEMENTS-COMPARATIVE APPROACH

A leasing agreement is defined as a contract which satisfies the necessity of the lessee to use a determinate good, movable or not, given by the lessor to whom the lessee pays periodical premiums with the possibility, at the end of the lease, of becoming proprietary of such good by paying the accorded residual value, of returning it to the lessor, or of agreeing on a new leasing contract over the same object.[36]

Even today there is a growing debate as to how these contracts should be classified, specially in many Civil Law jurisdictions where until recently there were no laws expressly covering them. In Europe, for example, many legal scholars concur in classifying these contracts as atypical ones because they include characteristics of different legal figures previously recognized under their respective Civil Codes.

If a comparison of leases is done with sell agreements that include a title reservation clause, in the latter the property is automatically acquired by the buyer at the end of the contract while in the former the operator must exercise his/her option to buy in order to become owner of the object.[37] On the other hand if

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See M.J. Morillas-Jarillo, "Algunos aspectos del leasing de aeronaves en España" (1993) 208 Revista de Derecho Mercantil 471 at 478.

37

A. Cabanillas-Sanchez, "El leasing financiero y la Ley de Ventas a Plazos de bienes muebles" (1980) III Anuario de Derecho Civil 759.

compared with loan agreements, there is no transfer of property interest in favor of the lessee as there is in loans.

Most of the confusion generated by leasing agreements in Civil Law jurisdictions comes up when compared with renting contracts which in Spanish are called "contratos de arrendamiento o de alquiler" while leases are called "contratos de arrendamiento financiero" because leasing contracts share some characteristics of renting and some characteristics of financial leases as known by the Common Law tradition.

One of the differences that can be drawn from both types of contracts is that under a renting contract the rent paid by the renter is considered the fee in exchange for the use of the object while in leasing the use is only part of the total payment made by the lessee. It also includes the cost of depreciation and the lessee's eventual acquisition of the object after paying the residual value.

In terms of entering into an aircraft or engine leasing agreement and its international recognition, the requirements varies from country to country. For this reason we would embark on a comparison among some jurisdictions to demonstrate the multiplicity of laws and statutes regulating these contracts and how uniformity is desperately needed by the industry as intended by UNIDROIT's Convention and Protocol on Mobile Equipment and Aircraft.

1. BELGIUM

Belgian Law follows Art. 17 of the Chicago Convention by decreeing that nationality of an aircraft is not linked to the nationality of its owner but to the country

of its registration. All aircrafts registered in Belgium are considered to bear Belgian nationality. There is an Aeronautic Register of the Aeronautics Administration at the Ministry of Communications and only aircrafts with Belgian nationality can be registered there.[38]

The main problem faced in by lessors to Belgian nationals in 1992 was that Belgian legislation did not provide for the possibility of creating a mortgage on an aircraft and no system of registering securities in them was available. In the case of engines, there was no system for their registration prompting Belgian courts to examine the security interests created under foreign laws by applying their conflicts of laws regulations.[39]

The situation became more complex because, although Belgium signed the Geneva Convention of 1948, no ratification of the convention followed. In cases of bankruptcy of the buyer, the title reservation technique was not effective and the seller was treated as an unsecured creditor. Similar treatment was given to the seller under an agreement for the rental of equipment if the lessee, automatically or as a result of the economics of the transaction, was bound to become owner of the goods delivered. The only situation in which protection to lessors was given was in those of financial leases that satisfied the definition given for the regulation of the

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W. Goris et G. Jakhian, "Security Rights in Aircrafts under Belgian Law" (1992) XVII-2 Air & Space Law 61 at 62.

39

Ibid.

economic activity of financial lessors.[40] Therefore, it was extremely important for any transaction involving financial leases to duly classify under that special law to secure the lessor's property interest in the movable good leased to a Belgian lessee.

Belgium finally deposited its Instrument of Ratification of the Geneva Convention in 1993 and it entered into force on January the 20th of 1994[41] which lead to an overhaul of Belgian laws related to aircraft security interests and registration.

2. GERMANY

German law presents a more flexible approach toward the taxation implication of leases and also toward the recognition of property interests in leased aircrafts and their equipment. In terms of the taxation benefits, the useful life of an aircraft in Germany is very short and a great part of the cost is written off in the first years of the useful life of the aircraft.[42] This fact has helped leasing to become a popular instrument of fleet financing and has also given German operators the opportunity to have access to newer up-to-date equipment as compared to other countries.

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40 *Ibid.*

41 See *Geneva Convention*: List of Parties (1993) XVII-II Ann. Air & Sp. L. 535.

42 K. Gunther et P. Erbacher, "Aspects of Aircraft Leasing in Germany" (1992) XVII-2 Air & Space Law 92 at 100.

In terms of property rights, it is clear under German law that lessors retain legal title of the aircraft although all responsibilities and risks of it are to borne by the lessee, whose legal position in this respect has more resemblance to that of a full-scale buyer.[43] This is also true for engines that are bought and delivered as part of the aircraft, no matter whether they are fixed to the aircraft or removed from it later for replacement.[44] Finally, due to the fact that lessors retain the title to the aircraft, no other creditor of the airline can have access to it under any circumstances.[45]

It used to be the public policy of the German government that only aircrafts owned by nationals were allowed to be registered in the Aircraft Register prompting foreign lessors to began transferring title to the aircraft to German trustees in order to obtain registration of their interests. As of 1991, the German Federal Minister of Traffic issued a new policy opening the doors for the recognition and registration of property interests in foreignly owned aircrafts. German law does also recognizes the creation of mortgages over aircrafts of German nationality.

Germany ratified the Geneva Convention in 1959 and has also been an active member of UNIDROIT's Drafting Committee of the draft Convention covering mobile equipment and its Protocol on aircraft.

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43 *Ibid.*

44 *Ibid* at 94.

45 *Ibid.*

3. SPAIN

Spain is one of the Civil Law tradition countries which has not yet adopted a modern statute to regulate financial leases, although in 1988 several new policies were introduced by the Spanish government that had some impact in the configuration of these agreements. There are two registries in Spain dealing with aircrafts: the Aircraft Registry and the Mercantile Registry.

As in the abovementioned countries the Spanish Aircraft Registry is only open to aircrafts owned by individuals or companies with Spanish nationality or aircrafts leased to them. Nonetheless, the Mercantile Registry is only opened to Spanish aircrafts and in the case of leases by non-Spanish lessors, they are only registered in the Aircraft Registry. Such registration in the Aircraft Registry serves as a protection for their property interests and as a notice to third parties evidencing that the registered aircraft is owned by the corresponding owner and not by the Spanish lessee which is operating it.[46] In addition, lessors will be the owners with legal title to the aircraft until the Spanish airline decides to exercise the purchase option, if any is included in the leasing agreement, and the lessee will only have the right to use the equipment for the duration of the lease.

When it comes to repossessing the equipment special attention is given as to whether the agreement is governed by Spanish law or by foreign law and the position assumed by the local lessee. All those elements will activate different

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See F. Lopez-Anton et J. Falcon-Ravelo, "Aircraft Financing in Spain" (1992) XVII-2 Air & Space Law 104 at 105.

statutes and procedures before Spanish courts. If the lessee goes bankrupt there is a chance that the equipment will be included in the estate because the aircraft was in the possession of the company in bankruptcy.[47] The Spanish Code of Commerce provides for this action regardless of the property interests involved although after a thorough demonstration of such interests, they are returned to their legal owners. Therefore, the main concern for lessors is that long periods can pass before they may repossess their equipment and no expedite process is set forth by the law except the possible negotiation with the judge in charge of the proceedings to exclude those goods from the estate of the bankrupt corporation.[48]

In the case of aircraft mortgages, the Spanish Chattel Mortgage Law must be followed to be able to register it in Spain. It is important to highlight that under Spanish law the concept of 'lex rei sitae' as applied to aircrafts, is construed by reference to the place where the aircraft is registered and not to the physical place where the aircraft may be located at any time[49]. Accordingly, in order to have a mortgage valid in Spain over an aircraft, it must be done before the aircraft is registered in that jurisdiction because otherwise it will be governed by Spanish Law. It has not been decided in Spain whether a lessor will be secondarily liable for certain debts incurred by the lessee connected to the operation of the aircraft, as

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47 *Ibid* at 106.

48 *Ibid.*

49 *Ibid.*

airport and repairers' charges, to prevent the aircraft from being attached by those creditors. What is clear is that a mortgagee will not be subjected to any claim or liability related to the aircraft because his only interest is the security given by the owner in connection with its credit.[50]

4. CANADA

Canada is one of the countries that has not ratified the Geneva Convention of 1948 and one may wonder which is the reason for not doing so if both ICAO and IATA are located in Montreal. The answer is simple: under the Constitutional Act, 1867 a constitutional federal system of government was established and specific powers were set out for both, the federal Parliament and the provincial legislatures. Although no express mention was made about aircrafts, it has been established by numerous court rulings that it is for the federal Parliament to exert legislative powers over the topic. Up to here no problems arise but they do as soon as the issue moves into answering the question of who was vested with the power to establish a central registry for security interests in aircrafts. In this case it is for the provincial governments to legislate in the field of securities on movable property.[51] This is why the Canadian Federal Government is prevented from creating a centralized registry

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Ibid at 108.

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See R. Rosales, "Recordation of Rights in Aircraft and International Recognition: A Comparison Between the American and Canadian Situations" (1995) XVI Ann. Air & Sp. L. 195 at 218.

for securities on aircraft, as in the United States, and it is the main reason why they have not been able to ratify the Geneva Convention.

Under the current Canadian federal and provincial legal framework each province sets out its own system of securities registration proceedings with the aggravating factor that in some of them there is a registry of securities on movable objects in each county. This is not the only peril lessors must protect from because in addition to those circumstances there are three distinct movable property security regimes in Canada: (1) the civil law system in force in Quebec, (2) the traditional common law chattel security regime, and (3) the comprehensive personal property security legislation regimes of other provinces.[52]

The main consequence of this amalgam of statutes was that Canadian operators were in great disadvantage to their American competitors because creditors required higher leasing payments and extra title insurance to protect their interests in cases of default, bankruptcy, or repossession.

Later the 'Registre des droits et reels mobiliers du Quebec' was created introducing the new technological breakthrough of electronic registry for securities in movable objects in the province of Quebec. Most important is the fact that Canada was not only the original proponent to draft an international convention on the topic of international recognition of security interests in mobile equipment but Canada was also elected Chair of the Registration Subcommittee and Deputy Chair

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See G. FitzGerald, "A Canadian Central Registry for Security Interests in Aircraft: a Progress Report" (1984) IX Ann. Air & Sp. L. 8. Also see J.M. Fortier, "Leasing of Aircraft in the Province of Quebec" (1990) XV Ann. Air & Sp. L. 61 at 62.

of the Drafting Committee in the First UNIDROIT-ICAO Joint Session held in Rome, Italy in February of 1999.

Nonetheless, no Canadian ratification of the Geneva Convention was accomplished and it is widely expected that Canada, being the original sponsor of this effort to unify international securities recognition, will sign and ratify both the draft Convention and the Protocol as soon as they are opened for signature by states. If the current proposal to create a centralized international registry for international securities in movable equipment is adopted, we understand that Canada shall not face any constrains as to the approval of that particular innovation under its federal and provincial laws because it would be specifically directed toward the international protection and recognition of those interests while keeping in place its provincial registries system.

5. UNITED STATES

In 1938 the Congress of the United States enacted a federal law called the Civil Aeronautics Act in which for the first time the federal government required that all aircrafts and instruments affecting their title be recorded in a central registry or clearing house. That law was followed by the Federal Aviation Act of 1958 which is the present federal statute regulating this matter. Under the Aviation Act two related filing systems affecting all civil aircrafts were created: one system for the registration of aircraft as to nationality and a second system for the recordation of conveyances

affecting title to and interest in aircraft.[53] The provisions covering registration and recordation are found in Title 49 of the United States Code, Sections 1401 through 1406, also referred as Sections 501 to 506 of the Aviation Act.

Under Section 501[54] it is unlawful for any person to operate or navigate any aircraft eligible for registration if such aircraft is not registered by its owner. Subsection (b) limits the registration to aircrafts owned by U.S. citizens, permanent residents, or U.S. corporations and which are not registered elsewhere. Once the aircraft is registered, its registration only serves as evidence of nationality and not of ownership.[55] This section incorporates to the national level the obligations assumed by the United States under Arts. 17-19 of the Chicago Convention. As in the case of other countries, foreign lessors and/or corporations may employ the mechanism of creating a trust and transfer their title rights over the aircraft to it, to create a local subsidiary, or to establish a U.S. based corporation to accomplish U.S. registration.[56]

Section 502[57] provides for the separate registration of aircraft engines,

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See Rosales, *supra*, note 51 at 197.

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49 U.S.C. sec. 1401

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49 U.S.C. sec. 1401(f)

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See T. Whalen et T. Lynes, "Foreign Ownership of U.S. Registered Aircraft: The Voting Trust" (1992) XVII-2 Air & Space Law 153 at 158.

57
49 U.S.C. sec. 1402

propellers, and appliances. The incorporation of this section distinguishes the act as one of most advanced ones enacted by any country, specially if looked from a chronological standpoint when today one can still find countries where there are no provisions to create a mortgage over an aircraft, not to say an engine or a component.

Section 503[58] is the central provision for recordation of aircraft ownership and interests. It requires that all leases, mortgages, trusts, contracts of conditional sales and any other instrument executed for security purposes in aircraft, engines of 750 horsepower or more and propellers suitable for use on such engines be dully registered. For purposes of perfecting an ownership or security interest in aircraft, the critical date is the date of filing for recordation, not the actual date of it, which usually takes some time to be done.[59]

Lastly, under section 504[60] any person holding a security interest over an aircraft or equipment will only be liable for injuries caused to others when the subject aircraft or equipment is in the actual possession of the security holder. Per consequence, any damage or injury caused by the aircraft or its equipment while the lessee has the actual possession of the movable good will only make the

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49 U.S.C. sec. 1403

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See L.W. Nelsen, "An Overview of Registration, Recordation, Ownership, and Secured Interests in Aircraft under the Federal Aviation Act of 1958" (1988) 53 J. of Air L. 933 at 935.

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49 U.S.C. sec. 1404

operator (lessee) liable and the security holder is protected against it.

Besides these peculiarities, the Aviation Act is praised by many international lessors and lenders up to the point that many prefer U.S. aircraft registration, where the transaction permits. Among the reasons cited for this practice one can mention: first, the statutes and regulations governing registration have been in existence for a number of years and their enforceability, as well as their meaning and application, have been fairly tested by litigation. Secondly, the Federal Aviation Administration (FAA) in practice, adheres to the regulations it promulgates and the administrative rulings it makes, creating a dependable set of rules. Lastly, in terms of maintaining value, U.S. registered aircrafts must be maintained and operated in accordance to FAA standards.[61]

Many judicial controversies emanated from the securities recordation sections of the Act. The first case in which the U.S. Supreme Court interpreted any of the recording provisions of the Aviation Act was in the case of *Philko Aviation, Inc. v. Shacket*,[62]where the Court ruled that all interests over aircraft must be federally recorded before they can obtain whatever priority they are entitled under state law.

When it comes to possessory liens,[63] section 9-310 of the Uniform

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See Whalen et Lynes, *supra*, note 56.

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462 U.S. 406 (1983)

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Those that arise by operation of law on property in the possession of persons who have supplied goods and/or services which enhance or preserve the value of the

Commercial Code (UCC) as well as most states' laws give priority to them over perfected security interest in the same property. Still, it has not been resolved in the United States whether the holder of a possessory lien must register or at least notify the Aircraft Registry of it in order to exercise the priority given by local and federal laws in cases where other secured interests are involved.

As to security interests in aircraft operated by foreign carriers, U.S. laws have different approaches depending on whether the movable good is an aircraft or not. Under the general scope of the UCC the law of the jurisdiction in which the debtor is located governs the perfection and the effect of the perfection or non-perfection of the interest.[64] If the debtor is a foreign carrier as defined by the Aviation Act, it shall be deemed located at the designated office of the agent upon whom service of process may be made on behalf of the foreign carrier.[65]

Regardless of what the UCC establishes, the United States has several international duties as a party to the Geneva Convention. Arts. I and II of the Convention are to the effect that the law of the State of registry of the aircraft will govern questions relating to the validity of security interests and priorities between competing claims.[66] Therefore, only in those situations involving a foreign carrier

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property.

64 UCC Sec. 9-103

65 UCC Sec. 9-103(d)

66 Rosales, *supra*, note 51 at 208.

with an aircraft registered in a country not party to the Geneva Convention, the UCC choice of law regulation will apply. In that case, the law of the state where the carrier has its designated agent for reception of service of process under the Aviation Act will govern the issue of validity of any security interest.[67]

The best example would be that of Canadian carriers because Canada has not ratified the Geneva Convention and two Canadian major air carriers operate to/from the United States. In this case the law applicable to security instruments done or given in the United States over Canadian registered aircraft will have to comply with the law of the state where those carriers have designated a resident agent for serving of process purposes and not Canadian law as under the Geneva Convention.

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67 *Ibid.*

PART E TYPES OF LEASES

Due to the increasing importance of leasing agreements for the use of mobile equipment, many classifications based in accounting and taxation laws have originated with the consequence that a same type of leasing contract can be classified and called in multiple ways depending on where and by whom the lease is done and who classifies it. Nonetheless, the majority of legal scholars and financiers agree in encompassing all leases in two categories: (1) operating leases and (2) capital leases from the side of the lessee and three categories from the side of the lessor: (1) operating leases, (2) sale-type leases, and (3) direct finance leases.[68]

A capital lease is a contract involving payments of specific amounts during a fixed term sufficient in the aggregate to amortize the lessor's capital outlay and provide its profit. The term is normally of a long duration relative to the useful life of the leased equipment and the lessee normally acquires the asset either because of an option to purchase granted as a term of the lease or as result of a 'put' exercised by the lessor.[69]

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[68] See Selby, *supra*, note 30 at 5. Also see Section 3065 of the Canadian Institute of Chartered Accounts (CICA) Handbook which in 1979 codified leases accordingly.

[69] See Bunker, *supra*, note 6 at 25.

In addition to the abovementioned characteristics of capital leases, the core of these leases rests on financial considerations serving as a security to loan financing and giving lessors a financial role. As also mentioned before, capital leases are divided in two general categories for the lessor: (1) sale-type and (2) direct financing leases. This division recognizes the two major sources of leasing: (1) manufacturers who lease their product and thereby earn both a profit margin over cost and a financing and leasing margin; and (2) financial intermediaries who acquire the leased asset for purposes of leasing it to a specific third party and expect to realize a financing margin.[70] It can be said that the basic difference between the two main categories of leasing is that under an operating lease the lessee has the right to possession of property whereas in a capital lease the lessee has a right in the thing leased and acquires incidents of ownership.[71]

The guidelines to determine if the lease is a capital lease from lessees' viewpoint are the following:

- "if there is a reasonable assurance that the lessee will obtain title to the leased asset during or at the end of the lease term;
- if the lessee will receive substantially all the economic benefit of the leased property over its life span ("the 75% test");
- if the lessor would receive over 90% of his or her investment in the leased property plus a return on the investment as a result of the

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See R. Selby, *supra*, note 30 at 31.

71

See D. Bunker, *supra*, note 6.

lease agreement;

- the credit risk associated with the lease is normal when compared to the risk of similar receivables; and
- the amount of unreimbursable costs that are likely to be incurred by the lessor under the lease can be reasonably estimated".[72]

On the other hand, operating leases are frequently called "true leases" because they do not hide financial objectives behind the transactions. They cover all other forms of equipment leases where the capital cost of the asset is not wholly amortized over the lease term and the lessor's profit is not necessarily derived from rentals during a single term. Additionally, the lessee seldom acquires title to the leased equipment at the end of or during the term.[73]

These are relatively short term leasing contracts and the lessor is able to rent the equipment several times in sequence. Three other characteristics can be mentioned about operating leases:

- first, residual values are important for operating lessors because they rely upon present and future aircraft values for their business to

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See R. Selby, *supra*, note 30 at 31 and 32.

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See D. Bunker, *supra*, note 6 at 25. Another excellent source of information as to the comparison of the different types of leases can be found in A. Hajji, *Le financement d'achat d'avions par les compagnies aeriennes:le projet commun arabe* (D. L. These, Faculte des Sciences Juridiques, Economiques et Sociales, Universite Hassan II, Casablanca, Morocco, 1994) at 213.

flourish;[74]

- secondly, several provisions are usually included in operating leases dealing and regulating specific services as insurance, installation, maintenance, delivery, and fuel that can be itemized as separate charges;[75]
- lastly, unlike financial lessors, operating lessors are really aircraft investors and traders managing a portfolio of assets.[76]They are in the business because their specialized skills in evaluating residual values of aircraft and in re-leasing them effectively.[77]

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See S. Holloway, *Aircraft Acquisition Finance* (United Kingdom: Pitman, 1992) at 144.

75

Ibid.

76

Ibid at 151.

77

Pompongsuk, *supra*, note 10 at 16.

PART F CLASSIFICATION OF LEASING AGREEMENTS

As mentioned before, classifying leasing contracts implies a strenuous task due to the fact that an exact type of leasing is called in multiple ways depending the classifier's standpoint, the jurisdiction, the objectives of the lease, and the deal *per se*. However, for purposes of this study we would try to explain the most frequently used leasing agreements from a neutral standpoint as to the parties involved and the kind of deal entered.

Sale-Leaseback:

This is a kind of lease to which corporations and specially air carriers resort to in times of economic downturn where they experience cash shortages or to increase their liquidity by selling major assets to an investor and leasing them back. According to taxation laws if the lease is on a basis which permits the owner/lessee to reacquire the asset or to use up substantially all its useful life, then the sale and leaseback is treated as financing.[78] It is widely used by air carriers who have old and fully depreciated aircrafts, specially to fund the acquisition of newer ones.

Back-to-Back Lease:

a lease of equipment which is leased to a leasing company and then sub-

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See R. Selby, *supra*, note 30 at 11.

leased to the actual operator.[79]

Closed-End Lease:

it is an operating lease in which the lessor assumes the risk of depreciation and residual value. The lessee bears little or no obligation at the end of the conclusion of the lease besides that of returning the asset to the lessor in good conditions.[80]

Cross-Border Lease:

these are leases where both parties, the lessor and the lessee, are in different countries or come from different legal systems. In some cases, as in leveraged leases, all the parties to the agreement are located in different jurisdictions creating the need for in depth legal counseling to accomplish it.

Wet Lease:

lease where the aircraft is leased complete with crew. In cases of wet leases with partial crew only, they are referred to as Damp Leases. They usually are transitory and short-term in nature because they are mostly used to replace, on short notice, aircrafts with mechanical problems to which the carrier has no available substitute readily. In other cases it is frequently used by some carriers to

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See D. Bunker, *supra*, note 6 at 34

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Ibid.

cope with increased traffic demands on specific routes due to seasons or festivities.[81]

Dry Lease:

lease where the aircraft is leased without the lessor providing neither directly nor indirectly the aircrew to operate it.

Double Dip Leasing:

these arrangements involve two jurisdictions in which concepts of ownership differ allowing a double depreciation of the same asset. It is used in situations where the jurisdiction of the lessor recognizes only the concept of legal ownership and the lessor is treated as the owner of the asset merely because it holds title to the asset. By reason of this approach, he is allowed to depreciation allowances.[82]

On the other hand, the jurisdiction of the lessee further recognizes economic ownership. The lessee may therefore be entitled to depreciation allowances, even though it has no legal title to the asset, provided some specific requirements are

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A good example of this situation is the wet lease done between Saudia, the Saudi Airline, and World Airways, an international wet lessor, for 2 MD-11's during the period of pilgrimage to Mecca by Muslim devotees. Another example are the wet leases entered between Aer Lingus and Avianca with World Airways to manage increased traffic in some of their routes due to festivities or seasonal travel.

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See J.P. Le Gall et S. Reeb. "Highlighting Various Tax and Security Law Aspects of Aircraft Financing- France" (1992) 17 Air and Space Law 87 at 90.

met.[83] The requirements vary from jurisdiction to jurisdiction. For example France only recognizes legal ownership of the asset. In other countries, as Belgium, Switzerland, Canada, or the United Kingdom they focus mainly on the existence of a purchase option while the United States and Germany mainly consider the value of rents.[84]

Open-End Lease:

a lease which contains a provision for the extension of the lease on pre-determined terms after the end of the fixed period.[85]

Direct Financing Lease:

lease where a financial intermediary acts as lessor and expects to earn finance income rather than a gross margin on sale plus finance income. In general, such agreements are full-payout leases, with the lessee having the option of acquiring the asset at the conclusion of the lease term for a nominal amount or a "bargain purchase".[86]

83
Ibid.

84
Ibid.

85
D. Bunker, *supra*, note 6 at 48.

86
See R. Selby, *supra*, note 30 at 33.

Sale-Type Lease:

lease typically used in transactions by dealers or manufacturers as a marketing tool of their products to promote customers buying or leasing. If the parties enter in any type of leasing arrangement, excluding operating leases, the manufacturer or the dealer will earn double income: profit for the sale of the product and for the finance income earned over the lease term. [87]

Security Lease:

a lease in which the lessee is considered the owner for both contract law and income tax purposes.[88]

Leveraged Lease:

a leveraged lease presents a differentiating characteristic as to the parties involved in this type of deal because it brings together a triangle of distinctive and conflicting interests that are necessary to create it. Those parties are: the lessee, a long-term creditor (lender or loan participants), and a lessor each of whom has a different objective.

The lessor avoids the burden of financing the cost of the equipment out of currently available funds while receiving some taxation benefits by claiming the depreciation of the asset. On the other hand, lender's basic desire is to ensure that

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Ibid at 35.

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D. Bunker, *supra*, note 6 at 52.

they will receive their principal and interests payments or, in leu thereof, a valuable, marketable aircraft. Legal title to the aircraft is held by an "owner trustee", typically a large bank, which borrows money from the lenders on a nonrecourse basis, pays the seller of the aircraft in full, leases the aircraft to the lessee, and issues loan certificates to the lenders evidencing their interests.[89]

From a practical point of view the transaction develops in the following manner: one airline needs an aircraft and there are some investors, also called owner participants or lessors, looking for a way to pay less taxes for their business. Then the investors approach a pension fund for the money but under United States law, pension funds are forbidden by law from lending funds to buy aircrafts.

Here is where a bank, also called owner trustee, comes into the picture because it is the bank the one who borrows the money from the pension fund. The reasons for the presence of the owner trustee is for purposes of easier administration, insulation of the lenders from the effects of future bankruptcy of the equitable owner of the aircraft, and possible insulation of the equitable owner or lessor from tort liability for damage caused by the aircraft.[90]

It is the owner participants or lessors the ones who hold equitable and residual title to the aircraft because they also invest a small portion of the cost and receive any rent that is not required to meet the lender's debt service or to pay

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See S.R. Kruft, "Leveraged Aircraft Leases: The Lender's Perspective" (1989) 44 Bus. Law. 737 at 738.

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Ibid.

various expenses. They are also entitled to claim the tax benefits from depreciation.

The airplane, after being purchased, is leased to the airline and the lease is assigned to the bank by the lessor, as a mean of security, and the bank is paid as the lessee pays to the lessor. In that way lessors are not accountable to the bank and get the tax advantages at the same time.

At the end of the transaction, the owner participants buy the aircraft with bank's money, borrowed from a pension fund and they only put a small percentage of the total investment while getting 100% of the depreciation benefits. By the time the depreciation is over then lessors are called to pay taxes for all the tax savings of those years. Lessors should have had invested those savings in other financial projects as to be able to pay the taxes and have profits larger than the amount of taxes to be paid to the government.

As these leases became more and more popular governments realized that they were the ones losing money and came up with a new policy requiring lessor-investors to assume a real part of the risk inherent to the transaction. The minimum investment requirement was set at 20% of the total amount of the transaction in order to have the privilege of claiming 100% of the asset's depreciation. This operation is what is called leverage. Also depreciation in the United States was limited at 25% of the value of the asset per year.

Notwithstanding the tax benefits these leases allow investors there is growing concern that prospective shareholders of airlines using these kind of financial arrangements receive a hidden debt to equity ratio because they are not included in their balance sheets. This is called off balance sheet financing. For this reason

many regulatory boards and administrative commissions are starting to regulate the accounting principles previously used to hide such agreements in order to have access to a real financial picture of the corporation.

PART G TITLE RESERVATION

A title reservation agreement is defined as an agreement for the sale of an object on terms that ownership does not pass until fulfillment of the condition or conditions stated in the agreement.[91] It serves to assure the seller that payment will ultimately be made and allows the owner of the goods to seize the property should the debtor fail in one of his obligations. The principal significance of a retention of title clause from the seller's perspective is the potential priority it may give her vis-a-vis other creditors in the event of the buyer's insolvency.[92] This is also called a conditional sale. If the purchase price is payable in installments then the agreement is called hire-purchase.

The economic purpose of these contracts is the furtherance of credit given to persons or corporations who do not dispose of ready money and are not in a position to give any other security than that attaching upon chattels they daily use or deal in. Many arrangements are allowed varying from country to country. In some, the seller is the one who keeps or reserves the title whereas in others a finance company intervenes receiving through transfer the title reservation from the

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Art. 1 of the Text of the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment as Reviewed by the Drafting Committee, June 1999.

92

See R. B. Johnston, "A Uniform Solution to Common Law Confusion: Retention of Title under English Law and U.S. Law" (1994) 12 Int'l Tax & Bus. Law. 99 at 101.

seller.[93]

Three alternative categories of title reservation clauses, all of which derive from the simplest one, are used in commercial transactions. These are the enlarged, the extended, and the all-monies retention of title clauses. The first one is frequently used in cases where seller's goods are commingled or mixed with other goods so that such goods are no longer separable and/or identifiable. The extended clause serves to extend seller's rights in the delivered goods to the proceeds of resale and/or to buyer's claims against subpurchasers. The last one allows the seller to retain title to any or to all seller's goods in the buyer's inventory until all monies owed by the buyer have been paid.[94]

As mentioned before, under the U.S. Aviation Act and the UCC reservation of title is also recognized as a security interest. The only restrain found in the UCC is Sec. 9-203 that limits the enforceability of this security instrument until it is attached which is accomplished by fulfilling the three requirements found in Sec. 9-204(1). Nonetheless, it is a common way to secure property interests in the United States although it is not in other jurisdictions, as the United Kingdom, because of outdated laws and uncertain judicial interpretations that tend to declare them invalid.

Up to here we have discussed the framework used by creditors to secure their property interests in general. Now we must move to the international side of

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C.C.A. Voskuil and J.A. Wade, *Hague-Zagreb Essays 5 on the Law of International Trade* (The Hague: Martinus Nijhoff Publishers, 1985) at 55.

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See Johnston, *supra, note 92* at 103.

the equation and describe previous, present, and future efforts to unify this area of law in lieu of facilitating the international lease and sale of highly movable goods as aircrafts are.

CHAPTER II - CURRENT INTERNATIONAL CONVENTIONS IN FORCE REGULATING INTERNATIONAL LEASES

PART A 1948 GENEVA CONVENTION

From it origins, international aircraft finance has been plagued with a series of significant burdens arising from the own nature of cross-border transactions that involved multiple parties, each one situated in different jurisdictions, and an asset capable of flying from one country to another or of being operated in several of them. The main consequence of these multiplicity of parties is the potential application of conflicting national laws putting lessors and creditors alike in the fragile position of losing their property interest over the aircraft or of losing their credit rank to local creditors.

Each State, under its sovereign powers, adopts its property laws that set out the rules for the creation and recognition of security rights. The creation of a security interest over an aircraft is a matter regulated by national property laws and imply an *erga omnes* right that can be invoked to exclude others and enforced against any third party.

As early as 1926 the Comite International d'Experts Juridiques Aeriens (CITEJA) was created and was assigned the task of drafting a convention on

aeronautical registers, aircraft ownership, rights *in rem*, and mortgages.[95] Two draft conventions were produced in 1931 by the CITEJA but the Second World War hampered any further efforts to adopt both draft conventions. After the war the United States exhorted the international community to adopt a convention to manage the increasing legal controversies caused by the growth of international aviation.

In 1948 ICAO approved the draft presented by CITEJA in its second session held in Geneva and the *Convention on the International Recognition of Rights in Aircraft* later came into force. An analysis of its articles certainly leads to the conclusion that it is a system created to deal with issues of conflicts of laws.

The four basic objectives of the Geneva Convention are:

- the protection of secured creditors who have lent money on the security of the aircraft;
- the protection of third parties dealing in or with aircraft against hidden charges;
- the definition and protection of "privileged" or "priority" claims against aircraft;
- the facilitation of the transfer of aircraft from one national registry to another.[96]

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See G. N. Calkins, Jr., "Creation and International Recognition of Title and Security Rights in Aircraft" (1948) 15 J. of Air L. 156 at 162.

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See R.O. Wilberforce, "The International Recognition of Rights in Aircraft" (1948) 2 Int'l. L. Q. 421 at 424.

Under Article 1 of the Convention each contracting State undertakes to recognize:

- rights of property in aircraft;
- rights to acquire aircraft by purchase coupled with possession of the aircraft;
- rights to possession of aircraft under leases of six months or more; and
- mortgages, hypotheques and similar rights in aircraft which are *contractually* created as security for payment of an indebtedness.[97](emphasis given)

However, the recognition of those rights is not automatically achieved with the creation of a legal instrument because Art. I also requires two critical additional conditions for it to apply: (1) that those rights and securities "have been constituted in accordance with the law of the contracting State in which the aircraft was registered as to nationality at the time of their constitution; and (2) that those rights and securities "are regularly recorded in a public record of the contracting State in which the aircraft is registered". This second requirement of having a central registry for the recordation of securities is the one preventing Canada from ratifying the Convention.

Art. II of the Convention provides that the effects of recording any right, with

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It is fundamental for the reader of this study to understand that under the Geneva Convention the security interest *must* be created by contract and not by operation of law.

regard to third parties, are determined according to the law of the contracting State where it is recorded. Hence, any controversy involving priority issues over recorded rights is to be resolved under the law of the State of nationality of the aircraft. Additionally, "a contracting State may prohibit the recordation of any right which cannot validly be constituted according to its national laws".[98]

The result is that with respect to civil aircraft registered in a country which is a party to the Convention, those valid interests in aircraft recorded in that country will be recognized and will be given priority on judicial sale by every other country which is party to the Convention. For this to happen it must be understood that both the country where the aircraft is registered and the country where the owner or financier is enforcing its rights must be parties to the Convention before there is any benefit.[99]

Art. III(2) confers the right to any person to receive from the authority duly certified copies or extracts of the particular recorded. The importance of this clause derives from the fact that the Geneva Convention expressly elevates the validity of such copies or extracts considering them *prima facie* evidence of the contents of the record. This means that third parties are protected against hidden security rights and may rely on what is there recorded to constitute and record theirs. The Convention also protects third parties interests by requiring, under Art. II(1) that all

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Art. II(3) of the Geneva Convention, *supra*, note 4.

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See C. Thaine, "Security Interests in Aircrafts and Spare Parts I: England and Wales", (1987) 15 I. B. L. 167 at 168.

recordings relating to a given aircraft must appear in the same record facilitating any title search done by present and future creditors.

Although the Convention's main objective was to ease the recordation and recognition of international securities over aircraft, it also gives priority to a restricted number of claims that are to be considered privileged over all other interests there recognized. Art. IV of the Convention sets out a priority system for claims. It provides that in the event of any claim related to compensation for salvage of the aircraft or extraordinary expenses indispensable for the preservation of the aircraft give rise, under the law of the contracting State where those operations were terminated, to a right conferring a charge against the aircraft such claims receive priority over all other rights.

It is important to highlight that under Art. IV(3) any of the rights mentioned in Art. IV(1) may be noted on the national record, within three months from the date of the termination of the salvage or preservation operations. Hence, the previous discussion on whether a possessory lien in the United States under Section 9-310 of the UCC, as well as under state's laws, must be registered or at least notified to the Aircraft Registry to exercise the given priority over other secured interests tends to lead to the conclusion that if the holder wants to have priority over secured creditors, the lien must be registered in order to receive recognition in other international jurisdictions.

Therefore, in the unresolved debate of how a case in the United States involving an internal controversy of purely national creditors and a holder of a possessory lien over an American aircraft, it can be argued that if under the Geneva

Convention the lien must be registered to receive the protection and priority given by the Convention and following the holding in the case of *Philko Aviation*, it is imperative to conclude that the same treatment shall be followed in these internal cases. In this way there would only be one procedure to be followed for national and international claims; to record it and domestic priority will be automatically given under the UCC, states' laws and internationally under the Convention.

The recognition of mortgage and securities amounts extends to all sums secured by them but the amount of interests claimed may not exceed three years prior to the execution proceedings together with those accrued during the execution proceedings.[100]

In the unfortunate case of an execution against the aircraft the proceedings of the sale shall be determined by the law of the contracting State where the sale takes place provided that the date and the place of the sale must be fixed at least six weeks in advance.[101] Other procedures must also be followed under the Convention before for the sale in execution as: the submission of certified extracts of the executing creditor's recorded rights, one month's public notice of the sale, and a notification to all other recorded owners and holders of recorded rights in the aircraft and to the holders of rights mentioned under Art. IV of the Convention (salvage and preservation expenses).

The consequences of failure to observe these requirements are determined

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Art. V of the Geneva Convention, *supra*, note 4.

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Art. VII(1) and (2)(a) of the Geneva Convention, *supra*, note 4.

by the law of the contracting State where the sale takes place. However, Art. VII(3) adds that any sale taking place in contravention of the requirements of the Convention can be annulled upon demand made within six months from the date of sale by any person suffering damage as the result of such contravention. Additionally, if the executing creditor is not first in rank, all rights having priority over his claim must be covered by the proceeds of the sale or assumed by the purchaser.[102] Finally, the transfer of property of the aircraft is effected free from all rights not assumed by the purchaser.[103]

As to the priority order given by the Convention, it is as follows:

- claims based on Art. XII arising from customs, immigration, and air navigation charges.[104]
- claims based on Art. VII (6) for the costs of sale in execution which "shall be paid out of the proceeds of sale before any other claim, including those given preference by Art. IV".[105]
- claims based on Art.. X concerning spare parts.[106]
- claim based on Art. IV for preservation and salvage of the aircraft

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102
Art. VII(4) of the Geneva Convention, *supra*, note 4.

103
Art. VIII of the Geneva Convention, *supra*, note 4.

104
Art. XII of the Geneva Convention, *supra*, note 4.

105
Art. VII of the Geneva Convention, *supra*, note 4.

106
Art. X of the Geneva Convention, *supra*, note 4.

costs.[107]

Art. IX of the Convention limits the transfer of an aircraft from the national registry or record of a contracting State to that of another contracting State to only cases where all holders of recorded rights have been satisfied or consent to the transfer. The exception is the case of a sale in execution under Art. VII, process previously discussed in this study.

Engines and spare parts are covered by Art. X of the Convention which recognizes recorded security interests over them if the law of the aircraft's State of registry so provides. Nonetheless, for the international recognition of security interests in spare parts to operate a couple of requirements must be fulfilled. First, the spare parts must be stored in a specific place and must remain there stored in order for the security interest to receive recognition in other contracting States and secondly, there must be an appropriate public notice fully disclosing all the details of the security interests as to inform third parties that those spare parts are encumbered.

Last, but not the least, the Convention also specifies that recognition of security interests in spare parts can only be recognized when done in extension of a charge created upon an aircraft. Therefore, security interests in spare parts exclusively is out of the scope of the Convention. Presently, aircraft engines interchangeability is a leading practice in the industry and creditors may find their security and property interests hindered or unprotected, in the worst cases, because

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Art. IV of the Geneva Convention, *supra*, note 4.

the Convention does not protects them. This lack of protection has leaded to the increasing use of title insurance and complicated legal frameworks to ensure the property interest of creditors in international transactions resulting in higher costs for all parties involved.

Among the effects of non-ratification of the Convention is that the non-contracting State, as a matter of public international law, has no duty to recognize a security interest perfected in another country. Instead of recognizing the mortgage to the extent to which it would be recognized in the state where it is registered the foreign court might apply its local rules as to enforceability, possession, and priority and enforce the security only to the extent that it would be enforceable if it were a local mortgage.[108]

Notwithstanding the advantages that the Geneva Convention introduced in 1948, the field of aircraft finance has developed to a degree where the Convention appears to be outdated and needs to be modernized to further strengthen its objective. Also the limited number of countries that have ratified it diminishes its application leaving ratifying countries and their investors in a vacuum as to the recognition and enforceability of their security interests in non-ratifying countries. Finally, the lack of recognition of secured interests in spare parts has also frustrated the original objective of the Convention leaving out of its scope of application one of the areas of higher importance in aviation industry today.

A new draft convention was adopted in 1988 called The UNIDROIT

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See C. Thaine, *supra*, note 99 at 169.

Convention on International Financial Leasing[109] with the objective of modernizing the Geneva Convention in part and to forward the recognition of financial leases internationally.

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The UNIDROIT Convention on International Financial Leasing, 28 May 1988, (1988) Revue de Droit Uniforme 135, *supra*, at note...

PART B UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

Financial leases have become a leading mechanism used by airlines to secure access to newer technology and equipment. It is this increased role in the aviation industry that obliges borrowers to enter into contractual relationships with numerous international leasing companies based in many countries. Financiers then rely on the leasing arrangements thereby created to secure their interests but, as previously discussed, each State is free to adopt domestic laws to regulate such contracts and the rights there stipulated.

As a result of the multiple legal frameworks in force in each country, lessors and creditors face an uncertain and unpredictable legal environment that results in extremely complex transactions with the only purpose of securing their investment internationally. The best example of the development of financial leases is the cross-border lease where the three parties to it: the manufacturer, the lessor, and the lessee are usually situated in different States involving three different legal systems and laws. The lack of homogeneous treatment, fiscally and substantively speaking, is the source of conflicts that limit the development of these type of transactions.

The international response to unify and simplify this area of the legal practice was the adoption of the Leasing Convention in 1998 with the purpose to unify property and commercial laws adapting them to the triangular relation find in

international financial leases. A relation characterized by the existence of two different contracts: one between the supplier and the lessor and another between the lessor and the lessee. It is this relation the one that frames the scope of the Leasing Convention encompassing under Art. 1(1) a transaction in which the lessor, on the specifications of the lessee, enters into an agreement with a third party, the supplier, to acquire plant, capital goods or other equipment on terms approved by the lessee and grants the lessee the right to use the equipment in return for the payment of rentals. Those rentals payed under the leasing agreement are to be calculated so as to take into account in particular the amortization of the whole or a substantial part of the cost of the equipment.[110]

This Leasing Convention applies to all financial leasing transactions in relation to all equipment excluding those to be used primarily for the lessee's personal, family, or household use.[111] Notwithstanding the fact that this is a Convention with unifying purposes no national taxation laws and policies have been affected by it while it addresses the legal aspects of the transaction and the duties owed by each party to the other.[112] It also applies whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a

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110
Art. 1(2)(c) of the Leasing Convention, *supra*, note 109.

111
Art. 1(4) of the Leasing Convention, *supra*, note 109.

112
See M.D. Rice, "Current Issues in Aircraft Finance" (1991) 56:4 J. Air L. 1027.

further period, and whether or not for a nominal price rental.[113] It must be emphasized that under domestic taxation laws these alternatives become flags pointing out toward the classification of the lease as an operating or financial one for tax purposes and imply significant differences in depreciation of the asset allowances.

1. Scope of Application of the Convention

The Leasing Convention has three requirements in order to apply to financial leases:

(1) the lessor and the lessee must have their places of business in different States; and

(2) those States and the State in which the supplier has its place of business are contracting States; ***or***

(3) both the supply agreement and the leasing agreement are governed by the law of a contracting State. (emphasis supplied)

It is clearly stated that there are two alternatives way to activate the application of the Leasing Convention. The first alternative involves the situation where the lessor and the lessee have their places of business in different States and those States and the State in which the supplier has its place of business are

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113 Art. 1(3) of the Leasing Convention, *supra*, note 109.

contracting States. The other alternative renders the Leasing Convention applicable when the lessor and the lessee have their places of business in different States and both the supply agreement and the leasing agreement are governed by the law of a contracting State.[114]

The second alternative presents a singular situation because it only requires the involvement of one contracting State in the transaction. For example: an American lessee leases an Airbus aircraft from an Irish lessor and they sign the agreement in Rome, Italy. Meanwhile the lessor accords with Airbus to purchase the aircraft and also signs the supply agreement in Rome, Italy. Under these circumstances the Leasing Convention will be applicable to the transaction due to the fact that Italy, along with France, Nigeria, and Hungary[115] ratified it and in case of any controversy the rights of all of the parties will be analyzed under the Leasing Convention, even in a case brought up in the United States which is not a contracting State, so far.

Contrary to the Geneva Convention, the Leasing Convention has an opt-out clause that allows parties to exclude its application but only in the case where each of the parties to the supply agreement and each of the parties to the leasing agreement agree to do so.[116] Furthermore, parties to a leasing agreement under the

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Art. 3(1)(a) and (b) of the Leasing Convention, *supra*, note 109.

115

See UNIDROIT, "Report on the Activity of the Institute-1996" Report 1996-C.D. (76)2 (1997) 1 UNIDROIT Actes et Documents at 22.

116

Art. 5(1) of the Leasing Convention, *supra*, note 109.

Leasing Convention can also derogate from or vary the effect of any of its provisions except as stated in Arts. 8(3) and 13(3)(b) and (4).[117]

2. Rights and Duties of the Parties

(a) Lessor

The Leasing Convention protects lessor's rights in the equipment by even making them valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution.[118] The applicable law to solve this situation will be that of the State where the aircraft is registered.[119] However, the lessor's rights shall not affect the priority of any creditor having:

(1) a consensual or non-consensual lien or security interest in the equipment arising otherwise than by virtue of an attachment or execution, or

(2) any right of arrest, detention or disposition conferred specifically in relation to ships or aircraft under the law applicable by virtue of the rules of private international law.[120]

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117 Art. 5(2) of the Leasing Convention, *supra*, note 109.

118 Art. 7(1)(a) of the Leasing Convention, *supra*, note 109.

119 Art. 7(3)(b) of the Leasing Convention, *supra*, note 109.

120 Art. 7(5)(a) and (b) of the Leasing Convention, *supra*, note 109.

Generally speaking, lessors will not be liable for any liability arising from the use of the equipment, except as expressly indicated in the Convention. The first exception is where the lessee has suffered a loss as the result of its reliance on the lessor's skills and judgement and for the lessor's intervention in the selection of the supplier or the specifications of the equipment.[121] The Leasing Convention provides that lessors are excluded from liability to third parties for death, personal injury or damage to property caused by the equipment but it does not governs lessor's liability in any other capacity as owner, per example.[122]

Lessors are also obliged to warrant lessees' quiet possession of the equipment against any eviction judgement and that such possession will not be disturbed by a person who has a superior title or right or claims it, where such right or claim is not derived from an act or omission of the lessee.[123]

(b) Lessee

The main duties imposed upon lessees are:

1- to take proper care of the equipment;

2- to use it in a reasonable manner; and

3- to keep it in the condition in which it was delivered, subject to fair

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121 Art. 8(1)(a) of the Leasing Convention, *supra*, note 109.

122 Art. 8(1)(b) and (c) of the Leasing Convention, *supra*, note 109.

123 Art. 8(2) of the Leasing Convention, *supra*, note 109.

wear and tear and to nay modification of the equipment agreed by the parties.[124]

4- to return the equipment to the lessor in good conditions unless exercising a right to buy the equipment or to hold it on lease for a further period.[125]

(c) Supplier

Article X of the Convention introduces one important innovation in international financial leases because it assigns duties to the supplier in favor of the lessee bypassing the fact that there is not direct contractual link between both of them. The duties of the supplier under the supply agreement are also owed to the lessee as if it were a party to that agreement and if the equipment were to be supplied directly to the lessee. However, the supplier shall not be liable to both the lessor and the lessee in respect to the same damage.[126] The only limitation to this privilege given to the lessee is that it cannot terminate or rescind the supply agreement without the consent of the lessor.[127]

The real innovation of the Convention is creating the fiction of a duty between

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124 Art. 9(1) of the Leasing Convention, *supra*, note 109.

125 Art. 9(2) of the Leasing Convention, *supra*, note 109.

126 Art. 10(1) of the Leasing Convention, *supra*, note 109.

127 Art. 10(2) of the Leasing Convention, *supra*, note 109.

two parties that contractually have none although it is a common practice in aircraft leasing agreements and specially in financial leases, that the lessor assigns the lessee all claims against the supplier or manufacturer related to warranty covered services, among others. Here direct and bilateral duties are created and recognized between those two parties: the lessee and the supplier. From a practical standpoint, assigning a duty to the supplier in favor of the lessee is a legitimate idea because it is the lessee the party that really uses and possess the equipment during most of its useful life and is the one who faces all the inconveniences, if any, of operating the supplied equipment. Meanwhile, financial lessors are taken out of the picture because they are only providing the financial support for the transaction and commonly have no contact with the aircraft whatsoever. They only receive a secured interest in the asset, nothing else.

3. Non-Performance by the supplier and/or the lessor

The Leasing Convention recognizes alternative actions to both the lessee and the lessor to act against the supplier in case the equipment is not delivered, delivered late or fails to conform to the supply agreement. It can be said that this is part of the triangular nature of the transaction and also part of the innovations introduced by the Convention. In a certain way, the lessor is somewhat protected from the lessee because it can resort to act directly against the supplier bypassing the lessor.

If a default occurs the lessee has the right, as against the lessor, to reject the equipment or to terminate the leasing agreement and the lessor has the right to

remedy its failure to tender equipment in conformity with the supply agreement as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.[128]

The lessee has two additional rights in case of lessor's default. First, the lessee is entitled to withhold rentals payable under the leasing agreement until the lessor has remedied its failure to tender equipment.[129] The second right allows the lessee, after exercising its rights to terminate the leasing agreement, to recover any rentals and other sums paid in advance, less a reasonable sum for any benefit the lessee has derived from the equipment.[130] However, the lessee has no other executable right against the lessor for non-delivery, delay in delivery or delivery of non-conforming equipment unless the default is a result of the act or omission of the lessor.[131]

4. Default by lessee

There are two parallel procedures for the lessor to deal with lessee's default set forth in the Convention that are directly related to the degree of the default. In case of a lessee's default the lessor may recover accrued unpaid rentals, together

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128
Art. 12(1)(a) and (b) of the Leasing Convention, *supra*, note 109.

129
Art. 12(3) of the Leasing Convention, *supra*, note 109.

130
Art. 12(4) of the Leasing Convention, *supra*, note 109.

131
Art. 12(5) of the Leasing Convention, *supra*, note 109.

with interests and damages.[132] However, where the lessee's default is *substantial* then lessor may also require accelerated payment of the value of the future rentals, if the lease agreement so provides, or terminate the leasing agreement. After such termination the lessor may recover possession of the equipment and may recover damages to place him in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms.[133]

If the lessor chooses to terminate the leasing agreement, it is not entitled to enforce a term of the agreement providing for acceleration of payment of future rentals but the value of those rentals may be taken into account when computing the damages.[134]

The world substantial default was highlighted because there is no definition in the Convention as to what default constitutes a substantial one to activate the additional remedies in favor of the lessor. How many unpaid rentals shall be owed and outstanding? Can a simple default become a substantial one if the lessee does not respond immediately to lessor's pleads? These are questions that national Courts will have to answer while interpreting the Convention.

In case the parties provided a clause in the leasing agreement on how to compute the recoverable damages, such clause shall be enforceable between the

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132
Art. 13(1) of the Leasing Convention, *supra*, note 109.

133
Art. 13(2)(a) and (b) of the Leasing Convention, *supra*, note 109.

134
Art. 13(4) of the Leasing Convention, *supra*, note 109.

parties unless it would result in damages substantially in excess of those provided under Art. 13(2)(b).[135] Once again national courts will have to interpret the world substantial to rule whether the alternative damages clause will operate or not, leaving another loophole that may lead to an unequal application of the Convention depending on the State the case is filed.

Moreover, the faculty of the lessor to exercise its right of acceleration or of terminating the leasing agreement is restricted to lessor's notification to the lessee giving him a reasonable opportunity of remedying the default so far as it can remedied.[136]

Finally, lessors have the duty to mitigate their losses and they are not entitled to recover damages to the extent they have failed to take all reasonable steps to mitigate them.[137]

5. Transfer of rights

Pursuant to Art. 14(1) of the Convention the lessor may transfer or otherwise deal with all or any of its rights in the equipment or under the leasing agreement. However, that transfer shall not relieve him of any of its duties under the agreement or alter either the nature of it or its legal treatment under the Convention.

135
Art. 13(3)(a) and (b) of the Leasing Convention, *supra*, note 109.

136
Art. 13(5) of the Leasing Convention, *supra*, note 109.

137
Art. 13(6) of the Leasing Convention, *supra*, note 109.

Meanwhile, the lessee may transfer the right to use the equipment or any other rights under the leasing agreement only with the consent of the lessor and subject to the rights of third parties.[138]

Even though the Leasing Convention introduces various legal innovations and helps to unify the international aspects of leasing agreements, it seems to be suffering from two unexpected troubles: first, countries in general have not demonstrated much interest in ratifying the Convention which may lead to the same unfortunate situation encountered by the Geneva Convention. By comparison, the new draft conventions are much more specific and cover more situations able to lead toward a real unification of private international laws in the field of security interests in mobile equipment.

Second, it may be concluded that the Leasing Convention was the initial effort leading to the present drafts and is destined to be superseded by the new Convention and Protocol preventing countries from ratifying it while they await for the final adoption of the drafts.

The fact that ICAO has assumed an active role in drafting and discussing the proposed drafts implies that the international community is, at least, paying attention to and is aware of this latest effort by UNIDROIT. Even the Geneva Convention is destined to be superseded by the Protocol on aircraft equipment draft if it is finally adopted and ratified which may also explain the international halt in terms of ratifications of both conventions.

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138 Art. 14(2) of the Leasing Convention, *supra*, note 109.

CHAPTER III - DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND THE PROTOCOL RELATED TO AIRCRAFT EQUIPMENT

As this study has tried to demonstrate the field of mobile equipment leases probably is the fastest growing area of financial transactions involving assets to be used for commercial purposes. These assets have been increasing in price due to the technological developments they incorporate, their longer useful life, and their capacity to generate more profits by allowing operators to embark in more complex services and operations by virtue of higher dependability indexes.

Two international conventions are presently in force dealing with leasing agreements and the security interests thereby created to protect financiers. They are the Geneva Convention and the UNIDROIT Convention on International Financial Leasing. Nonetheless, the degree to which these transactions have evolved and the amounts of money they represent make it necessary for the international community to respond with an unifying convention on the matter.

The necessity of a new convention increases with the fact that securities, default, and bankruptcy laws are matters of domestic legislation while financial and operating leasing agreements involve multiple parties subject to different national laws. This circumstance increases costs to lessees and reduces the opportunities to some others located in non-trusted countries where domestic laws do not encompass financial transactions as these.

The genesis of UNIDROIT's drafts on security interests in mobile equipment can be traced back to 1988 at the 67th Session of the Governing Council held in Rome, Italy. In that session the Canadian delegation made a proposition suggesting a study to further unify the laws relating to security interests in personal property. It became clear at that moment that the Leasing Convention was only the first step toward total unification in this field. Even UNIDROIT's Secretary General acknowledged in the same session that he was informed of the interest shown in the subject by representatives of a number of delegations.[139]

Pursuant to a decision of UNIDROIT's Governing Council in its 68th Session, a study and a questionnaire were prepared by Prof. Ronald C. Cuming, member of the Canadian delegation, and circulated to banks, financial institutions, and businesspeople to receive their views and feedbacks about the topic.

In 1992 UNIDROIT's Governing Council authorized the creation of a Working Group to examine the feasibility of drawing up uniform rules on certain international aspects of security interests in mobile equipment. The Working Group met for the first time from 9 to 11 March, 1992 in Rome, Italy and began considering different aspects related to the project.[140]

Latter in the exploratory process an Aviation Working Group was created due

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See UNIDROIT, "Report of the Session, Governing Council 67th Session" (Rome:1988) UNIDROIT' s Proceeding and Papers, C.D. 67- Doc. 18.

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See UNIDROIT, "Report of the Restricted Exploratory Working Group to Examine the Feasibility of Drawing up Uniform Rules on Certain International Aspects of Security Interests in Mobile Equipment" (Rome: 1992) UNIDROIT's Proceedings and Papers, Study LXXII-Doc. 5 and Doc. 4.

to the potential significance the proposed Convention could have in international aviation finance. The Aviation Working Group[141] was co-organized by The Boeing Company and Airbus Industrie and was assigned the task of preparing a memorandum to UNIDROIT recommending the desired content of the proposed convention as related to aviation equipment and aviation finance.[142]

The Aviation Working Group produced a Memorandum where it was made clear that special attention was to be rendered to issues in aviation finance as part of the efforts leading to draft an international convention in the area of securities in mobile equipment. They also expressed that one of the fundamental mechanism necessary to ensure the proper working of the proposed convention was centering it on an international asset registry which, subjected to certain local priorities, shall establish priorities on a first-to-file basis. The second recommendation made, amongst others, was to include an analogous provision to UNIDROIT Convention on International Financial Leasing regarding the perfection of security and leasing rights in the context of insolvency and bankruptcy proceedings.[143] Special attention

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The Aviation Working Group's members were: Airbus Industrie, Bank Indosuez, Douglas Aircraft Company, General Electric Aircraft Engines, International Lease Finance Corporation, Kreditanstalt fur Wiederaufbau, Rolls Royce, Snecma, The Boeing Company, The Long Term Credit Bank of Japan, and United Technologies Pratt & Whitney.

142

See Cohen, *supra*, note 34.

143

See UNIDROIT, "Memorandum of the Study Group for the Preparation of Uniform Rules on International Interests in Mobile Equipment: Sub-Committee for the Preparation of a First Draft, Aviation Working Group" (Rome: 1995) II-UNIDROIT's Proceedings and Papers, Study LXXII - Doc. 16.

was given to the recordation of security interests in aircraft engines and a Subgroup was created to address that particular issue. The Subgroup also supported the effort to draft a convention and suggested the development of an international aircraft engine registry to record engines ownership and title conveyances as well as other interests in aircraft engines, including security interests, leasehold interests, and aircraft lease assignments.

According to the Aircraft Engine Subgroup, while it is felt that the Title Tracking System will create a greater burden on aircraft lessors and financiers to develop, negotiate, and thereafter manage engine use covenants and restrictions, the creation of a clear system of recordation of engine ownership and other interests:

- outweighs the administrative burden that would be created initially; and
- the ability of operators to acquire spare engines will be enhanced over time as engine financiers become accustomed to a clear international standard.[144]

The next foreordained objective in this study is to canvass some of the articles of the proposed texts with the *caveat* to the reader that the proposed convention and aircraft protocol are still drafts under study by multiple committees and sub-committees. The drafts used are those circulated by the Canadian Government for analysis by its national advisors and identified as the ones up for

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144
Ibid.

discussion in the Second Joint Session of UNIDROIT-ICAO set to begin at the end of the month of August of 1999 in Montreal, Canada.

PART A PRELIMINARY DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT

This convention is conceived by the drafters as the pivot from which each derivative protocol will takeover and will broaden the scope of the convention as specifically applied to their areas of its concentration. There are at least two other Working Groups drafting protocols on space and railway equipments, in addition to the one exclusively dedicated to aviation.

The first difference apparent to the reader of this Draft Convention, as compared with the Geneva Convention and the UNIDROIT Convention on International Financial Leasing, is that it begins with a section of definitions setting out the meaning of certain words as they are used in the draft convention. Three kind of agreements are thus recognized: (1) a security agreement; (2) a title reservation agreement; and (3) a leasing agreement.[145]

1. The International Interest

For purposes of the Draft Convention an international interest in mobile equipment is an interest, constituted under the formal requirements of Art. 7, in a uniquely identifiable object of a category as such objects designated in a Protocol:

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See Art. 1 of the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment, Appendix 1 of this study [hereinafter Draft Convention]. Due to the fact that these drafts are not yet available in any published resource a copy of both drafts has been included as appendixes to this study to facilitate and familiarize the reader with the text of them as explained herein.

- granted by the chargor under a security agreement;
- vested in a person who is the conditional seller under a title reservation agreement; or
- vested in a person who is the lessor under a leasing agreement.[146]

A special chapter in the Draft Convention has been dedicated to non-consensual rights or interests as possessory liens, expenses for salvage of the equipment, or extraordinary expenses for the preservation of it. Nevertheless, after a deeper examination of the Draft Convention the reader can identify multiple proposed additions and/or amendments throughout the draft that make reference to non-consensual rights or interests.[147]

The Draft Convention has been construed in such a way that it will govern:

- the constitution of an international interest, its effects, its assignment and rights of subrogation;
- matters relating to the international registration system and the modalities of registration; and
- questions of jurisdiction.[148]

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146 See Art. 2(2) of the Draft Convention, *supra*, note145.

147 For example see Arts 15(1)(a) and 20(4) of the Draft Convention, *supra*, note 145.

148 See Art. 2(4) of the Draft Convention, *supra*, note 145. As mentioned before, these texts are under study and have suffered numerous changes and it is clear that they will suffer lots more before they are finally adopted.

2. Scope of Application

Pursuant to Art. 3 of the Draft Convention, it will apply when at the time of the conclusion of the agreement creating or providing for the international interest (1) the obligor is situated in a contracting State or (2) the object to which the international interest relates to has a connection, as specified in the Protocol, with a contracting State. This clause serves as the link between the Chicago Convention on matters of aircraft registration and nationality, and the Aircraft Protocol.

It is the place where the lessee is located that activates the application of the Convention or the place of registration of the aircraft. Meanwhile, the obligor or lessee is considered to be located in any contracting State where it:

- is incorporated;
- has its registered office;
- has its centre of control; or
- has its place of business[149]

An additional clause has been proposed to explain that the obligor's place of business shall, if it has more than one place of business, mean its principal place of business or, if it has none, its habitual residence.

If compared with the Leasing Convention, the Draft Convention seems to be broader in scope and a detailed list has been added as to where the obligor's place of business is located. The list also serves as a ranking mechanism stating the order of alternatives that can be used to establish it in case of doubts or

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149 See Art. 4 of the Draft Convention, *supra*, note 145.

controversies.

3. Formal Requirements

Art. 7 of the Draft Convention provides that any international interest created or provided under the Convention must:

- be in writing;
- relate to an object of which the chargor, conditional seller or lessor has power to dispose;
- enables the object to be identified in conformity with the Protocol; and
- in the case of a security agreement, enables the secured obligations to be determined, but without the need to state a sum or maximum sum secured.

This is a new approach to the creation of international security interests because the Geneva Convention, Art. I, only requires that such interests are created by virtue of a contract. The Leasing Convention remains silent about any formal requirement while it makes reference over and over to the leasing and supply agreement.

4. Default Remedies

In this Chapter the Draft Convention adopts a two tier system depending on whether the party having an international interest is a chargee under a security agreement in one side or a conditional seller or lessor in the other. In the event of a default, the chargee, to the extent that the chargor has so agreed, may (i) take

possession or control of any object charged to it, (ii) sell or grant a lease of any such object, and/or (iii) collect or receive any income or profits arising from the management or use of any such object.[150]

However, in the case the default arises under a title reservation agreement or under a leasing agreement, the conditional seller or the lessor may (i) terminate the agreement and take possession or control of any object to which the agreements relates, or may (ii) apply for a court order authorizing or directing either of these acts.[151] Contrary to the Leasing Convention provisions, the alternatives given to the lessor in case of a lessee's default in the Draft Convention are limited because nothing is said about interests, damages, and accelerated payment of the value of future rentals.

Being an updated convention, the drafters included an article to define default allowing parties to agree as to the events that may constitute it while in the absence of such agreement, the default has to be a substantial one to activate chargee and lessor's rights under the Draft Convention.[152] Once again we are faced with the question of what constitutes a *substantial default* as meant by the Draft Convention and no further explanation is given about it. In any event, any of the remedies provided by the Draft Convention must be exercised in conformity with the

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150
See Art. 8(1) of the Draft Convention, *supra*, note 145.

151
See Art. 10 of the Draft Convention, *supra*, note 145.

152
See Art. 11 of the Draft Convention, *supra*, note 145.

procedure prescribed by the law of the place where the remedy is to be exercised.[153]

Another innovation contemplated by the Draft Convention is provided under Art. 14. It imposes upon contracting States the duty to ensure that an obligee who adduces *prima facie* evidence of default by the obligor, pending final determination of its claim and to the extent the obligor has so agreed, may obtain speedy judicial relief in the form of one or more of the following orders as the obligee requests:

- preservation of the object and its value;
- possession, control or custody of the object;
- immobilization of the object;
- sale, lease or management of the object;
- application of the proceeds or income of the object.[154]

Nevertheless, the courts of a contracting State will only have jurisdiction to grant these judicial reliefs where:

- the object is within or physically controlled from the territory of that State;
- the defendant is situated within that territory; or
- the parties have agreed to submit to the jurisdiction of that court.[155]

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153 See Art. 12 of the Draft Convention, *supra*, note 145.

154 See Art. 14 of the Draft Convention, *supra*, note 145.

155 See Art. 40 of the Draft Convention, *supra*, note 145.

5. The International Registration System

Here we are faced with the most difficult part of the Draft Convention because these articles are the ones subjected to the higher degree of scrutiny not only by the Drafting Committee but also from a special Registration Working Group that was created to do a thorough analysis of its drafting and implications. In the last Joint Session held in February of 1999 in Rome, Italy the report filed by the mentioned working group included countless propositions to change the text of almost all the articles relating to the International Registration System foreseen in the Draft Convention.

Besides these problems, it is important to mention that this probably is the main breakthrough and objective of the Draft Convention upon which all parties involved in the drafting process seem to concur as to the necessity of creating it and the benefits it will introduce to the financial industry.

The planned International Registry will be established to register (i) international interests, prospective international interests [and registrable non-consensual rights and interests] if the brackets are finally included, (ii) assignments and prospective assignments of international interests, and (iii) subordinations of interests under (i).[156]

An additional characteristic of the international Registry is that it will be given international legal personality as may be necessary for the exercise of its functions

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See Art. 15 of the Draft Convention, *supra*, note 145.

and the fulfillment of its purposes.[157] It would also be liable to any person that suffers loss by reason of any error or system malfunction and immune from any other legal process and seizure unless expressly waived by the International Registry itself. [158]

As it is currently proposed there are two alternatives on how it will operate. The first is creating two bodies: the Intergovernmental Regulator and the operators of the International Registry. The Regulator will establish the International Registry, designate the Registrar and oversee the operation and administration of the Registry thereof.[159] Nonetheless, the Registration Working Group recently proposed that instead of creating two different bodies an alternative to be considered is an unitary International Registry Authority which would act as both operator and regulator.[160]

This is not the only difficult task in hands of the Registration Working Group because another great uncertainty is deciding who is going to oversee the aircraft and engines registry, whether ICAO or an independent authority created for that specific purpose. This particular issue will be addressed later in our study.

157
See Art. 15(2) of the Draft Convention, *supra*, note 145.

158
See Art. 26 of the Draft Convention, *supra*, note 145.

159
See Art. 16 of the Draft Convention, *supra*, note 145.

160
This alternative was submitted by the Registration Working Group as part of the recommendations made to the Preliminary Draft Protocol on Matters Specific to Aircraft Equipment.

Another special attribute of the International Registry is that it will allow parties to register not only international interests but also prospective ones and prospective assignments which may be converted later to full security interests. It is for the protocols and the regulations to set the conditions and requirements which must be fulfilled to effect such registration.[161]

Finally, if an interest first registered as a prospective international interest becomes an international interest, the international interest will be treated as registered from the time of registration of the prospective international interest receiving priority over other security interests later registered in the Registry.[162]

As in the case of the Geneva Convention, certificates issued by the International Registry are recognized the evidentiary value of *prima facie* proof of the facts recited in it.[163]

6. Effects of an International Interest as Against Third Parties

Any registered interest is given priority over any other interest subsequently registered and over an unregistered one while the buyer of an object acquires its interest in it (i) subject to an interest registered at the time of its acquisition, and (ii) free from an unregistered interest even if it has actual knowledge of such an

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161
See Art. 17 of the Draft Convention, *supra*, note 145.

162
See Art. 19(3) of the Draft Convention, *supra*, note 145.

163
See Art. 24 of the Draft Convention, *supra*, note 145.

interest. [164]

Under clause (6) of Art. 27, the holder of a registrable non-consensual right or interest that wishes to maintain its priority must provide notice in writing to all parties with registered interests in the same object. If read in conjunction with the clause that declares all objects acquired by a buyer free from all unregistered interests, it may be concluded that the holder of those rights will have no option but to register such rights in order to receive proper recordation and recognition under domestic laws in cases involving international mobile assets.

In cases where a bankruptcy occurs the international interest will be valid against the trustee and creditors of the obligor if, and only if, prior to the commencement of the bankruptcy that interest was registered in conformity with the Draft Convention.[165] Bankruptcy has been defined as to include a liquidation, administration or other insolvency proceeding involving the administration of the estate or affairs of the obligor for the benefit of the general body of the obligor's creditors.[166]

7. Non-Consensual Rights and Interests

It for each contracting State to list the categories of non-consensual rights

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164
See Art. 27 of the Draft Convention, *supra*, note 145.

165
See Art. 28 of the Draft Convention, *supra*, note 145.

166
Ibid.

and interests which will be registrable under the Draft Convention as regards any category of object as if the right or interest were an international interest and be regulated accordingly.[167]

Additionally, any non-consensual rights and interests, other than a registrable one, which under the law of a contracting State would have priority over an interest in the object, has priority over the international interest to the extent that (i) such priority is specified by that State in a declaration, and (ii) the non-consensual right or interest would, under the domestic law of that State, have priority over a registered interest of the same type.[168]

Art. 23 of the Draft Convention also imposes upon the Registrar the duty to maintain a list of the categories of non-consensual rights and interests registrable in each contracting State as declared in conformity with Art. 38.

8. Conclusion

The main hindrance the drafters of this Draft Convention face, so far, is how to create, organize, and put to work a new international organism to unify the matter of international interests' registration and recognition. Several delegations including Canada, Singapore, and the United States are members of the Registration Working Group and are contributing their respective expertise in the field of registries of mobile assets and the new technological application of electronic

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167
See Art. 37 of the Draft Convention, *supra*, note 145.

168
See Art. 38 of the Draft Convention, *supra*, note 145.

registries.

Nonetheless, much work is needed to polish and develop a comprehensive system of registration of international security interests and entrust such delicate task to a supranational body, completely out of the scope of control of any State.

Another concern widely shared by many delegations in the last Joint Session of UNIDROIT and ICAO held in Rome is that the Draft Convention seems to carry an approach excessively inspired by the Common law legal tradition. This is an understandable concern because one must not forget that Common law jurisdictions were the first ones to recognize and develop the concepts of securities and leases of mobile equipment while many Civil law countries are now beginning to adopt special laws to regulate them.

On the other hand, there are other cumbersome duties resting upon drafters that may jeopardize the final outcome of the committees. The first one is the possibility to replace the Convention-Protocol structure by a series of equipment-specific Conventions. This proposal was brought up by the German delegation in the Joint Session adducing that they were not sure whether other preliminary drafts Protocols would in fact materialize, that there are too many ambiguities when you consolidate both texts, and that there are difficulties in relation to form prevailing over substance (i.e. the reading of the instruments is not user friendly), with which one agrees. The real fact that the Draft Convention, if ratified alone solves none of the problems the aviation industry is aiming to resolve, may serve as a boost to the German proposition although the other Protocols are at an advance stage of preparation.

The other policy issue that needs more attention is to look for an appropriate solution to the problem of a possible overlapping between the future international regime and the Convention on Assignment in Receivable Financing under preparation by an UNCITRAL working group. The UNIDROIT Secretariat proposed a solution by introducing a clause in the future UNCITRAL instrument providing that the instrument should not apply to receivables covered by the future UNIDROIT Convention.[169]

If these special circumstances are solved, the financial industry will surely benefit from the Draft Convention and the unification of domestic laws it will create in the field of international securities in mobile equipment, provided that the Protocols are also adopted.

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For a complete exposition of these and more policy issues regarding the Draft Convention, the reader may obtain copy of the Report of the First Plenary Session held in Rome, Italy which should be latter published in UNIDROIT's Proceedings and Papers periodical.

PART B PRELIMINARY DRAFT PROTOCOL TO THE PRELIMINARY DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT

As it was previously mentioned in this study the Draft Convention relies on specific protocols to really operate and unify law as applied to international security interests. The Draft Protocol on Matters Specific to Aircraft Equipment, hereinafter Draft Protocol, is the protocol that regulates the area of the aviation industry and, if adopted, it will replace both the Geneva Convention and the Leasing Convention with a modern international instrument.

It can be argued that one of the reasons that prompted the drafting of both the Draft Convention and Draft Protocol is the economic impact aircraft and aircraft equipment financial leases have in the international markets. Airlines have also been forced to enter more and more in deals which bring together multiple parties with particular interests situated around the World.

Meanwhile, financiers' troubles securing their multi-million investments have served as a pressure element upon national governments not only to adopt domestic laws recognizing such interests but also to justify the necessity of drafting farsighted international agreements in the matter. This is a typical example of the increasing phenomena where laws are becoming outdated and governments are being forced to react or to trail behind the international trends. Who would have said that ten years after the adoption of the Leasing Convention, the same international organization was going to be drafting a completely new convention to group the

developments in the field of mobile equipment and aircraft finance?

One can really evaluate the significance of the Draft Protocol for the aviation industry when ICAO, the international organization in charge of civil aviation, became directly involved in the drafting process through the States members of a Sub-Committee of the ICAO Legal Committee.

Another proof of the importance both drafts are receiving from the international community is the number and the parties represented in the Joint Session, 34 States' representatives,[170] five intergovernmental organizations,[171] and nine non-governmental organizations[172] attended it.

It is expected that the potential membership of future Joint Sessions will change to become bigger because the ICAO Secretariat may bring forward the drafts or draft of an unified instrument before the full membership of the Legal Committee and before a Diplomatic Conference by the end of year 2000, swelling

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Argentina, Austria, Belgium, Canada, China, Colombia, Croatia, Czech Republic, Egypt, Finland, France, Germany, Greece, Indonesia, Ireland, Italy, Japan, Malta, Mexico, Netherlands, Nigeria, Paraguay, Republic of Korea, Romania, Russian Federation, Saudi Arabia, Singapore, Slovak Republic, South Africa, Sweden, Switzerland, United Kingdom, United States of America, and Venezuela.

171

European Bank for Reconstruction and Development, European Organization for the Safety of Air Navigation (Eurocontrol), European Space Agency, Hague Conference on Private International Law, and the United Nations Commission on International Trade Law (UNCITRAL).

172

Aviation Working Group, Banking Federation of the European Union, International Air Transport Association, International Bar Association, International Law Association, International Union of Latin Notaries, International Union of Private Wagons, Rail Working Group, and the Space Working Group.

the probable number of delegations to include all 185 members States of ICAO plus the 58 member States of UNIDROIT.

The Draft Protocol, as the Draft Convention does, begins with a Chapter specifically dedicated to define terms as they are used in the text of the Protocol. For the first time an international instrument dealing with aircraft finance defines the words aircraft, which was defined to include helicopters, and aircraft engines which was defined to mean any aircraft engine powered by jet propulsion or turbine or piston technology and:

- in the case of jet propulsion aircraft engines, have at least 1750lbs of thrust or its equivalent; and
- in the case of turbine powered or piston-powered aircraft engines, have at least 550 rated take-off shaft power or its equivalent,

together with all modules and other installed, incorporated or attached accessories, parts and equipment and all data, manuals and relating thereto.[173]

Helicopters are also a new incorporation in this type of international instrument because previously they were implicitly included in the definition of aircraft although no direct reference was made about them. Helicopter was defined in the Draft Protocol as a heavier-than-air-machine supported in flight chiefly by the reactions of the air on one or more power-driven rotors on substantially vertical axes and which are type certified by the competent aviation authority to transport (i) at

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173 See Art. 1(2) of the Draft Protocol, *supra*, note 145.

least five persons including crew or (ii) goods excess of 450 kilograms.[174]

1. Scope of Application

Pursuant to Art. 3(b) of the Draft Convention it will apply when the object to which the international interest relates has a connection, as specified in the Protocol, with a contracting State. The Draft Protocol expands the definition by providing that such connection will be satisfied with respect to the Protocol if an aircraft object is registered in a national aircraft register of a Contracting State or if the agreement provides that the aircraft object shall be registered, and the aircraft object becomes so registered, in a contracting State.[175]

2. Formalities and Effects of Contracts

The Draft Protocol, contrary to the Draft Convention, only makes reference to the formalities of contracts of sale requiring them to: (i) be in writing, (ii)relate to an aircraft object of which the transferor has power to dispose, and (iii) that identifies the aircraft object.[176] It must be understood by the reader that both drafts are to be read and interpreted together as one single instrument and as such they

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174

Ibid.

175

See Art. III(1) of the Draft Protocol, *supra*, note 145.

176

See Art. V(1) of the Draft Protocol, *supra*, note 145.

complement each other.[177] Therefore, the Draft Protocol expands the scope of the Draft Convention by regulating contracts of sale of aircraft objects.

For matters of identification required by both drafts, the Protocol specifies that a description of an aircraft object that contains its manufacturer's serial number, the name of the manufacturer and its model designation is sufficient to identify the object for purposes of the Convention and the Protocol.[178]

3. Default Remedies and Priorities

As with other sections of both drafts, the explanation that follows is subject to the present text but it is clearly noted in the Draft Protocol that another alternative is going to be considered later in the drafting process.

In addition to the remedies specified in Arts. 8(1), 10 and 14(1) of the Convention which were previously detailed, the Draft Protocol provides that the obligee may, to the extent that the obligor has at the time so agreed and in the circumstances specified in such provisions:

- de-register the aircraft; and
- export and physically transfer the aircraft object from the territory in which it is situated.[179]

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177 See Art. II(2) of the Draft Protocol, *supra*, note 145.

178 See Art. VII of the Draft Protocol, *supra*, note 145.

179 See Art. IX(1) of the Draft Protocol, *supra*, note 145.

These remedies can only be exercised with the previous consent in writing of a holder of any registered interest ranking in priority to that of the obligee[180] provided that the remedies are exercised in a commercially reasonable manner and the obligee cannot take control or possession of an aircraft object otherwise than by lawful means. A new Article 13*bis* is being proposed to the Draft Convention to incorporate these concepts of commercially reasonable manners.

If a case of insolvency by the obligor presents, the Draft Protocol articles will apply where:

- any solvency proceedings against the obligor have been commenced by the obligor or another person in a contracting State which is the primary insolvency jurisdiction of the obligor; or
- the obligor is located in a contracting State and has declared its intention to suspend, or has actually suspended payment to creditors generally.[181]

4. Registry

The main question drafters face in this part of the Draft Protocol is what alternative they should adopt. The first one is to follow the Draft Convention in creating an International Registry regulated and operate by the International Registry Authority. The second alternative will put the Council of ICAO, or such

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See Art. IX(2) of the Draft Protocol, *supra*, note 145.

181
See Art. XI(2) of the Draft Protocol, *supra*, note 145.

other permanent body designated by it, in charge of regulating the International Registry.[182]

Nonetheless, the private sector represented by the Aviation Working Group already expressed interest in the creation of an independent International Registry outside of ICAO's jurisdiction.[183] The Canadian delegation also agrees with this posture.[184]

It was also questioned in the Joint Session the relationship, if any, that may exist between national registries under the Chicago Convention and the International Registry and if such relationship needs to be settled on the basis of consultations with the governments before it could be dealt with in the Preliminary Draft Protocol.

The process of analysis and drafting of this section of the drafts will take a long round of negotiations and the delegations only agree in the necessity of creating the International Registry as a *sine qua non* requirement of the new instruments, but no further compromises have been reached, so far.

One of the drafters' objectives in the Protocol is to provide for closed terms

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See Art. XVI of the Draft Protocol, *supra*, note 145. The two alternatives are clearly explained in the Draft Protocol.

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See UNIDROIT, "Memorandum of the Study Group for the Preparation of Uniform Rules on International Interests in Mobile Equipment: Sub-Committee for the Preparation of a First Draft, Aviation Working Group", *supra*, note 143.

184

See "Report of the Canadian Delegation to the First UNIDROIT-ICAO Joint Session in Rome, February 1999. Report prepared in Ottawa, May 7, 1999.

in which judicial relieves reliefs must be issued to protect the international interest of the financier. Unfortunately, some delegations have opposed such proposition in the grounds that it would be impossible to impose a delay on a judge or a court of law.

The Canadian delegation also proposed on the Plenary Session of the Joint Session that the exclusions relating to aircraft used in "military, customs or police services" under the Draft Protocol be deleted because some of those aircrafts are often financed by governments either directly through the international financing markets or by contracting through private sectors operators and such financing parties should be afforded the protections of the Convention.[185]

The Second Joint Session will be held in Montreal at the end of the month of August, 1999 and it is surely expected by the writer that significant changes will be introduced to the texts of the drafts, specially those related to the International Registry articles.

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185 *Ibid*, at 9.

CONCLUSION

Since the adoption of the Geneva Convention in 1948 the financial world has changed dramatically to an unforseen level and inside that trend aircraft and aircraft equipment leases have been one of the leading industries. Today it accounts for more than 50% of the operating fleet in the World and the numbers are rising.

From the point of view of financiers their main goal is to obtain adequate international security for their interests over highly expensive and movable equipment. While at the beginning governments were somewhat reluctant to modernize their domestic laws either through national legislation or by ratifying international conventions on the topic, now a days they have been pushed into the international movement to unify these laws due to the economic significance the aviation industry has acquired and their lobby power.

The first example of such change was the adoption of the Leasing Convention in 1988 that served as the first step taken toward unification by the international community of State. Nonetheless, the industry needs a more modern international instrument to facilitate and further unify the standards, rights, and duties of the parties in these kind of contracts.

One example of how important it has become for financiers and airlines to update the international framework of leases is the difference in time it has taken two proposals to come into force or simply be drafted. For example, it took ICAO 17 years to achieve the entry in force of Article 83*bis* of the Chicago Convention which

only allows for the transfer of certain oversight responsibilities from the State of Registry to the State of the operator in case of international lease, charter or interchange of aircraft. By contrast UNIDROIT has drafted and is already in the process of analysis of a completely new convention and protocol in about 6 years and only 11 years have passed since the adoption of the Leasing Convention.

The question is how this time difference can be explained; simply by the interest of the financial and aviation industry. While Art. 83*bis* did not represent much for the economic powers behind the scenes, the proposed drafts by UNIDROIT can really make a difference specially in the area of registration and recognition of an international security interest.

Also the aviation industry and financiers have been directly involved in the process to draft and negotiate the Draft Convention and Protocol which, if approved, will represent a major breakthrough in international finances and the protection of security interests worldwide. ICAO has also joined in the effort to the degree that is has become a co-sponsor and is expected to play a significant role in assuring the adoption and ratification of the outcome of these Joint Sessions.

A constant tendency can be foreseen in international finance transactions which will continue to lead the legal community toward newer and more complex relationships involving multiplicity of parties and legal systems. The UNIDROIT Convention on International Interests in Mobile Equipment and the Protocol on Matters Related to Aircraft Equipment are the latest responses to this flourishing industry. What will be next is a question that only time will answer.

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APPENDIX I

TEXT OF THE PRELIMINARY DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AS REVIEWED BY THE DRAFTING COMMITTEE *

PRELIMINARY DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT

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Article 15 The International Registry
Article 16 The Intergovernmental Regulator and the Registrar

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* *Note by the Secretariat:*
The Drafting Committee did not have the time to complete its giving of headings to each Article of the preliminary draft Convention; in this text headings are accordingly only given up to and including Article 26.

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[PREAMBLE

THE STATES PARTIES TO THIS CONVENTION,

AWARE of the need to acquire and use high-value mobile equipment and to facilitate the financing of the acquisition and use of such equipment in an efficient manner,

RECOGNISING the advantages of asset-based financing and leasing for this purpose and desiring to facilitate these types of transaction by establishing clear rules to govern them,

DESIRING to provide broad economic benefits for all interested parties,

BELIEVING that such rules must reflect the principles underlying asset-based financing and leasing and promote the autonomy of the parties necessary in these transactions,

CONSCIOUS of the need to establish an international registration system as one of the essential features of the legal framework applicable to international interests in high-value mobile equipment,

HAVE AGREED upon the following provisions:]

CHAPTER I

SPHERE OF APPLICATION AND GENERAL PROVISIONS

Article 1
Definitions

In this Convention the following words are employed with the meanings set out below:

"agreement" means a security agreement, a title reservation agreement or a leasing agreement;

"assignment" means a consensual transfer, whether by way of security or otherwise, which confers on the assignee rights in the international interest;

"associated rights" means all rights to payment or other performance by the obligor under an agreement or a contract of sale secured by or associated with the object;

"buyer" means a buyer under a contract of sale;

"chargee" means the grantee of an interest in an object under a security agreement;

"chargor" means the grantor of an interest in an object under a security agreement;

"conditional buyer" means the buyer under a title reservation agreement;

"conditional seller" means the seller under a title reservation agreement;

"contract of sale" means a contract for the sale of an object which is not an agreement;

"court" means a court of law or an administrative or arbitral tribunal established by a Contracting State;

"Intergovernmental Regulator" means, in respect of any Protocol, the intergovernmental regulator referred to in Article 16(1);

"international interest" means an interest to which Article 2 applies and which is constituted in conformity with Article 7;

"International Registry" means the international registry referred to in Article 15(3);

"leasing agreement" means an agreement by which one person ("the lessor") grants a right to possession or control of an object (with or without an option to purchase) to another person ("the lessee") in return for a rental or other payment;

"object" means an object of a category to which Article 2 applies;

"obligee" means the chargee under a security agreement, the conditional seller under a title reservation agreement or the lessor under a leasing agreement;

"obligor" means the chargor under a security agreement, the conditional buyer under a title reservation agreement, the lessee under a leasing agreement [or the person whose interest in an object is burdened by a registrable non-consensual right or interest];

"prospective assignment" means an assignment that is intended to be made in the future, upon the occurrence of a stated event, whether or not the occurrence of the event is certain;

"prospective international interest" means an interest that is intended to be created or provided for as an international interest in the future, upon the occurrence of a stated event (which may include the obligor's acquisition of an interest in the object), whether or not the occurrence of the event is certain;

"prospective sale" means a sale which is intended to be made in the future, upon the occurrence of a stated event, whether or not the occurrence of the event is certain;

"Protocol" means, in respect of any category of object and associated rights to which this Convention applies, the Protocol in respect of that category of object and associated rights;

["qualified proceeds" means proceeds of an object payable by reason of the loss or physical destruction of the object or payable by a Government or State entity in respect of the confiscation, condemnation or requisition of the object;] [1]

"registered" means registered in the International Registry pursuant to Chapter V;

"registered interest" means an international interest [or a registrable non-consensual right or interest] registered pursuant to Chapter V;

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[1] Consideration should be given to an optional provision for compensation in respect of such governmental acts to be paid before they are performed in order to reduce political risk.

["registrable non-consensual right or interest" means a right or interest registrable pursuant to an instrument deposited under Article 37;]

"Registrar" means, in respect of any category of object and associated rights to which this Convention applies, the person designated under Article 16(3);

"regulations" means regulations made, pursuant to the Protocol, by the Intergovernmental Regulator under Article 16(4);

"sale" means a transfer of ownership of an object pursuant to a contract of sale;

"secured obligation" means an obligation secured by a security interest;

"security agreement" means an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure the performance of any existing or future obligation of the chargor or a third person;

"security interest" means an interest created by a security agreement;

"title reservation agreement" means an agreement for the sale of an object on terms that ownership does not pass until fulfilment of the condition or conditions stated in the agreement;

"unregistered interest" means a consensual interest or non-consensual right or interest [(other than an interest to which Article 38 applies)] which has not been registered, whether or not it is registrable under this Convention[; and

"writing" means a record of information (including information [sent][obtained] by teletransmission) which is in tangible form or is capable of being reproduced in tangible form and which [identifies][indicates] by reasonable means the person sending the record and that person's approval of it].

Article 2
The international interest

1.– This Convention provides for the constitution and effects of an international interest in mobile equipment and associated rights.

2.– For the purposes of this Convention, an international interest in mobile equipment is an interest, constituted under Article 7, in an uniquely identifiable object of a category of such objects designated in a Protocol:

(a) granted by the chargor under a security agreement;

(b) vested in a person who is the conditional seller under a title reservation agreement; or

(c) vested in a person who is the lessor under a leasing agreement.

An interest falling within sub-paragraph (a) does not also fall within sub-paragraph (b) or (c).

3.– This Convention does not determine whether an interest to which the preceding paragraph applies falls within sub-paragraph (a), (b) or (c) of that paragraph.

[4.– This Convention governs only:

(a) the constitution of an international interest, its effects, its assignment and rights of subrogation;

(b) matters relating to the international registration system and the modalities of registration;

(c) questions of jurisdiction,

as provided for in Articles 2 to 41.]

[5.– An international interest in an object extends to [qualified proceeds] of that object.]

Article 3
Sphere of application

[1.–] This Convention shall apply when at the time of the conclusion of the agreement creating or providing for the international interest:

(a) the obligor is situated in a Contracting State; or

(b) the object to which the international interest relates has a connection. as specified in the Protocol, with a Contracting State.

[2.– The fact that the obligee is situated in a non-Contracting State does not affect the applicability of this Convention.]

Article 4
Where obligor is situated

[1.–] For the purposes of this Convention [other than the provisions of Article 40], the obligor is situated in any Contracting State where it:

(a) is incorporated;

(b) has its registered office;

(c) has its centre of control; or

(d) has its place of business

in that State.

[2.– A reference in this Convention to the obligor's place of business shall, if it has more than one place of business, mean its principal place of business or, if it has no place of business, its habitual residence.]

Article 5
Derogation

In their relations with each other, the parties may, by agreement in writing, derogate from or vary the effect of any of the provisions of Chapter III, except as stated in Articles 8(2)-(6), 9 (3) and (4), 12(1) and 13.

Article 6
Interpretation and applicable law

1. – In the interpretation of this Convention, regard is to be had to its purposes as set forth in the preamble, to its international character and to the need to promote uniformity and predictability in its application.

2. – Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the applicable law.

3. – References to the applicable law are [, except as provided in Articles ...,] to the law applicable by virtue of the rules of private international law of the forum State.

4. – Where a State comprises several territorial units, each of which has its own rules of law in respect of the matter to be decided, and where there is no indication of the relevant territorial unit, the law of that State decides which is the territorial unit whose rules shall govern. In the absence of any such rule, the law of the territorial unit with which the case is most closely connected shall apply.

CHAPTER II

CONSTITUTION OF AN INTERNATIONAL INTEREST

Article 7
Formal requirements

An interest is constituted as an international interest under this Convention where the agreement creating or providing for the interest:

(a) is in writing;

(b) relates to an object of which the chargor, conditional seller or lessor has power to dispose;

(c) enables the object to be identified in conformity with the Protocol; and

(d) in the case of a security agreement, enables the secured obligations to be determined, but without the need to state a sum or maximum sum secured.

CHAPTER III

DEFAULT REMEDIES

Article 8
Remedies of chargee

1. – In the event of default as provided in Article 11, the chargee may, to the extent that the chargor has so agreed, exercise any one or more of the following remedies:

(a) take possession or control of any object charged to it;

(b) sell or grant a lease of any such object;

(c) collect or receive any income or profits arising from the management or use of any such object,

or apply for a court order authorising or directing any of the above acts.

2. – Any remedy given by sub-paragraph (a), (b) or (c) of the preceding paragraph shall be exercised in a commercially reasonable manner [and by lawful means]. A remedy shall be deemed to be exercised in a commercially reasonable manner where it is exercised in conformity with a provision of the security agreement except where such a provision is manifestly unreasonable.

3. – A chargee proposing to sell or grant a lease of an object under paragraph 1 otherwise than pursuant to a court order shall give reasonable prior notice in writing of the proposed sale or lease to:

(a) interested persons specified in paragraph 6 (a) and (b); and

(b) interested persons specified in paragraph 6 (c) who have given notice of their rights to the chargee within a reasonable time prior to the sale or lease.

4. – Any sum collected or received by the chargee as a result of exercise of any of the remedies set out under paragraph 1 shall be applied towards discharge of the amount of the secured obligations.

5. – Where the sums collected or received by the chargee as a result of the exercise of any remedy given in paragraph 1 exceed the amount secured by the security interest and any reasonable costs incurred in the exercise of any such remedy, then unless otherwise ordered by the court the chargee shall pay the excess to the holder of the international interest registered immediately after its own or, if there is none, to the chargor.

6. – In this Article and in Article 9 "interested persons" means:

(a) the chargor;

(b) any person who, for the purpose of assuring performance of any of the obligations in favour of the chargee, gives or issues a suretyship or demand guarantee or a standby letter of credit or any other form of credit insurance;

(c) any other person having rights subordinate to those of the chargee in or over the object.

Article 9
Vesting of object in satisfaction; redemption

1.– At any time after default as provided in Article 11, the chargee and all the interested persons may agree that ownership of (or any other interest of the chargor in) any object covered by the security interest shall vest in the chargee in or towards satisfaction of the secured obligations.

2.– The court may on the application of the chargee order that ownership of (or any other interest of the chargor in) any object covered by the security interest shall vest in the chargee in or towards satisfaction of the secured obligations.

3.– The court shall grant an application under the preceding paragraph only if the amount of the secured obligations to be satisfied by such vesting is reasonably commensurate with the value of the object after taking account of any payment to be made by the chargee to any of the interested persons.

4.– At any time after default as provided in Article 11 and before sale of the charged object or the making of an order under paragraph 1, the chargor or any interested person may discharge the security interest by paying in full the amount secured, subject to any lease granted by the chargee under Article 8(1). Where, after such default, the payment of the amount secured is made in full by an interested person, that person is subrogated to the rights of the chargee.

5.– Ownership or any other interest of the chargor passing on a sale under Article 8(1) or passing under paragraph 1 of this Article is free from any other interest over which the chargee's security interest has priority under the provisions of Article 27.

Article 10
Remedies of conditional seller or lessor

In the event of default under a title reservation agreement or under a leasing agreement as provided in Article 11, the conditional seller or the lessor, as the case may be, may:

(a) terminate the agreement and take possession or control of any object to which the agreement relates; or

(b) apply for a court order authorising or directing either of these acts.

Article 11
Meaning of default

1.– The obligor and obligee may agree as to the events that constitute a default or otherwise give rise to the rights and remedies specified in Articles 8 to 10 and 14.

2. – In the absence of such an agreement, "default" for the purposes of Articles 8 to 10 and 14 means a substantial default.

Article 12
Procedural requirements

1. – Subject to paragraph 2, any remedy provided by this Chapter shall be exercised in conformity with the procedure prescribed by the law of the place where the remedy is to be exercised.

2. – Any remedy available to the obligee under Articles 8 to 10 which is not there expressed to require application to the court may be exercised without leave of the court except to the extent that the Contracting State where the remedy is to be exercised has made a declaration under Article Y or in the Protocol.

Article 13
Additional remedies

Any additional remedies permitted by the applicable law, including any remedies agreed upon by the parties, may be exercised to the extent that they are not inconsistent with the mandatory provisions of this Chapter as set out in Article 5.

Article 14
Relief pending final determination

1. – A Contracting State shall ensure that an obligee who adduces *prima facie* evidence of default by the obligor may, pending final determination of its claim and to the extent that the obligor has [2] so agreed, obtain speedy judicial relief in the form of [such] one or more of the following orders [as the obligee requests]:

(a) preservation of the object and its value;

(b) possession, control or custody of the object;

(c) immobilisation of the object; [3]

(d) sale, lease or management of the object;

(e) application of the proceeds or income of the object.

[2. – In making any order under sub-paragraphs (d) or (e) of the preceding paragraph, the court may impose such terms as it considers necessary to protect the obligor in the event that the obligee:

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[2] The question remains to be considered whether the words "at any time" need to be added.

[3] It was proposed that the comment by a delegation seeking to ensure that Article 14(1)(c) should not run counter to any other international instrument on the subject should be dealt with at the appropriate time in the Final Provisions.

(a) in implementing any order granting such relief, fails to perform any of its obligations to the obligor under this Convention; or

(b) fails to establish its claim, wholly or in part, on the final determination of that claim.]

[3.] – Ownership or any other interest of the obligor passing on a sale under the preceding paragraph is free from any other interest over which the obligee's international interest has priority under the provisions of Article 27.

[4.] – Nothing in this Article limits the availability of forms of interim judicial relief other than those set out in paragraph 1.

[CHAPTER IV [4]

THE INTERNATIONAL REGISTRATION SYSTEM

Article 15
The International Registry

1. – An International Registry shall be established for registrations of:

(a) international interests, prospective international interests [and registrable non-consensual rights and interests];

(b) assignments and prospective assignments of international interests; and

(c) subordinations of interests referred to in sub-paragraph (a) of this paragraph.

[2. – The International Registry shall have international legal personality and such legal capacity as may be necessary for the exercise of its functions and the fulfilment of its purposes under this Convention.]

[3.] – Different registries may be established for different categories of object and associated rights. For the purposes of this Convention, "International Registry" means the relevant international registry.

[4.] – For the purposes of this Chapter and Chapter V, the term "registration" includes, where appropriate, an amendment, extension or discharge of a registration.

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[4] The provisions of this Chapter are presented in square brackets in that they were not the subject of consideration by the Drafting Committee pending the outcome of their consideration by the Registration Working Group. It should be noted that the Registration Working Group has proposed considerable amendments to the provisions of this Chapter.

[Article 16
The Intergovernmental Regulator and the Registrar

1.– The Protocol shall designate an Intergovernmental Regulator [5] to exercise the functions assigned to it by this Chapter, Chapter V and the Protocol.

2.– The Protocol may provide for Contracting States to designate operators of registration facilities in their respective territories. Such operators shall be transmitters of the information required for registration and, in such capacity, shall constitute an integral part of the registration system of this Convention. The Protocol may specify the extent to which the designation of such an operator shall preclude alternative access to the International Registry.

3.– The Intergovernmental Regulator shall establish the International Registry, designate the Registrar and oversee the International Registry and the operation and administration thereof. [6]

4.– The manner in which such oversight is conducted, the responsibilities of the Registrar and operators of registration facilities and the fees to be paid by users of the international registration system shall be prescribed in the Protocol and/or from time to time in the regulations.

5.– The Registrar shall:

(a) operate the International Registry efficiently and responsibly;

(b) perform the functions assigned to it under this Convention, the Protocol and the regulations;

(c) report to the Intergovernmental Regulator on its performance of these functions and otherwise comply with the oversight requirements specified by the Intergovernmental Regulator;

(d) maintain financial records relating to its functions in a form specified by the Intergovernmental Regulator; and

(e) insure against liability for its acts and omissions in a manner acceptable to the Intergovernmental Regulator.

6.– The Intergovernmental Regulator shall have power to require acts and omissions which are in contravention of this Convention, the Protocol or the regulations to be rectified.

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[5] The present text assumes that the Intergovernmental Regulator and the operators of the International Registry will be different bodies. However, as indicated in the preliminary draft Protocol on Matters specific to Aircraft Equipment, an alternative to be considered is an unitary International Registry Authority which would act as both operator and regulator (cf. Article XVI(1) of that text which provides as follows:

ALTERNATIVE A

[1.– [The International Registry shall be regulated and operated by the International Registry Authority.] [The International Registry shall be regulated by the International Regulator and operated by the Registrar.]].

[6] It was noted by the Aircraft Protocol Group that Article 16(3) is an example of the type of provision which was envisaged as being within Article U(b) and which may therefore find itself modified by the terms of a Protocol.

7. – The Protocol and/or the regulations may prescribe the procedures pursuant to which the Registrar and operators of registration facilities may request advice from the Intergovernmental Regulator regarding the exercise of their respective functions under this Convention, the Protocol and the regulations.]]

[CHAPTER V [7]

MODALITIES OF REGISTRATION

Article 17
Registration requirements

The Protocol and regulations may contain conditions and requirements, including the criterion or criteria for the identification of the object, which must be fulfilled in order:

(a) to effect a registration; or

(b) to convert the registration of a prospective international interest or a prospective assignment of an international interest into registration of an international interest or of an assignment of an international interest.

Article 18
Transmission of information

The information required for a registration shall be transmitted, by any medium prescribed by the Protocol or regulations, to the International Registry or registration facility prescribed therein.

Article 19
When registration takes effect

1. – A registration shall take effect upon entry of the required information into the International Registry data base so as to be searchable.

2. – A registration shall be searchable for the purposes of the preceding paragraph at any time when:

(a) the International Registry has assigned to it a sequentially ordered file number; and

(b) the registration, including the file number, may be accessed at the International Registry and at each registration facility in which searches may be made at that time.

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[7] The provisions of this Chapter are presented in square brackets in that, with the exception of Article 20(1) and (2), they were not the subject of consideration by the Drafting Committee pending the outcome of their consideration by the Registration Working Group. It should be noted that the Registration Working Group has proposed considerable amendments to the provisions of this Chapter.

3. – If an interest first registered as a prospective international interest becomes an international interest, the international interest shall be treated as registered from the time of registration of the prospective international interest.

4. – The preceding paragraph applies with necessary modifications to the registration of a prospective assignment of an international interest.

5. – The International Registry shall record the date and time a registration takes effect.

6. – A registration shall be searchable in the International Registry data base according to the criteria prescribed by the Protocol.

Article 20
Who may register

[1. – An international interest which is a security interest, a prospective international interest or an assignment or prospective assignment of an international interest may be registered by or with the consent in writing of the chargor or assignor or intending chargor or assignor, as the case may be. Any other type of international interest may be registered by the holder of that interest.] [8]

[2.] – The subordination of an international interest to another international interest may be registered by or with the written consent of the person whose interest has been subordinated.

[3.] – A registration may be amended, extended prior to its expiry or discharged by or with the consent in writing of the party in whose favour it was made.

[4. – A registrable non-consensual right or interest may be registered by the holder thereof].

Article 21
Duration of registration

Registration of an international interest remains effective for the period of time [specified in the Protocol or the regulations as extended in conformity with Article 20(3)] [agreed between the parties in writing].

Article 22
Searches

1. – A person may, in the manner prescribed by the Protocol and regulations, make or request a search of the International Registry concerning interests registered therein.

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[8] Consideration should be given to whether the written consent of obligors under leasing and title reservation agreements should also be required for the registration of international interests.

2. – Upon receipt of a request therefor, the Registrar, in the manner prescribed by the Protocol and regulations, shall issue a registry search certificate with respect to any object:

(a) stating all registered information relating thereto, together with a statement indicating the date and time of registration of such information; or

(b) stating that there is no information in the International Registry relating thereto.

[Article 23
List of declared non-consensual rights or interests

The Registrar shall maintain a list of the categories of non-consensual right or interest declared by Contracting States in conformity with Article 38 and the date of each such declaration. Such list shall be recorded and searchable in the name of the declaring State and shall be made available as provided in the Protocol and regulations to any person requesting it.]

Article 24
Evidentiary value of certificates

A document in the form prescribed by the regulations which purports to be a certificate issued by the International Registry is *prima facie* proof:

(a) that it has been so issued; and

(b) of the facts recited in it, including the date and time of a registration under Article 20.

Article 25
Removal of registration

1. – When the obligations secured by a security interest [or the obligations giving rise to a registrable non-consensual right or interest] have been discharged or the conditions of transfer of title under a title reservation agreement have been fulfilled, the obligor may, by written demand delivered to the holder of such a registered interest, require the holder to remove the registration relating to the interest.

2. – Where a prospective international interest or a prospective assignment of an international interest has been registered, the intending grantor or assignor may by notice in writing, delivered to the intended grantee or assignee at any time before the latter has given value or incurred a commitment to give value, require the relevant registration to be removed.]

[CHAPTER VI [9]

LIABILITIES AND IMMUNITIES OF THE INTERNATIONAL REGISTRY

Article 26
Indemnity and immunity

1. – Any person suffering loss by reason of any error or system malfunction in the International Registry shall be entitled to an indemnity in respect of such loss. The measure of liability shall be compensatory damages for loss incurred as the result of the act or omission.

2. – The courts [of the Contracting State[s] in which the Registrar or the operators of registration facilities, as the case may be, [is] [are] situated] shall have jurisdiction to resolve any disputes arising under this Article.

3. – Subject to paragraph 1, the International Registry, the Registrar and staff of the International Registry, the Intergovernmental Regulator and the operators of registration facilities and the staff thereof shall, in the exercise of their functions, enjoy immunity from legal process except:

(a) to the extent that the International Registry expressly waives such immunity; or

(b) as otherwise provided by agreement with a State in which the International Registry is situated.

4. – The assets, documents and archives of the International Registry shall be inviolable and immune from seizure or legal process except to the extent that the International Registry expressly waives such immunity.]

CHAPTER [VII]

EFFECTS OF AN INTERNATIONAL INTEREST AS AGAINST THIRD PARTIES

Article 27 [10]

1. – A registered interest has priority over any other interest subsequently registered and over an unregistered interest.

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[9] The provisions of this Chapter are presented in square brackets in that they were not the subject of consideration by the Drafting Committee pending the outcome of their consideration by the Registration Working Group. It should be noted that the Registration Working Group has proposed considerable amendments to the provisions of this Chapter.

[10] It was proposed by the Committee that the question of registration by the trustee in bankruptcy of the date of commencement of the bankruptcy raised by one delegation be considered in the context of the general review of the insolvency-related provisions of the two instruments. The Committee did not believe itself to be in a position to deal with the question of non-consensual rights and interests, in the absence of adequate instructions from the Joint Session.

2. – The priority of the first-mentioned interest under the preceding paragraph applies:

(a) even if the first-mentioned interest was acquired or registered with actual knowledge of the other interest; and

(b) even as regards value given by the holder of the first-mentioned interest with such knowledge.

3. – The buyer of an object acquires its interest in it:

(a) subject to an interest registered at the time of its acquisition of that interest; and

(b) free from an unregistered interest even if it has actual knowledge of such an interest.

4. – The priority of competing interests under this Article may be varied by agreement between the holders of those interests, but an assignee of a subordinated interest is not bound by an agreement to subordinate that interest unless at the time of the assignment a subordination had been registered relating to that agreement.

5. – Any priority given by this Article to an interest in an object extends to [qualified proceeds].

[6.– For a registrable non-consensual right or interest to maintain its priority, the holder thereof must provide notice in writing, within ... days of the registration thereof, to all parties with registered interests in the same object.] [11] [12]

[Article 28 [13]

1. – An international interest is valid against the trustee in bankruptcy and creditors of the obligor if prior to the commencement of the bankruptcy [14] that interest was registered in conformity with this Convention. [15]

2. – For the purposes of this Article and Article 35:

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[11] The question was left open as to whether the more appropriate place for this provision would be Article 27(6) or Article 37.

[12] It is for consideration whether the Registrar should be required to provide the notice referred to in this paragraph.

[13] This Article will be revised in the light of a general review of the insolvency provisions of the preliminary draft Aircraft Protocol and consideration of the transfer of some or all of those provisions to the preliminary draft Convention itself.

The Committee moreover proposed that, on the occasion of the general review of the insolvency-related provisions, the definition of "bankruptcy" be extended to cover reorganisation and that consideration possibly be given to the definitions appearing in the Uncitral Model Law on Cross-Border Insolvency.

[14] Consideration should be given to the ability of an obligee to determine the commencement of bankruptcy proceedings.

[15] This paragraph is intended to state the substantive rights of the holder of the international interest but not to displace special rules of bankruptcy law restricting the exercise of remedies or avoiding unfair preferences.

(a) "bankruptcy" includes a liquidation, administration or other insolvency proceeding involving the administration of the estate or affairs of the obligor for the benefit of the general body of the obligor's creditors;

(b) "trustee in bankruptcy" includes a liquidator, administrator or other person appointed to administer the estate or affairs of the obligor for the benefit of the general body of creditors.

3. – Nothing in this Article affects the validity of an international interest against the trustee in bankruptcy where that interest is valid against the trustee in bankruptcy under the applicable law.]

CHAPTER [VIII]

ASSIGNMENTS OF INTERNATIONAL INTERESTS AND RIGHTS OF SUBROGATION

Article 29

1. – The holder of an international interest ("the assignor") may make an assignment of it to another person ("the assignee") wholly or in part.

2. – An assignment of an international interest shall be valid only if it:

(a) is in writing;

(b) enables the international interest and the object to which it relates to be identified;

(c) in the case of an assignment by way of security, enables the obligations secured by the assignment to be determined in accordance with the Protocol [but without the need to state a sum or maximum sum secured].

Article 30

1. – An assignment of an international interest in an object made in conformity with the preceding Article transfers to the assignee, to the extent agreed by the parties to the assignment:

(a) all the interests and priorities of the assignor under this Convention; and

(b) all associated rights.

2. – Subject to paragraph 3, an assignment made in conformity with the preceding paragraph shall take effect subject to:

(a) all defences of which the obligor could have availed itself against the assignor;

(b) any rights of set-off in respect of claims existing against the assignor and available to the obligor; and

(c) any restrictions on assignment contained in the agreement.

3. – The obligor may by agreement in writing waive all or any of the defences and rights of set-off referred to in the preceding paragraph.

4. – In the case of an assignment by way of security, the assigned rights revest in the assignor, to the extent that they are still subsisting, when the security interest has been discharged.

Article 31 [16]

1. – To the extent that an international interest has been assigned in accordance with the provisions of this Chapter, the obligor in relation to that interest is bound by the assignment, and, in the case of an assignment within Article 30(1)(b), has a duty to make payment or give other performance to the assignee, if but only if:

(a) the obligor has been given notice of the assignment in writing by or with the authority of the assignor;

(b) the notice identifies the international interest [; and

(c) the obligor does not have [actual] knowledge of any other person's superior right to payment or other performance].

2. – Irrespective of any other ground on which payment or performance by the obligor discharges the latter from liability, payment or performance shall be effective for this purpose if made in accordance with the preceding paragraph.

3. – Nothing in the preceding paragraph shall affect the priority of competing assignments.

Article 32

In the event of default by the assignor under the assignment of an international interest made by way of security, Articles 8, 9 and 11 to 14 apply (and, in relation to associated rights, apply in so far as they are capable of application to intangible property) as if references:

(a) to the secured obligation and the security interest were references to the obligation secured by the assignment of the international interest and the security interest created by that assignment;

(b) to the chargee and chargor were references to the assignee and assignor of the international interest;

(c) to the holder of the international interest were references to the holder of the assignment; and

(d) to the object included references to the assigned rights relating to the object.

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[16] A question to be considered is whether these provisions should be left to the Protocol, which might in turn refer to the applicable law.

Article 33

Where there are competing assignments of international interests and at least one of the assignments is registered, the provisions of Article 27 apply as if the references to an international interest were references to an assignment of an international interest.

Article 34

Where the assignment of an international interest has been registered, the assignee shall, in relation to the associated rights transferred by virtue of the assignment, have priority over the holder of associated rights not held with an international interest to the extent that the first-mentioned associated rights relate to:

(a) a sum advanced and utilised for the purchase of the object;

(b) the price payable for the object; or

(c) the rentals payable in respect of the object,

and the reasonable costs referred to in Article 8(5).

Article 35

1.– An assignment of an international interest is valid against the trustee in bankruptcy of the assignor if prior to the commencement of the bankruptcy that assignment was registered in conformity with this Convention.

2.– Nothing in this Article affects the validity of an assignment of an international interest against the trustee in bankruptcy where that interest is valid against the trustee in bankruptcy under the applicable law.

[Article 36

1.– Subject to paragraph 2, nothing in this Convention affects rights or interests arising in favour of any person by operation of principles of legal subrogation under the applicable law.

2.– The priority between any interest within the preceding paragraph and a competing interest may be varied by agreement in writing between the holders of the respective interests.]

[CHAPTER [IX]

NON-CONSENSUAL RIGHTS AND INTERESTS

Article 37

A Contracting State may at any time in an instrument deposited with the depositary of the Protocol list the categories of non-consensual right or interest which shall be registrable under this Convention as regards any category of object as if the right or interest were an international interest and be regulated accordingly.

Article 38

[1.–] A non-consensual right or interest (other than a registrable non-consensual right or interest) which under the law of a Contracting State would have priority over an interest in the object equivalent to that held by the holder of the international interest (whether in or outside the insolvency of the obligor) has priority over the international interest to the extent, and only to the extent that:

(a) such priority is specified by that State in a declaration; and [17]

(b) the non-consensual right or interest would, under the domestic law of that State, have priority over a registered interest of the same type as the international interest without any act of publication.

[2.– The non-consensual interest has priority only over an international interest registered after the declaration takes effect.] [18]

[CHAPTER [X]

APPLICATION OF THE CONVENTION TO SALES

Article 39

The Protocol may provide for the application of this Convention, wholly or in part and with such modifications as may be necessary, to the sale or prospective sale of an object.]

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[17] This sub-paragraph will need to be reviewed in the context of the Final Provisions, so as to state that such a declaration could be made at any time.

[18] This paragraph will need to be reviewed in the context of the Final Provisions.

[CHAPTER [XI]

JURISDICTION

Article 40 [19]

1. – A court of a Contracting State has jurisdiction to grant judicial relief under Article 14(1) where:

(a) the object is within [or is physically controlled from] the territory of that State;

(b) the defendant is situated within that territory; or

(c) the parties have agreed to submit to the jurisdiction of that court.

2. – A court may exercise jurisdiction under the preceding paragraph even if the trial of the claim referred to in Article 14(1) will or may take place in a court of another State or in an arbitral tribunal.

[Article 41

A court of a Contracting State to which Article 40(1) applies has jurisdiction in all proceedings relating to this Convention, but no court may make orders or give judgments or rulings against or purporting to bind the International Registry.]]

[CHAPTER [XII]

RELATIONSHIP WITH OTHER CONVENTIONS] [20] [21]

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[19] Article 40 will be amended in order to make it clear that it is intended to operate independently of Article 14(1). This Article and Article 41 will be comprehensively reviewed in the light of advice from the Hague Conference on Private International Law and the remarks made by some delegations.

[20] It is thought that the only existing Conventions needing to be dealt with in Chapter XII are the UNIDROIT Convention on International Financial Leasing and, possibly, the UNIDROIT Convention on International Factoring. It is thought that relations between this Convention and other equipment-specific Conventions should be left to each Protocol.

[21] This Chapter was not reviewed by the Drafting Committee in line with the decision taken by the Joint Session not to consider this Chapter at this stage.

CHAPTER [XIII]

[OTHER] FINAL PROVISIONS [22]

Article U

1. – This Convention enters into force on the first day of the month following the expiration of six months after the date of deposit of the ... instrument of ratification, acceptance, approval or accession but only applies as regards any category of object listed in Article 3 [23]:

(a) as from the time of entry into force of the Protocol;

(b) subject to the terms of that Protocol; and

(c) as between Contracting States Parties to that Protocol.

2. – This Convention and the Protocol shall be read and interpreted as a single instrument.

Article V

A Contracting State may declare at the time of signature, ratification, acceptance, approval of, or accession to the Protocol that it will not apply this Convention in relation to [a purely domestic transaction]. [24] Such a declaration shall be respected by the courts of all other Contracting States.

Article W

[Insert provision for accelerated procedure to finalise further Protocols]

[Article X

A Contracting State shall declare at the time of ratification, acceptance, approval of, or accession to the Protocol the relevant "court" or "courts" for the purposes of Article 1 of this Convention.]

Idem.

Note by the Secretariat:

This reference to the former Article 3 will need to be reviewed in the light of the decision to delete that article at the first Joint Session.

To be defined by taking account of the location of the object and the parties.

Article Y

1. – A Contracting State may declare at the time of signature, ratification, acceptance, approval of, or accession to the Protocol that while the charged object is situated within, or controlled from its territory the chargee shall not grant a lease of the object in that territory.

2. – A Contracting State may declare at the time of signature, ratification, acceptance, approval of, or accession to the Protocol that any remedy available to the obligee under Articles 8 to 10 which is not there expressed to require application to the court may only be exercised with leave of the court.

Article Z

A Contracting State may declare at the time of signature, ratification, acceptance, approval of, or accession to the Protocol that it will not apply the provisions of Article 14, wholly or in part.

[Remaining Final Provisions to be prepared by the Diplomatic Conference]

APPENDIX II

TEXT OF THE PRELIMINARY DRAFT PROTOCOL TO THE PRELIMINARY DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT AS REVIEWED BY THE DRAFTING COMMITTEE

PRELIMINARY DRAFT PROTOCOL TO THE PRELIMINARY DRAFT UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT

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APPENDIX **FORM OF IRREVOCABLE DE-REGISTRATION AND EXPORT REQUEST AUTHORISATION**

PREAMBLE

THE CONTRACTING STATES TO THIS PROTOCOL,

MINDFUL of the demand for, and utility of aircraft equipment and the need to finance the acquisition and use thereof as efficiently as possible,

RECOGNISING the advantages of asset-based financing and leasing for this purpose and desiring to facilitate these transactions by establishing clear rules to govern them,

BELIEVING that such rules must (i) reflect the principles underlying asset-based financing and leasing of aircraft objects and (ii) provide transaction parties with autonomy to allocate risks and benefits to the extent consistent with the policy decisions made by Contracting States in this Protocol,

CONSCIOUS of the need for an international registration system as an essential feature of the legal framework applicable to international interests in aircraft equipment,

CONSIDERING it necessary to implement the UNIDROIT Convention on International Interests in Mobile Equipment so as to meet the requirements of aircraft finance and the purposes described above,

HAVE AGREED upon the following provisions relating to aircraft equipment:

CHAPTER I

SPHERE OF APPLICATION AND GENERAL PROVISIONS

Article I
Defined terms

1. – Terms used in this Protocol and defined in Article 1 of the Convention are employed herein with the meanings there stated.

2. – In this Protocol the following terms are employed with the meanings set out below:

"aircraft" means airframes with aircraft engines installed thereon or helicopters:

"aircraft engines" means aircraft engines [(other than those used in military, customs or police services)] powered by jet propulsion or turbine or piston technology and:

(a) in the case of jet propulsion aircraft engines, have at least 1750 lbs of thrust or its equivalent; and

(b) in the case of turbine-powered or piston-powered aircraft engines, have at least 550 rated take-off shaft horsepower or its equivalent,

together with all modules and other installed, incorporated or attached accessories, parts and equipment and all data, manuals and records relating thereto;

"aircraft objects" means airframes, aircraft engines and helicopters;

"airframes" means airframes [(other than those used in military, customs and police services)] that, when appropriate aircraft engines are installed thereon, are type certified by the competent aviation authority to transport:

(a) at least eight (8) persons including crew; or

(b) goods in excess of 2750 kilograms,

together with all installed, incorporated or attached accessories, parts and equipment (other than aircraft engines), [1] and all data, manuals and records relating thereto;

"authorised party" means the party referred to in Article XIII(2);

"Chicago Convention" means the Convention on International Civil Aviation, signed at Chicago on 7 December 1944, as amended;

"common mark registering authority" means the authority maintaining the non-national register in which an aircraft of an international operating agency is registered in accordance with Article 77 of the Chicago Convention;

"de-register the aircraft" means delete the registration of an aircraft from a national aircraft register;

"Geneva Convention" means the Convention on the International Recognition of Rights in Aircraft, signed at Geneva on 19 June 1948;

"guarantee contract" means a contract entered into by a person as guarantor;

"guarantor" means a person who, for the purpose of assuring performance of any obligations in favour of an obligee secured by a security agreement or under an agreement, gives or issues a suretyship or demand guarantee or a standby letter of credit or any other form of credit insurance;

"helicopters" means heavier-than-air machines [(other than those used in military, customs or police services)] supported in flight chiefly by the reactions of the air on one or more power-driven rotors on substantially vertical axes and which are type certified by the competent aviation authority to transport:

(a) at least five (5) persons including crew; or

(b) goods in excess of 450 kilograms,

together with all installed, incorporated or attached accessories, parts and equipment (including rotors), and all data, manuals and records relating thereto;

"insolvency date" means the date referred to in Article XI(1);

["International Registry Authority" means the permanent international body designated as the International Registry Authority under this Protocol;]

["International Regulator" means [the permanent international body designated as the International Regulator under this Protocol] [the entity designated as the International Regulator in Article XVI(1)];]

"national aircraft register" means the national register in which an aircraft is registered pursuant to the Chicago Convention;

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[1] Consider the position of propellers.

"national registry authority" means the national authority, or the common mark registering authority in a Contracting State which is the State of registry responsible for the registration and de-registration of an aircraft in accordance with the Chicago Convention;

"primary insolvency jurisdiction" means the insolvency jurisdiction of the State in which the centre of the obligor's main interests is situated;

"prospective sale" means a sale that is intended to take effect on the conclusion of a contract of sale in the future;

["Registrar" means [the entity designated as the Registrar under this Protocol] [the entity initially designated or subsequently appointed or re-appointed as the Registrar, as the case may be, as specified in Article XVI];] and

"State of registry" means in respect of an aircraft the State, or a State member of a common mark registering authority, on whose national aircraft register an aircraft is entered under the Chicago Convention.

Article II
Implementation of Convention as regards aircraft objects

1. – The Convention shall apply in relation to aircraft objects as implemented by the terms of this Protocol.

2. – The Convention and this Protocol shall be read and interpreted together as one single instrument and shall be known as the UNIDROIT Convention on International Interests in Mobile Equipment as applied to aircraft objects.

Article III [2]
Sphere of application

1. – The connection with a Contracting State under Article 3(b) of the Convention is satisfied with respect to this Protocol if an [aircraft object] is registered in a national aircraft register of a Contracting State [or if the agreement provides that the aircraft object shall be registered, and the aircraft object becomes so registered, in a Contracting State].

[2. – Notwithstanding the provisions of Article V of the Convention, this Protocol shall apply to [a purely domestic transaction].]

[3.] – In their relations with each other, the parties may not derogate from or vary the provisions of this Protocol, except, by agreement in writing, Articles IX(1), X or XI(1) - (6).

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[2] Add a paragraph inserting as a connecting factor the situation of the transferor under a contract of sale

Article IV
Application of Convention to sales

The following provisions of the Convention apply *mutatis mutandis* in relation to a sale and a prospective sale as they apply in relation to an international interest and a prospective international interest:

Article 15(1) other than sub-paragraph (c);

Articles 17 - 19;

Article 22;

Articles 24 and 26;

Chapter VII; and

Article 38.

Article V
Formalities and effects of contract of sale

1. – For the purposes of this Protocol, a contract of sale is one which:

(a) is in writing;

(b) relates to an aircraft object of which the transferor has power to dispose; and

(c) identifies the aircraft object.

2. – A contract of sale transfers the interest of the transferor in the aircraft object to the transferee according to its terms.

3. – A sale may be registered by either party to the contract of sale in the International Registry by or with the consent in writing of the other party.

Article VI
Representative capacities

A party to an agreement or a contract of sale may enter into an agreement, or register a related interest in an aircraft object in an agency, trust or other representative capacity. In such case, that party is entitled to assert rights and interests under the Convention to the exclusion of the party or parties represented.

Article VII
Description of aircraft objects

A description of an aircraft object that contains its manufacturer's serial number, the name of the manufacturer and its model designation is sufficient to identify the object for the purposes of Article 7(c) of the Convention and Article V(1)(c) of this Protocol.

Article VIII
Choice of law

1.– The parties to an agreement or a contract of sale or a related guarantee contract or subordination agreement may agree on the law which is to govern their rights and obligations under the Convention, wholly or in part.

2.– Unless otherwise agreed, the reference in the preceding paragraph to the law chosen by the parties is to the rules of law in force in the designated State or political subdivision of a State other than its rules of private international law.

CHAPTER II

DEFAULT REMEDIES, PRIORITIES AND ASSIGNMENTS

Article IX
Modification of default remedies provisions

1.– In addition to the remedies specified in the provisions of Articles 8(1), 10 and 14(1) of the Convention, the obligee may, to the extent that the obligor has at any time so agreed and in the circumstances specified in such provisions:

(a) de-register the aircraft; and

(b) export and physically transfer the aircraft object from the territory in which it is situated.

2.– The obligee may not exercise the remedies specified in the preceding paragraph without the prior consent in writing of the holder of any registered interest ranking in priority to that of the obligee. [3]

3.– (a) Article 8(2) of the Convention shall not apply to aircraft objects.

(b) A new Article 13[bis] shall be inserted after Article 13 of the Convention, to read as follows:

"1.– Any remedy given by this Convention shall be exercised in a commercially reasonable manner.

2.– An agreement between an obligor and an obligee as to what is commercially reasonable shall, subject to paragraph 3, be conclusive.

3.– An obligee may not take possession or control of an aircraft object otherwise than by lawful means. For these purposes, the removal of the aircraft object from service shall not in itself be deemed unlawful."

4.– A chargee giving ten or more working days' prior written notice of a proposed sale or lease to interested persons is deemed to satisfy the requirement of providing "reasonable

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[3] Further consideration is to be given to the situation of holders of other interests that are protected under Article IX of the Geneva Convention.

prior notice" specified in Article 8(3) of the Convention. The foregoing shall not prevent a chargee and a chargor or a guarantor from agreeing to a longer prior notice period.

Article X
Definition of speedy judicial relief

[1. —For the purposes of Article 14(1) of the Convention, "speedy" in the context of obtaining judicial relief means a period not exceeding [...] calendar days from the date on which the instrument initiating the proceedings is lodged with the court or its administrative office.]

[2.– The obligor may at any time agree that Article 14(2) of the Convention shall not apply.]

[3.]– The remedies specified in Article IX(1) shall be made available by the national registry authority and other administrative authorities, as applicable, in a Contracting State no later than [...] working days after the judicial relief specified in the preceding paragraph is authorised or, in the case of judicial relief authorised by a foreign court, approved by courts of that Contracting State.

[4.] – Judicial relief under Article 14(1) of the Convention may be granted in a Contracting State notwithstanding the commencement of insolvency proceedings [4] in another [Contracting] State unless its application would contravene an international instrument binding on that Contracting State.

Article XI
Remedies on insolvency

[Alternative A]

1. – For the purposes of this Article, "insolvency date" means the earliest date on which one of the events specified in paragraph 2 shall have occurred.

2. – This Article applies where:

(a) any insolvency proceedings[5] against the obligor have been commenced by the obligor or another person in a Contracting State which is the primary insolvency jurisdiction of the obligor; or

(b) the obligor is located in a Contracting State and has declared its intention to suspend, or has actually suspended payment to creditors generally.

3. – Within a period not exceeding [. . .][6] days from the insolvency date the obligor shall:

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[4] The phrase "insolvency proceedings" should be defined and brought into line with the terminology of the Convention.

[5] A Contracting State may find it appropriate or necessary to adjust its relevant domestic laws or regulations in order to give full effect to this Article and Article XII.

(a) cure all defaults and agree to perform all future obligations under the agreement and related transaction documents; or

(b) give possession of the aircraft object to the obligee [in accordance with, and in the condition specified in the agreement and related transaction documents].

4. – Where possession has been given to the obligee pursuant to the preceding paragraph, the remedies specified in Article IX(1) shall be made available by the national registry authority and other administrative authorities, as applicable, no later than [. . ..][7] working days after the date on which the aircraft object is returned.

5. – No exercise of remedies permitted by the Convention may be prevented or delayed after the period specified in paragraph 3.

6. – No obligations of the obligor under the agreement and related transactions may be modified [in the insolvency proceedings] without the consent of the obligee.

7. – No rights or interests, except for preferred non-consensual rights or interests listed in an instrument deposited under Article 38 of the Convention, shall have priority in the insolvency over registered interests.

[Alternative B] [8]

Article XII
Insolvency assistance

The courts of a Contracting State in which an aircraft object is situated shall, in accordance with the law of the Contracting State, co-operate to the maximum extent possible with foreign courts or other foreign authorities administering the insolvency proceedings referred to in Article XI in carrying out the provisions of that Article.

Article XIII
De-registration and export authorisation

1. – Where the obligor has issued an irrevocable de-registration and export request authorisation substantially in the form annexed to this Protocol and has submitted such authorisation for recordation to the national registry authority, that authorisation shall be so recorded.

2. – The person in whose favour the authorisation has been issued (the "authorised party") or its certified designee shall be the sole person entitled to exercise the remedies specified in Article IX(1) and may do so only in accordance with the authorisation and any

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[6] See Article XXX.

[7] See Article XXX.

[8] It was suggested that an alternative, more flexible formulation of the remedies on insolvency should be prepared. A proposed text does not yet exist, however.

applicable airworthiness or safety laws or regulations. Such authorisation may not be revoked by the obligor without the consent in writing of the authorised party. The national registry authority shall remove an authorisation from the registry at the request of the authorised party.

3. – The national registry authority and other administrative authorities in Contracting States shall expeditiously co-operate with and assist the authorised party in the exercise of the remedies specified in Article IX.

Article XIV
Modification of priority provisions

Article 27 of the Convention applies with the omission of paragraph 4.

Article XV
Modification of assignment provisions

1. – Article 29(2) of the Convention applies with the following being added immediately after sub-paragraph (c):

"(d) is consented to in writing by the obligor, whether or not the consent is given in advance of the assignment or specifically identifies the assignee."

[2. – Article 31(1) of the Convention applies with the omission of sub-paragraph (c).]

[3. – Article 34 of the Convention applies with the omission of the words following the phrase "not held with an international interest".][9]

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[9] Article 34 of the preliminary draft Convention, as may be modified by this preliminary draft Protocol, will have important implications for the competing rights of a receivables financier and an asset-based financier. Consideration should be given to the appropriate rule in the context of aviation financing as well as to its effects on general receivables financing.

[CHAPTER III [10]

REGISTRY PROVISIONS RELATING TO INTERNATIONAL INTERESTS IN AIRCRAFT OBJECTS

Article XVI
Regulation and operation of Registry

Alternative A

[1. – [The International Registry shall be regulated and operated by the International Registry Authority.] [The International Registry shall be regulated by the International Regulator [11] and operated by the Registrar.]] [12]

Alternative B

[1. – The International Registry shall be regulated by the Council of the International Civil Aviation Organization or such other permanent body designated by it to be the International Regulator.

2. – The initial Registrar hereby designated to operate the International Registry shall be a newly created, independent special purpose affiliate of the International Air Transport Association.

3. – The initial Registrar shall be organised in consultation with the International Regulator. Its constitutive documents shall contain provisions that:

(a) restrict it to acting as Registrar and performing ancillary functions; and

(b) ensure that it has no greater duties (fiduciary or otherwise) to members of the International Air Transport Association than to any person or entity in the performance of its functions as Registrar.

4. – The initial Registrar shall operate the International Registry for a period of five years from the date of entry into force of this Protocol. Thereafter, the Registrar shall be appointed or re-appointed at regular five-year intervals by the [Contracting States] [International Regulator].]

[2./5. – Article 16(1) and (3) of the Convention apply as modified by the preceding paragraphs of this Article.]

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[10] The provisions of this Chapter are presented in square brackets in that they were not the subject of consideration by the Drafting Committee pending the outcome of their consideration by the Registration Working Group.

[11] Further consideration needs to be given as to whether the appropriate term is *International* Regulator or *Intergovernmental* Regulator.

[12] The two bracketed provisions in this Alternative A are mutually exclusive, so that if the decision is to have an International Registry Authority references in other Articles to the International Regulator and the Registrar will be deleted, whilst if the latter are adopted references to the International Registry Authority will be deleted.

Article XVII
Basic regulatory responsibilities

1. – The [International Registry Authority] [International Regulator] shall act in a non-adjudicative capacity. This shall not prevent the [International Registry Authority] [International Regulator] from undertaking the functions specified in Article 16(6) and (7) of the Convention.

2. – The [International Registry Authority] [International Regulator] shall [be responsible to the Contracting States and shall report thereto on its regulatory [and oversight] functions. Such reports shall be made on a yearly basis or more frequently as the [International Registry Authority] [International Regulator] deems appropriate.]

[3. – The initial regulations shall be promulgated by the [International Registry Authority] [International Regulator] on entry into force of this Protocol.]

Article XVIII
Registration facilities

1. – At the time of ratification, acceptance, approval of, or accession to this Protocol, a Contracting State may, subject to paragraph 2:

(a) designate its operators of registration facilities as specified in Article 16(2) of the Convention; and

(b) declare the extent to which any such designation shall preclude alternative access to the International Registry.

2. – A Contracting State may only designate registration facilities as points of access to the International Registry in relation to:

(a) helicopters or airframes pertaining to aircraft for which it is the State of registry; and

(b) registrable non-consensual rights or interests created under its domestic law.

Article XIX
Additional modifications to Registry provisions

1. – For the purposes of Article 19(6) of the Convention, the search criterion for an aircraft object shall be its manufacturer's serial number, supplemented as necessary to ensure uniqueness. Such supplementary information shall be specified in the regulations.

2. – For the purposes of Article 25(2) of the Convention and in the circumstances there described, the holder of a registered prospective international interest or a registered prospective assignment of an international interest shall take such steps as are within its power to effect a removal thereof no later than five working days after the receipt of the demand described in such paragraph.

3. – The fees referred to in Article 16(4) of the Convention shall be determined so as to recover the reasonable costs of operating the International Registry and the registration facilities and, in the case of the initial fees, of designing and implementing the international registration system.

4. – The centralised functions of the International Registry shall be operated and administered by the [International Registry Authority] [Registrar] on a twenty-four hour basis. The various registration facilities shall be operated and administered during working hours in their respective territories.

5. – The regulations shall prescribe the manner in which the following provisions of the Convention shall apply:

Article 16(6) and (7);

Article 17;

Article 18;

Article 21;

Article 22(1) and (2);

Article 23; and

Article 24.]

CHAPTER IV

JURISDICTION

Article XX
Modification of jurisdiction provisions

For the purposes of Articles 40 and 41 of the Convention, a court of a Contracting State also has jurisdiction where that State is the State of registry.

Article XXI
Waivers of sovereign immunity

1. – Subject to paragraph 2, a waiver of sovereign immunity from jurisdiction of the courts specified in Article 41 of the Convention or relating to enforcement of rights and interests relating to an aircraft object under the Convention shall be binding and, if the other conditions to such jurisdiction or enforcement have been satisfied, shall be effective to confer jurisdiction and permit enforcement, as the case may be.

2. – A waiver under the preceding paragraph must be in a[n authenticated] writing that contains a description of the aircraft.

CHAPTER V

RELATIONSHIP WITH OTHER CONVENTIONS [13]

Article XXII

Relationship with 1948 Convention on the International Recognition of Rights in Aircraft

1. – Where a Contracting State is a party to the Geneva Convention:

(a) the reference to the "law" of such Contracting State for the purposes of Article I (1)(d)(i) of the Geneva Convention should be to such law after giving effect to the Convention;

(b) for the purposes of the Geneva Convention, the term "aircraft" as defined in Article XVI of that Convention shall be deleted and replaced by the terms "airframes," "aircraft engines" and "helicopters" as defined in this Protocol; and

(c) registrations in the International Registry shall be deemed to be regular recordations "in a public record of the Contracting State" for the purposes of Article I (1)(ii) of the Geneva Convention.

2. – Subject to paragraph 3, the Convention shall, for the Contracting States referred to in the preceding paragraph, supersede the Geneva Convention to the extent, after giving effect to the preceding paragraph, of inconsistency between the two Conventions.

3. – The provisions of the preceding paragraph shall not apply to Articles VII and VIII of the Geneva Convention where an obligee elects to exercise remedies against an obligor in accordance with those Articles [and provides the court with written evidence of that election].

Article XXIII

Relationship with 1933 Convention for the Unification of Certain Rules Relating to the Precautionary Arrest of Aircraft

The Convention shall, for Contracting States that do not make a declaration under Article Y(2) of the Convention, supersede the 1933 Convention for the Unification of Certain Rules Relating to the Precautionary Arrest of Aircraft.

Article XXIV

Relationship with 1988 UNIDROIT Convention on International Financial Leasing

The Convention shall supersede the 1988 UNIDROIT Convention on International Financial Leasing as it relates to aircraft objects.

CHAPTER VI

[OTHER] FINAL PROVISIONS [14]

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[13] With the exception of Article XXX, the meeting of governmental experts did not discuss Chapters V and VI, leaving consideration of those Chapters to a time nearer to a diplomatic Conference.

[14] It is envisaged that, in line with practice, draft Final Provisions will be prepared for the Diplomatic Conference at such time as governmental experts have completed their preparation of the draft Protocol. The

proposals for draft Final Provisions set out in the Addendum to this preliminary draft Protocol below are in no way intended to prejudge that process but simply to indicate the suggestions of the Aircraft Protocol Group on this matter. Particular attention is drawn to Articles XXXI(3) and XXXIII(3) (limiting the effect of any future declaration or reservation and denunciation respectively as regards established rights) and Article XXXIV (establishing a Review Board and contemplating review and revision of this Protocol).

CHAPTER VI

[OTHER] FINAL PROVISIONS

Article XXV
Adoption of Protocol

1. – This Protocol is open for signature at the concluding meeting of the Diplomatic Conference for the Adoption of the Draft Protocol to the UNIDROIT Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment and will remain open for signature by all Contracting States at [....] until [....].

2. – This Protocol is subject to ratification, acceptance or approval of Contracting States which have signed it.

3. – This Protocol is open for accession by all States which are not signatory Contracting States as from the date it is open for signature.

4. – Ratification, acceptance, approval or accession is effected by the deposit of a formal instrument to that effect with the depositary. [15]

Article XXVI
Entry into force

1. – This Protocol enters into force on the first day of the month following the expiration of [three] months after the date of deposit of the [third] instrument of ratification, acceptance, approval or accession.

2. – For each Contracting State that ratifies, accepts, approves or accedes to this Protocol after the deposit of the [third] instrument of ratification, acceptance, approval or accession, this Protocol enters into force in respect of that Contracting State on the first day of the month following the expiration of [three] months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.

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proposals for draft Final Provisions set out in the Addendum to this preliminary draft Protocol below are in no way intended to prejudge that process but simply to indicate the suggestions of the Aircraft Protocol Group on this matter. Particular attention is drawn to Articles XXXI(3) and XXXIII(3) (limiting the effect of any future declaration or reservation and denunciation respectively as regards established rights) and Article XXXIV (establishing a Review Board and contemplating review and revision of this Protocol).

[15] It is recommended that a resolution be adopted at, and contained in the Final Acts and Proceedings of, the Diplomatic Conference, contemplating the use by Contracting States of a model ratification instrument that would standardise, *inter alia*, the format for the making and/or withdrawal of declarations and reservations.

Article XXVII
Territorial units

1. – If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Protocol, it may, at the time of ratification, acceptance, approval or accession, declare that this Protocol is to extend to all its territorial units or only to one or more of them and may substitute its declaration by another declaration at any time.

2. – These declarations are to be notified to the depositary and are to state expressly the territorial units to which this Protocol extends.

3. – If a Contracting State makes no declaration under paragraph 1, this Protocol is to extend to all territorial units of that Contracting State.

Article XXVIII
Temporal application

This Protocol applies in a Contracting State to rights and interests in aircraft objects created or arising on or after the date on which this Protocol enters into force in that Contracting State.

Article XXIX
Declarations and reservations

No declarations or reservations are permitted except those expressly authorised in this Protocol.

Article XXX
Declarations disapplying certain provisions

A Contracting State, at the time of ratification, acceptance, approval of, or accession to this Protocol[[,][:

(a)] may declare that it will not apply any one or more of the provisions of Articles VIII and X to XIII of this Protocol[;

(b) to the extent that it has not made a declaration under sub-paragraph (a), must declare that it will apply time-periods as specified in its declaration for the purposes of Articles X and XII: and

(c) may declare that it will impose other conditions on the application of Articles VIII [, IX(1)] and X to XII as specified in its declaration].

Article XXXI
Subsequent declarations

1. – A Contracting State may make a subsequent declaration at any time after the date on which it enters into force for that Contracting State, by the deposit of an instrument to that effect with the depositary.

2. – Any such subsequent declaration shall take effect on the first day of the month following the expiration of [twelve] months after the date of deposit of the instrument in which such declaration is made with the depositary. Where a longer period for that declaration to take effect is specified in the instrument in which such declaration is made, it shall take effect upon the expiration of such longer period after its deposit with the depositary.

3. – Notwithstanding the previous paragraphs, this Protocol shall continue to apply, as if no such subsequent declaration had been made, in respect of all rights and interests arising prior to the effective date of that subsequent declaration.

Article XXXII
Withdrawal of declarations and reservations

Any Contracting State which makes a declaration under, or a reservation to this Protocol may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of [three] months after the date of the receipt of the notification by the depositary.

Article XXXIII
Denunciations

1. – This Protocol may be denounced by any Contracting State at any time after the date on which it enters into force for that Contracting State, by the deposit of an instrument to that effect with the depositary.

2. – Any such denunciation shall take effect on the first day of the month following the expiration of [twelve] months after the date of deposit of the instrument of denunciation with the depositary. Where a longer period for that denunciation to take effect is specified in the instrument of denunciation, it shall take effect upon the expiration of such longer period after its deposit with the depositary.

3. – Notwithstanding the previous paragraphs, this Protocol shall continue to apply, as if no such denunciation had been made, in respect of all rights and interests arising prior to the effective date of that denunciation.

Article XXXIV
Establishment and responsibilities of Review Board

1. – A five-member Review Board shall promptly be appointed to prepare yearly reports for the Contracting States addressing the matters specified in sub-paragraphs (a)-(d) of paragraph 2. [The composition, organisation and administration of the Review Board shall be determined, in consultation with other aviation interests, jointly by the International Institute for the Unification of Private Law and the International Civil Aviation Organization.]

2. – At the request of not less than twenty-five per cent of the Contracting States, conferences of the Contracting States shall be convened from time to time to consider:

(a) the practical operation of this Protocol and its effectiveness in facilitating the asset-based financing and leasing of aircraft objects;

(b) the judicial interpretation given to the terms of the Convention, this Protocol and the regulations;

(c) the functioning of the international registration system and the performance of the [International Registry Authority] [Registrar and its oversight by the Intergovernmental Regulator]; and

(d) whether any modifications to this Protocol or the arrangements relating to the International Registry are desirable.

Article XXXV
Depositary arrangements

1. – This Protocol shall be deposited with the [....].

2. – The [....] shall:

(a) inform all Contracting States which have signed or acceded to this Protocol and [....] of:

(i) each new signature or deposit of an instrument of ratification, acceptance, approval or accession, together with the date thereof;

(ii) each declaration made in accordance with this Protocol;

(iii) the withdrawal of any declaration;

(iv) the date of entry into force of this Protocol: and

(v) the deposit of an instrument of denunciation of this Protocol together with the date of its deposit and the date on which it takes effect;

(b) transmit certified true copies of this Protocol to all signatory Contracting States, to all Contracting States acceding to the Protocol and to [....];

(c) provide the [International Registry Authority] [Registrar] with the contents of each instrument of ratification, acceptance, approval or accession so that the information contained therein may be made publicly accessible; and

(d) perform such other functions customary for depositaries.

FORM OF IRREVOCABLE DE-REGISTRATION AND EXPORT REQUEST AUTHORISATION

[Insert Date]

To: [Insert Name of National Registry Authority]

Re: Irrevocable De-Registration and Export Request Authorisation

The undersigned is the registered [operator] [owner]* of the [insert the airframe/helicopter manufacturer name and model number] bearing manufacturer's serial number [insert manufacturer's serial number] and registration [number] [mark] [insert registration number/mark] (together with all installed, incorporated or attached accessories, parts and equipment, the "**aircraft**").

This instrument is an irrevocable de-registration and export request authorisation issued by the undersigned in favour of [insert name of obligee] ("**the authorised party**") under the authority of Article XIII of the Protocol to the UNIDROIT Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment. In accordance with that Article, the undersigned hereby requests:

(i) recognition that the authorised party or the person it certifies as its designee is the sole person entitled to:

(a) obtain de-registration of the aircraft from the [insert name of national aviation registry] maintained by the [insert name of aviation authority] for the purposes of Chapter III of the Chicago Convention of 1944 on International Civil Aviation; and

(b) export and physically transfer the aircraft from [insert name of country]; and

(ii) confirmation that the authorised party or the person it certifies as its designee may take the action specified in clause (i) above on written demand without the consent of the undersigned and that, upon such demand, the authorities in [insert name of country] shall co-operate with the authorised party with a view to the speedy completion of such action.

The rights in favour of the authorised party established by this instrument may not be revoked by the undersigned without the written consent of the authorised party.

Please acknowledge your agreement to this request and its terms by appropriate notation in the space provided below and lodging this instrument in [insert name of national registry authority].

[insert name of operator/owner]

_____

By: [insert name of signatory]
Its: [insert title of signatory]

Agreed to and lodged this
[insert date]

_____

[insert relevant notational details]

_____

* Select the term that reflects the relevant nationality registration criterion.