# The Legal Impacts of the Cape Town Convention on Aircraft Financing Transactions

by

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## Abstract

Airlines must maintain their aircraft up to a standard. This includes an acquisition of new aircraft with more modern facilities and better safety-related equipments. However, capital available for airlines to acquire their aircraft is limited as the cost of borrowing is high. One of the many problems is the uncertain law governing aircraft financing transactions. The Cape Town Convention and its Aircraft Protocol are expected to be the solution for the above problem. The Convention has successfully resolved some essential problems that historically impeded aircraft financing transactions. However, it causes several new difficulties which require international solutions. After critically analyzing the difficulties created by the Convention and studying their impact on creditors and debtors, vague terminologies used in the Convention and the opt-in and opt-out systems as well as the absence of universal ratification are among the new difficulties. The Convention is not without its weaknesses, but it does grant numerous economic benefits to the aviation industry. Also, the sooner the problems are pointed out, the earlier the better solutions are proposed. Thus, the Convention and the Aircraft Protocol may not be the perfect solution but it is a necessarily tool that will lead aviation industry to a greater step in the future.

## Résume

Les compagnies aériennes ont l'obligation de maintenir leur flotte à un certain niveau. Cela implique l'acquisition de nouveaux aéronefs bénéficiant des dernières technologies et de meilleurs équipements en matière de sécurité. Cependant, le budget dont disposent les compagnies aériennes, pour acquérir de nouveaux appareils, est limité. Les taux d'emprunt sont élevés. L'un des nombreux problèmes soulevés est le manque de sécurité juridique dans le domaine des opérations de financement des aéronefs. La convention du Cap et son Protocole Aéronautique devraient apporter des solutions aux difficultés sus-mentionnées. La Convention a remarquablement résolu certains problèmes fondamentaux qui faisaient autrefois obstacle aux opérations de financement des aéronefs. Cependant, elle soulève de nouvelles difficultés qui demandent une réponse internationale. Après avoir analysé de manière critique les problèmes engendrés par la Convention et étudié leur impact sur les créanciers et les débiteurs, les terminologies floues utilisées par la Convention, la possibilité de choisir le système applicable et l'absence de ratification universelle font partie des nouvelles difficultés soulevées. Cette Convention n'est pas sans faille, mais elle confère un certain nombre d'avantages économiques à l'industrie aéronautique. Par ailleurs, plus tôt les problèmes sont détectés, plus vite les solutions les plus adaptées sont proposées. Ainsi, la Convention et le protocole aéronautique ne sont sans doute pas la meilleure réponse, mais ils sont un outil nécessaire qui permettra à l'industrie aéronautique de gravir un nouvel échelon dans le futur.

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# Introduction

Aircraft financing is largely a global business by nature. Aircraft possess a unique character as both a highly valuable and a highly mobile asset that can carry passengers to numerous destinations across multiple jurisdictions. For example, on the same day the aircraft may leave Bangkok, Thailand, a Civil law jurisdiction, to Tokyo, Japan, a Civil law jurisdiction, and arrive at New York City, United States of America, a Common Law jurisdiction. Additionally, the acquisition of aircraft requires funding from sources within capital markets across the globe.[1] As a result of these international characteristics, creditors have numerous concerns with regard to the protection of his interest.

The absence of uniformity across jurisdictions in relation to secured transaction law is the basis for the above concerns.[2] The legal structures of asset-based financing are largely tied to the national legal system.[3] As such, the means of establishing legal interest in property, and default remedies of the creditor, differ from nation to nation, increasing the uncertainty as to whether a creditor's interest can be upheld against third parties in foreign jurisdictions. Such uncertainty leads to an increase in interest charged and other forms of securities, which ultimately results in higher airfares and rates for consumers.[4] The practitioners and scholars both acknowledge the problems caused by this lack of uniformity, spurring UNIDROIT to initiate the drafting of a new Convention. Completed in 2001 with the collaboration of ICAO and leading international

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[1] N. Humphrey & V. Nase, "The Cape Town Convention 2001: An Australian Perspective" (2006) 31 Air & Space L. 5 at 16.
[2] G. Tucci, "Towards a transnational commercial law for secured transactions: the preliminary draft UNIDROIT Convention and Italian law" (1999) 4 Unif. L. Rev. 371 at 373.
[3] J. Krupski, "Conflict of Laws in Aircraft Securitization" (1990) 24 Ann. Air & Sp. L. 91 at 95.
[4] *Ibid.* at 97.

organizations and aviation business leaders, the Convention on International Interests in Mobile Equipment (or the Cape Town Convention) is the main Convention and it works with its implementation Protocols.[5] To date, there have been 3 Protocols developed, but only the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (or the Aircraft Protocol) has come into force.[6] This thesis will focus on the Cape Town Convention and the Aircraft Protocol.

The Convention and Protocol have five basic goals.[7] First, it aims to facilitate aircraft financing transactions by creating a mechanism for ensuring that international interests in aircraft will be recognized across all Contracting States. Second, it provides greater confidence to the creditor by providing basic default remedies as well as efficient interim relief mechanisms. Third, the International Registry is established for the registration of interests and to serve as a means of publishing notices of international interests to the public, as well as ensuring that creditor prioritization is maintained on a first-to-register basis. Fourth, the particular needs of each industry sector are provided by the relevant protocol. Last but not least, the Convention aims to reduce the borrowing cost for the debtor by ensuring greater confidence that, in turn, will enhance their credit rating from the creditor.

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[5] L. Weber & S. Espinola, "The development of a new Convention relating to international interests in mobile equipment, in particular aircraft equipment: a joint ICAO-UNIDROIT project" (1999) 4 Unif. L. Rev. at 463.

[6] The Aircraft Protocol came into force on 1 March 2006 online: UNIDROIT <http://www.unidroit.org>

[7] R. Goode, *Official Commentary on Convention on International Interests in Mobile Equipment and Protocol thereto on Matters specific to Aircraft Equipment* (Rome: UNIDROIT, 2002) at 6.

Another goal of the Convention and the Protocol (as stated in its Preamble) is to create clear rules governing aircraft financing transactions.[8] Once these clear rules are established, it is expected that secured transaction law governing aircraft financing will be unified and transactions will be simplified.[9]

The Cape Town Convention is expected to bring economic benefits to the aviation industry. A study on the economic impact of the Convention conducted by a collaboration of New York University and INSEAD[10] concludes that the aviation industry as well as the governments and passengers *will* truly benefit from the Convention once it has been fully implemented.[11] The reason is simple: once the financier is ensured that his interests are protected, he is more likely to extend credit to the debtor or decrease the cost of the required securities. As such, the debtor's aircraft financing cost is reduced.[12]

However, after having been in force for 2 years, the Convention has not yet fully delivered its promised benefits. Thus, there are several criticisms from both scholars and practitioners whether the Convention will ultimately deliver its greatest benefits and fulfill everybody's expectations. There are concerns about the speedy remedy, which could be undermined by the requirement of leave of the court and regarding the insolvency remedy that leaves the option for the

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[8] As stated in paragraph 2 of the Preamble of the Cape Town Convention ' Recognizing 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'

[9] G. Mauri, "The Cape Town Convention on Interests in Mobile Equipment as Applied to Aircraft: Are Lenders Better Off Under the Geneva Convention?" (2005) 13 E.R.P.L. 641 at 647.

[10] INSEAD is an international graduate business school and research institution with campuses in France and in Singapore. The official name of the school is INSEAD which originally stood for Institut Européen d'Administration des Affaires. For more information, please see www.insead.edu.

[11] The study is called "the Innovation in International Law and Global Finance: Estimating the Financial Impact of the Cape Town Convention" by A. Saunders, A. Srinivasan & I. Walter.

[12] UNDROIT, *Cape Town Convention of 2001* online: UNIDROIT <www.unicroit.org>.

Contracting State to elect not to comply. The main criticisms of the convention are the opt-in and opt-out system which could create the disunity among the Contracting States, and the absence of universal ratification which could prevent the Convention from delivering its greatest benefits.

This thesis aims to tackle the impact of the Cape Town Convention on aircraft financing transaction by doctrinally analyzing the weaknesses of the Convention and examining the consequences of these weaknesses for the aviation industry. This thesis aims to underscore that there are some problems that have been successfully solved under the Convention's legal framework and there are several new difficulties caused by the Convention which urgently require international solutions. However, under the current circumstances even though the Convention only partially fulfills its goal, it does confer many economic advantages to the aviation industry. Thus, the Convention may not be the perfect answer but it is a necessary step toward a better solution.

Chapter 1 will study the financial instruments used for aircraft financing and critically analyze aircraft financing transactions. It will examine how the practical operation of these transactions, the types of financial instruments that are normally used by the aircraft financier. The focus of the discussion will be on leasing arrangements, as this is the most important and popular tool used in aircraft financing transactions.[13] Export Credit Agencies will also be reviewed, as their importance is increasing as additional instruments for financiers and

[13] D. Bunker, *International Aircraft Financing* (Montreal: International Air Transportation Association, 2005) at 178.

debtors.[14] Then, since the law governing aircraft financing has been unstable since the aviation industry emerged,[15] this chapter will outline the legal problems this has created which impede aircraft financing transactions, and which merit the development of a modernized international solution.

Chapter 2 will explore the Convention and critically analyze whether the Convention and the Protocol generally solve the long-standing problems of aircraft financing transactions as described in Chapter 1. It will examine the extent to which the Convention and the Protocol have created a clear rule governing aircraft financing as promised in the Preamble. This Chapter will be divided into five parts that are the heart of the Convention: international interests, default remedies, the international registration system, priority and assignment. For each aspect of the Convention, the leading supporting (as well as detracting) arguments will be presented. The criticism from scholars and practitioners that then arises is: has the Convention and the Protocol *actually* simplified these transactions and improved the position of the relevant parties?

Chapter 3 is the core of this thesis and it aims to examine the above criticisms by providing more factual details from real-world practical aircraft financing transactions, and more information about the various choices that Contracting States can make which may influence the applicability of parts of the Convention. In this Chapter, the leading weaknesses of the Convention will be considered. A practical scenario (as well as some variations thereof) will be used

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[14] A. Littlejohns & S. McGairl, *Aircraft Financing, ed.* (London: Euromoney Publications, 1998) at 47.
[15] *Supra* note 2 at 373.

to demonstrate each issue in order to fully explore the different prospects. Malaysia Airline and Thai Airways will be used as the examples in the practical scenario. Each of these is a leading airline serving global destinations. However, a big difference is that Malaysia has ratified the Convention whereas Thailand has not. Then, the consequences of the Convention for airlines, manufacturers, and passengers will be analyzed. Focus will be placed on the airlines, which will be categorized into two groups - airlines from a Contracting State and airlines from a non-Contracting State. Finally, this Chapter will determine whether it is feasible to expect the Convention to reach its objectives and deliver its promises to the aviation industry, and will put forward the suggested solutions to the current situations.

# Financial Instruments of Aircraft Financing

## Chapter Introduction

Aircraft can be described as highly mobile and ultra-expensive objects which enable us to journey beyond traditional geographic boundaries within a short period of time. This definition highlight the fact that (a) the aircraft is a constantly moveable asset that travels across multiple jurisdictions, (b) there can be substantial distance between the aircraft's physical location and its registered owner, and (c) the acquisition of aircraft heavily relies on multiple sources of funding as provided by the creditors. These unique characteristics lead to numerous legal problems in the course of aircraft financing transactions.

This Chapter aims to focus on the financial instruments that are generally used in aircraft financing transactions in order to analyze their practical functions in the aircraft financing business and examine the difficulties involved in the transactions. Also, the legal problems arising from these financial instruments will be highlighted as these difficulties are the original root of the Cape Town Convention.

In the first section, leasing, as the most important and widely used means of acquiring aircraft, will be critically analyzed and examined to ascertain how it practically functions and why it is the most advantageous tool for aircraft financiers. This section will review both *capital* and *operating* leases, and assess their similarities and differences from an economic perspective. Leveraged lease will be examined as the most important of all leasing structures developed for aircraft financing.

Then, Export Credit Agencies will be reviewed in the second section as they have become another important source of aircraft financing transaction. This

section aims to examine two structures that are mainly used in ECAs-supported financing: an ECAs-supported structure for Airbus aircraft and an Eximbank/ECGD-supported structure for Boeing aircraft.

Finally, in the third section, the legal problems which are highly concerning to all interested parties will be reviewed. These issues will be divided into two main areas: the essential problems that principally cause uncertainties for the creditor. The first area consists of the non-recognition of the creditors' title or security interest, the differences in forms of security interest and their ranking, repossession risks, and the deficiency of bankruptcy law. The second area discusses the concerns that arise only in some circumstances and they are managed under the means of contract. These concerns are the lack of registry authority, deregistration risks, and conflict of law. Undoubtedly, the absence of uniformity in secured transaction law and the deficiency in national law are key contributing factors of the above problems.

**Aircraft Financing Instruments**

The accessibility to significant capital markets for the purchase of aircraft is an ongoing concern facing many airlines, due to their unique position of operating a highly capital-intensive venture in a cyclical industry where cash flows can vary and be extremely volatile.[16] It is no surprise that sources of financing are of primary concern for the airlines, and there *are* several different financing sources available to airlines for the procurement of aircraft.

[16] P. Dempsey & L. Gesell, *Airline Management Strategies for the 21st Century*, 2nd ed. (Arizona: Coast Aire Publication: 2006) at 60.

**Section 1: Leasing**

Leasing is a popular, if controversial, tool in the financing of equipment in commercial enterprise and it is a principal means for airlines to finance aircraft for their fleets. In fact, out of all the methods available to finance aircraft purchases, leasing plays the most prominent role.[17]

In the simplest terms, leasing is a commercial arrangement for the use of property in return for payment to the owner (the lessor).[18] The lessee has dual rights to possess and use the leased equipment, and has an obligation to pay the number of fixed or flexible installments to the lessor who legally remains the owner of the leased item. The lessor, on the other hand, has an obligation to supply equipment corresponding with the description provided in the lease contract and must also take reasonable care to ensure that the equipment is delivered in reasonably fit condition for the lessee's purposes. [19]

At the expiry of the lease term, the lessee typically has the option to re-lease for a further period, upgrade the lease to cover a newer or different item, or offer to buy the leased property from the lessor, usually at a 'bargain value' agreed to at the start of the lease.[20] Traditional sources of lease financing are banks, merchant banks, specialist leasing companies, finance companies and leasing divisions which are offshoots of major equipment suppliers i.e. Boeing Capital.[21]

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[17] D. Bunker, "Aircraft Finance in the Future" (2002) 27 Ann. Air & Sp. L. 139 at 147.

[18] L. Gitman & S. Hennessey, *Principles of Corporate Finance*, 2nd. Canadian Edition (Toronto: Pearson Addison Wesley, 2008) at 854.

[19] Leasing online: Allbusiness <http://www.allbusiness.com>.

[20] *Supra* note 18 at 858.

[21] V. DuBose, "Sources of Finance" in S. Hall ed., *Aircraft Financing* (London: Euromoney Publications, 1998) (first page of essay) at 22.

Some attractions of leasing, from the lessee's point of view, are that it enables the lessee the advantages of tax benefit transfers and facilitates the acquisition of equipment at financing costs below those of conventional borrowing mechanisms.[22] Further, operating leases are not reported on the balance sheet as a financing item, which can be advantageous if the airline is seeking additional debt financing for other purposes.[23] Leasing also serves as an excellent security device where title to the leased equipment remains vested in the lessor during the financing term, thereby facilitating repossession in the event of a default by the lessee.[24]

### 1.1 Classifications of Leases

Many varieties of leases have been used over the years, and the possibilities are limited only by the imagination of the lawyers who construct these documents. In the end, of course, the aim is to fulfill the desire of the lessor and lessee whose contractual relationship may differ depending on circumstances.[25] A financial or capital lease, an operating lease, an U.S. leveraged lease, a Japanese lease, and a wet lease are examples of the types of leases used in aircraft financing.

Practically speaking, similar types of leases are often called by different names due to varying perceptions of the respective parties as to the purpose of taxation, accounting, securities legislation, banking regulations, and usury.[26] For example, all commercial leases are “tax leases”, but certain types of leases may be

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[22] D. Bunker, *International Aircraft Financing* (Montreal: International Air Transportation Association, 2005) at 178.
[23] *Ibid*.
[24] *Ibid*.
[25] *Supra* note 17 at 148.
[26] *Supra* note 18 at 856.

specifically designed as “tax leases” by leasing companies if the regulations allow such companies to take advantage of depreciation. Based on this criteria, a “capital lease” might also be called a “tax lease”, since the lessee is entitled to take advantage of depreciation expenses in this way. Therefore, classification seems to depend upon how the lease is perceived and by whom.[27] The form of lease used by the lessor and lessee deeply depends on their particular transaction and factual circumstances.

There are two main categories of leases: capital[28] and operating.

**A capital lease** is a contract under which the economic benefits and risks inherent to the ownership of the leased item transfer from the lessor to the lessee. The lease term is normally long and generally related to the useful life of the lease equipment. A capital lease exists if any one of the following four criteria is met. First, the lease transfers ownership of the property to the lessee at the end of the lease term. Second, a bargain purchase option exists. Third, the lease term is 75% or more of the life of the property. Fourth, the present value of the minimum lease payments equals or exceeds 90% of the fair value of the property.[29]

**An operating lease** covers all other type of leases (which do not meet the criteria for a capital lease). The characteristics of an operating lease are as follow.[30] First, it normally involves the leasing of equipment, where the benefits and risks remain with the owner of the equipment. Second, the contracts are ordinarily written for considerably less time than the useful life of the equipment and the lessor, generally the equipment manufacturer, handles all maintenance and

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[27] *Supra* note 13 at 250.
[28] As explained above, a “capital lease” may be called “finance lease”.
[29] Capital Lease online: Allbusiness <http://www.allbusiness.com>.
[30] Operating Lease online: Allbusiness <http://www.allbusiness.com>.

servicing.[31] Third, at the expiration of the lease term, the lessee seldom purchases the leased equipment, although the transaction may include an option to purchase the equipment under certain circumstances.[32] Fourth, the manufacturer typically expects to reclaim the equipment and re-lease it to other lessees after the end of the lease term. Operating leases are now common in many business sectors and major airlines are capitalizing on the financial benefits and fleet flexibility afforded by such leases.

### 1.2 Reasons for Leasing

Where aircraft financing is concerned, leasing is deemed as the most advantageous tool (among the various options described herein) for the involved parties. The key reasons are as follows: [33] First of all, as described above, it grants the airline the benefits of an off-balance sheet financing and a tax benefit transfer. The lessee can structure the lease to meet their accounting requirements on an off-balance basis which will result in preserving the lessee's debt-equity ratio.

The second reason is that it can be used as a security device granted to the creditors, as ownership is still considered by most lenders to be the best security. In the situation where a debtor becomes insolvent, a creditor who receives ownership of the aircraft in question is in a better position than the creditors who do not.

Third, leasing companies are more flexible than banks and other similar financial institutions; therefore, the lease agreement and its covenants are less restrictive than the loan agreement with respect to a contract structure. Fourth, it

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[31] It can be called a "service lease".
[32] *Supra* note 13 at 184.
[33] For more details regarding the reasons for leasing, please see *supra* note 13 at 250.

prevents the airlines from cash depletion by enabling the airlines to expand their fleet when it is necessary for a short period of time. In this way, the airlines can increase their capacity and generate more income without purchasing new aircraft.

Also, the short-term lease protects the airlines from lost investment due to technology changes. Moreover, it lowers the overall cost of aircraft compared to traditional methods of financing because of the key tax considerations.[34]

However, leases can, in some circumstances, introduce new complexities for the parties. Some of the difficulties are as follows.[35] First, withholding taxes may apply to some cross-border transactions. Second difficulty is that Sale-and-leaseback structures may result in recapture costs and/or double payment of sales taxes in certain jurisdictions. Third, it exposes the lessor to "capital" and "place of business" taxes in certain jurisdictions. Fourth, it causes the loss of investment tax credits.[36] Therefore, the above problems can cause the lease transaction to be more complicated and thereby decrease the perceived benefits to the participants.[37]

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[34] For more details regarding the use of tax to lower the cost of aircraft, please see *supra* note 13 at 251.

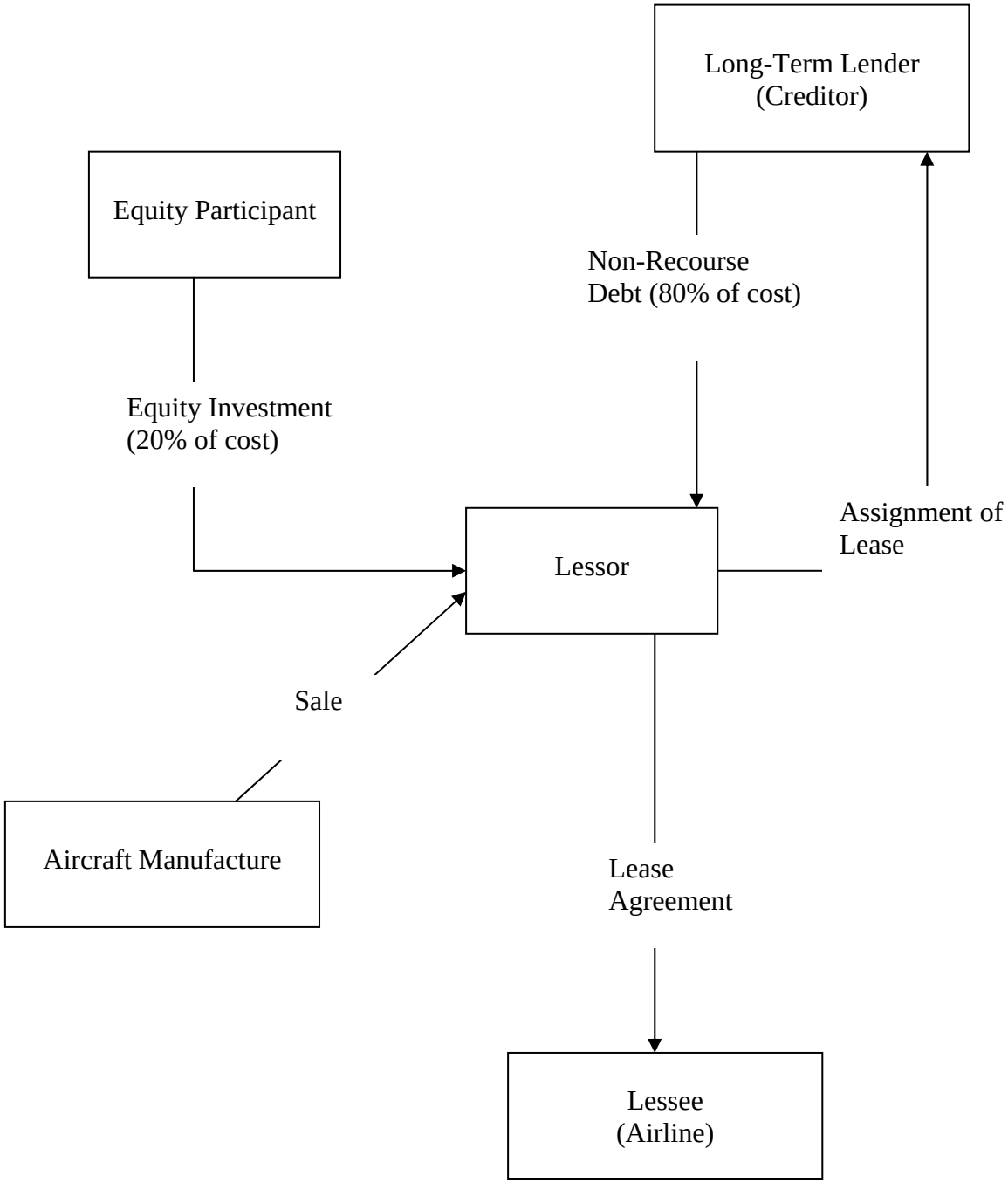
[35] For more details regarding the difficulty in leasing, please see *ibid* at 253.

[36] Investment tax credits are credits earned when qualified equipment are purchased for use in the business. The credits can be applied against federal income tax and federal surtax otherwise payable (it can not be applied against provincial income tax payable).

[37] *Supra* note 13 at 253.

**1.3 Leveraged Lease**

Leveraged Lease Structure[38]




[38] *Supra* note 13 at 202.

Aircraft creditors have exercised their tax benefit transfers on a massive scale through use of the “leveraged lease”. The leveraged lease is one type of capital lease and it is the most important of all structures developed for aircraft financing because it is considered to be the basis for all other variations of leasing agreements.[39] Therefore, the practical understanding of the leveraged lease is a basic requirement for any practitioner in this field.

The leveraged lease is a long-term lease that involves the creditors in addition to the lessor and lessee. The lessor borrows most of the funds needed to acquire the financed aircraft from the creditors, usually the banks or the leasing companies. The lessor makes an equity investment equal to, say, 20% of the aircraft's original cost, and borrows the remaining 80% by issuing non-recourse notes to the creditors. Then, the lessor will purchase the aircraft from the manufacturer and lease it to the airline lessee under a non-cancelable lease agreement. The lessee has an obligation to make periodic payments to the lessor, who in turn pays the creditors.[40]

Conversely, the creditors receive (1) a mortgage on the aircraft and (2) an assignment of the lease and lease rental payments from the lessor as the security devices. Accordingly, the creditors are entitled to repossess the aircraft in the event of lessee default.[41]

The lessor’s return on investment is encapsulated by the tax benefits associated with ownership of aircraft, including accelerated depreciation write-offs, deduction of interest payments on the bank loan, the investment tax credit[42]

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[39] *Supra* note 17 at 152.

[40] Leveraged Lease online: Allbusiness <http://www.allbusiness.com>.

[41] Leveraged Lease online: Allbusiness <http://www.allbusiness.com>.

[42] An investment tax credit is a reduction in income tax liability granted by the federal government.

for the purchase of the aircraft, and the residual value of the aircraft at the end of lease term.[43]

The airline, as the lessee, enjoys greater access the capital in order to add the new aircraft to its fleet, and is less concerned about their creditors' inordinate benefits enjoyment bestowed by the leveraged lease.[44]

## Section 2: ECAs Financing

### 2.1 Background

Export credit agency (ECA) is an official or quasi-official branch of the government which acts as a finance company for private domestic entities who conduct business abroad. Most industrialized countries have at least one ECA with the responsibilities of providing financial supports, guarantees and insurance covering both commercial and political risks to the exporter of the domestic products. Assistance may be provided through means such as direct credits/finance, refinancing, and interest rate support.[45]

In last two decades, ECA-supported financing has become an important source of aircraft finance.[46] With the financial support of the ECA, airlines can meet their resource requirements with the best overall cost when compared with banks or other similar institutions. The exporters and/or creditors are also able to reduce their risks with the guarantees and insurance from the ECA.[47] Due to its inherent benefits, ECA-supported finance has been developed and adapted in its

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[43] *Supra* note 17 at 154.
[44] *Ibid*.
[45] Export Credit Agency online: Wikipedia <http://www.wikipedia.org>.
[46] Online: Export-Import Bank of the United States <http://www.exim.ogv>.
[47] Mission online: Export-Import Bank of the United States <http://www.exim.ogv>.

structure to functionally support leveraged leases or capital leases in aircraft finance transactions.[48]

The key agencies most usually involved in aircraft finance are the European ECAs - ECGD of the UK, COFACE of France and HERMES of Germany - which support the export of Airbus and European manufactured equipment. Across the Atlantic, there is the Export-Import Bank of the United States (Eximbank), which assists the export of Boeing and US manufactured equipment. [49]

## 2.2 ECA Transaction Structure

Traditionally, ECAs supported airlines by providing direct financial aid in the form of loans to airlines; however, most support now is provided through lease structures with, in many cases, the lessor located in tax-neutral jurisdictions such as the Cayman Islands.[50]This section aims to examine the main structures that widely used in ECAs-supported financing: an ECAs-supported Airbus financing structure and an Eximbank/ECGD structure for Boeing aircraft with Rolls-Royce engines.

### *2.2.1 An ECA-supported Airbus Financing Structure*

The structure of an ECA-supported Airbus financing is relatively simple. The typical structure is illustrated in picture 2. In the Airbus aircraft finance transaction, all three principal ECAs from three main countries[51] engaged in -

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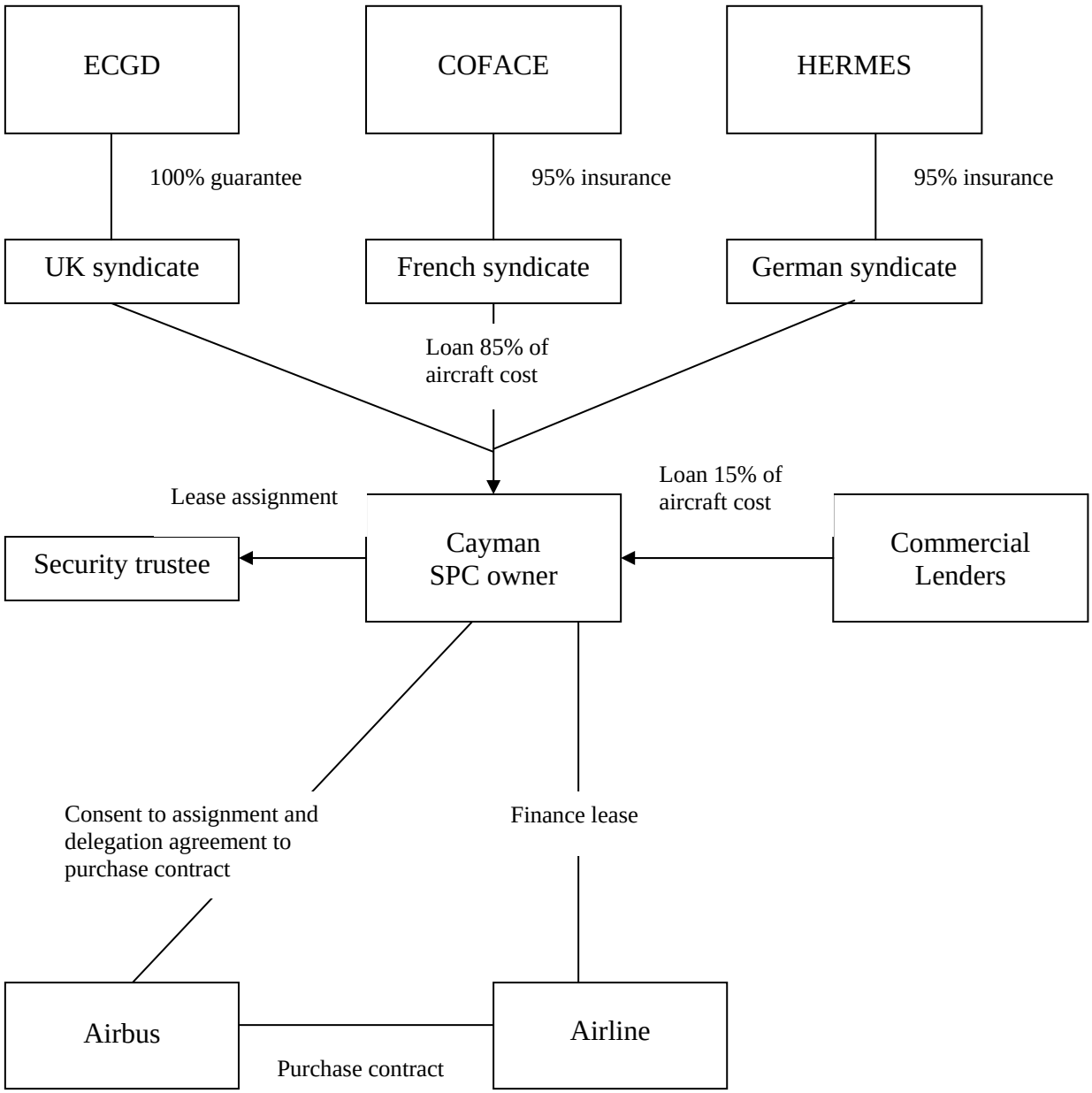
[48] *Supra* note 13 at 324.

[49] R. Murphy, "Export credit agency support" in A. Littlejohns & S. McGairl, ed., *Aircraft Financing* (London: Euromoney Publications, 1998) 47 at 50.

[50] *Ibid.* at 52.

[51] There are French, Germany and the UK respectively.

An ECAs-supported Airbus Financing Structure[52]




[52] *Supra* note 49 at 53.

the manufacture of Airbus aircraft are involved and, normally, represented by a syndicate bank on behalf of each of the respective countries. The percentages of involvement in each syndicate reflect the location where the aircraft manufacturer in question is based. Overall participation will vary by the aircraft chosen, the airline, and the engine used in such aircraft.[53]

The loan agreement between the syndicates and the borrower (the lessor in the lease agreement) will typically be for a single loan, although the funds are provided from three separate syndicates. The support from ECA generally covers 85 percent of the aircraft cost and the other 15 percent will be funded from commercial lenders. The lessor firm will be established for this special purpose and will preferably be located in a tax-neutral jurisdiction.[54] It is generally known as a special purpose company (SPC). This entity *may* be owned by the airline and it will enter into the loan agreement with the lead syndicate banks[55], but more typically, the SPC is owned by an agent appointed by the syndicate banks to enter into a full payout finance lease agreement with the airline.[56]

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[53] For example, if CFM engines are used in the manufacture of the A320, the French element is 49 percent, while the German and UK elements are 31 and 20 percent respectively; if Rolls-Royce engines are used on the same aircraft, the French element falls to 32 percent and the German and UK element increase to 36 and 32 percent respectively.

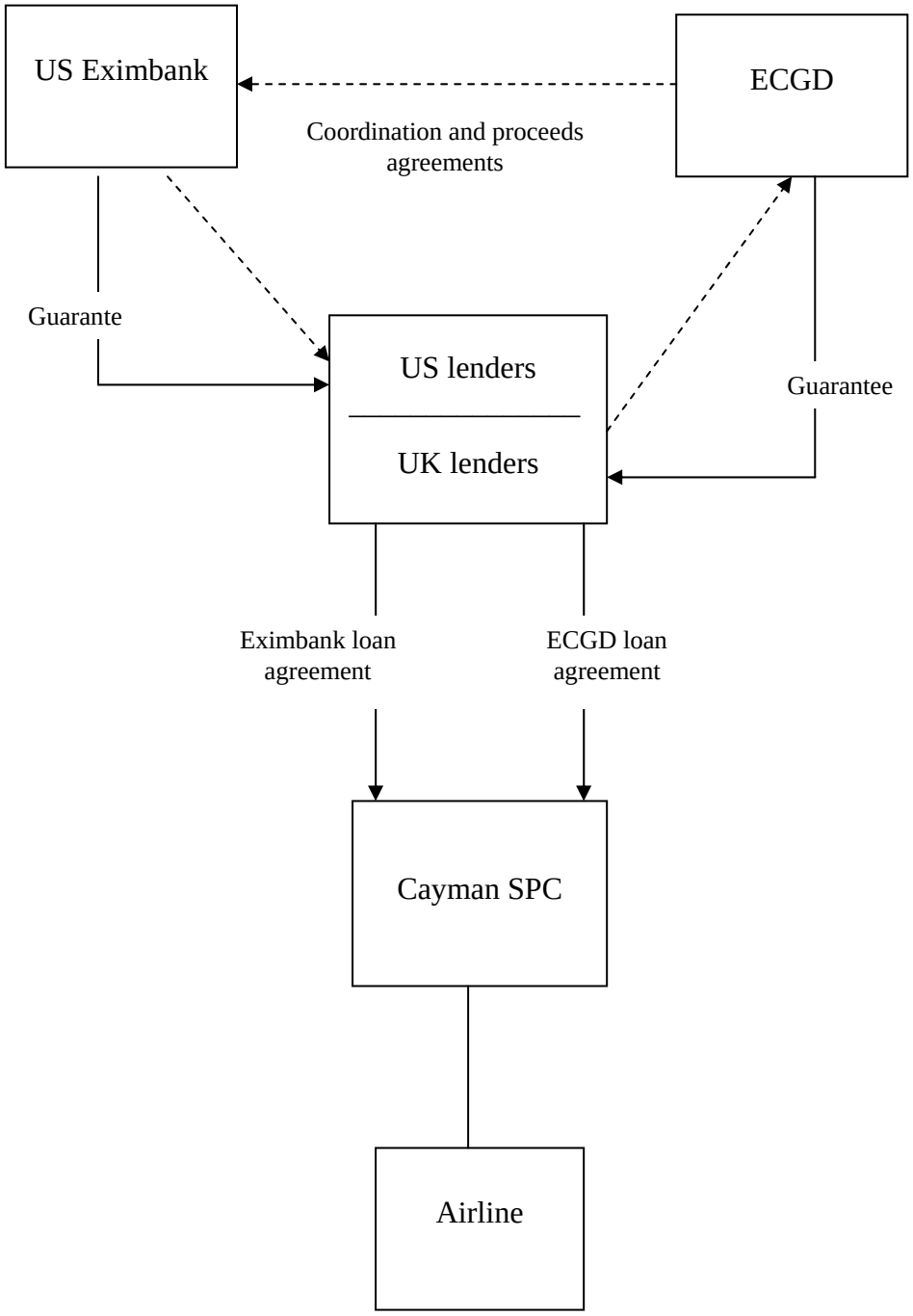
[54] It is, sometimes, will be set up as a GIE in French. However, this option is not preferable because it may cause many problems relating to the withholding tax between French, Germany and the UK.

[55] The banks in each syndicate normally are the British banks for the UK syndicate, the French banks for the French syndicate and the German banks for the German syndicate.

[56] *Supra* note 49 at 53.

*2.2.2 Eximbank/ECGD structure: Boeing aircraft with Rolls-Royce engines*

Eximbank/ECGD structure: Boeing aircraft with Rolls-Royce engines[57]




[57] *Supra* note 49 at 56.

Another broadly used structure is the Eximbank/ECGD-supported finance structure combining corroboration from the Eximbank of the US and the ECGD of the UK. It is applied in cases where a Boeing aircraft is powered with Rolls-Royce engines. For example, Boeing's new 787 DreamLiner is powered with Rolls-Royce's Trent 1000 engines, as illustrated in picture 3.[58]

Unlike the Airbus structure, this transaction is designed around the concept of a separate load. The Eximbank and the ECGD separately provide loans to a special purpose company, with the cost of engines being covered by the ECGD and the cost of aircraft by the Eximbank. The relationship between these two ECAs is governed by the coordination and precedes agreement and each ECA has its own duty to ensure that its supported loan is following its condition and requirements. In this case, the SPC will lease the selected aircraft to the airline in a full payout finance lease.[59]

Obviously, the ECAs have the same risks as the other creditors in the aircraft financing transaction; therefore, securities are required. The securities may be in forms of the pledge of the lessor's shares in a case where the lessor SPC is owned or controlled by the airline, an appropriate third party guarantee (including in some cases, a guarantee from the government of the airline) in the event of the default by the lessee, or an assignment of the right under an insurance contract in respect to the aircraft.[60]

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[58] Civil Aerospace, *Trent 1000*, Online: Rolls-Royce <http://www.rolls-royce.com>.
[59] *Ibid*.
[60] *Ibid.* at 57.

ECA-supported financing plays an increasing role in the aircraft financing industry due to the numerous advantages offered. ECAs facilitate the availability of funds to the airline where such funds would otherwise hardly be available through a traditional commercial loan, grant an enjoyment on a no-cost interest rate option up to three years prior to delivery to the airline particularly in the cases with the European ECAs under their *Large Aircraft Sector Understanding* (LASU) term,[61] and enable the financial institution to achieve a nil weighting in capital in most of the ECA-guaranteed debts.

At present, a major concern of the aircraft financing industry is whether the financing available will meet the needs of the industry. With the attractive benefits, widespread acceptance, and low-cost funding for the airlines, ECA-supported financing is a viable choice for the airline. On the other side, the creditors can enjoy the advantages of the risk-guarantee captured with the enhanced yields that, somehow, hardly exist in another financing structures.

**Section 3: Key Legal Problems in Aircraft Financing**

Having reviewed the typical financing structures utilized by the aircraft industry, it is clear that the creditors' interests are often in an unsecured state. The structures of aircraft financing necessary contain international characteristics, since the creditors in one jurisdiction finance the aircraft to be operated in another. Also, the aircraft itself has unique characteristics in that it may be registered in one country but based and/or operated in another (on a regular basis), and a creditor's interests and rights differ from country to country. This phenomenon

[61] *Supra* note 13 at 322.

creates uncertainty for the creditors who, in turn, will increase the interest rate or require more securities from the airlines.

It has to be noted that the arguments made in this section reflect the creditors' perspective, however they also have a significant impact on other parties' interests.[62]

### 3.1. The Essential Concerns

The following concerns are the most severe problems that essentially need international solutions. The cause of these problems is the absence of unification on secured transaction law governing aircraft financing and the deficiency of national law regarding these matters. Also, most of the uncertainties for the creditor as to whether or not his interests will be protected arise from the following key legal problems.

*a. Non-recognition of the Creditors' title or Security Interest*

The creditors' two basic interests are (a) the ownership interest under a conditional sale or leasing agreement as an owner or lessor, and (b) a security interest under a security agreement as a mortgagee.[63]

In a conditional sale or leasing structure, the creditors have to ensure that their ownership interest is globally recognized and accepted.[64] However, this may be impossible because there is no guarantee that an ownership interest that is

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[62] A. Littlejohns, "Legal issues in aircraft finance" in A. Littlejohns & S. McGairl, ed., *Aircraft Financing* (London: Euromoney Publications, 1998) at 281.
[63] *Ibid*.
[64] A. Djojonegoro, *The UNIDROIT International Aviation Finance Law Reform Project* (LL.M. Thesis, McGill University Institute of Air and Space Law, 2000) [unpublished] at 42.

recognized and accepted in one country will be treated the same in another.[65] The secured transaction law varies from country to country. For example, the conditional sale agreement, the leasing agreement, and the security agreement used are very clear in Europe and Asian jurisdictions that the conditional seller or the creditor lessor has full ownership interest over the aircraft object; however, this same concept does not apply in North American situations. The above agreements are not clearly divided. Mainly, these agreements are treated as forms of security and the conditional seller or the lessor's interest is treated as a security interest.[66] Thus, the recognition of the creditors' title or interest is hardly the same in different nations.

*b. The Differences in Forms of Security Interest and their Ranking*

As explained above, different nations have different legal systems. In this security structure, the creditors may find themselves in a situation where their interests under a mortgage agreement are not recognized in the state where the aircraft is operated.[67] In Brazil, Chile, South Korea and the Scandinavia jurisdiction, the mortgage agreement is recognized under specific conditions. The examples of these conditions include the requirement that the agreement is in a certain form and language and that it must comply with the respective local law. By contrast, in the Belgium jurisdiction, the aircraft mortgage agreement is not recognized by the local law at all and it is not accepted as a valid type of security.

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[65] *Supra* note 9 at 646.
[66] *Supra* note 6 at 10.
[67] *Supra* note 3 at 94.

Therefore, in such circumstances, the lawyer has to use different forms of security (i.e. pledge).[68]

Across jurisdictions, the ownership interest is not similarly recognized, and the priority ranking varies from jurisdiction to jurisdiction as well. Accordingly, creditors have to ensure that their acquired security interests are truly valid first priority ranking under a local law.[69]

*c. Repossession Risks*

In the event of default by the debtor or the lessee, the repossession of the aircraft object is one of the default remedies for the creditors. However, in some countries with unstable political situations or where they lack of well-mannered commercial law, the creditors' repossession right can be at risk.[70] Also, assuming that there is no such risk, the legal procedures in some countries may be ineffective and it may be delayed by the cumbersome administrative requirements. The worst case could be that the creditors' repossession right is deprived by the authority where the aircraft is registered.[71] Generally, the creditors calculate these risks into the cost of the aircraft and, in some circumstances, require the government guarantee over the transaction.

*d. The Deficiency of Bankruptcy Law*

In the event of insolvency by the debtor, there are several remedies that are available for the creditors. However, especially in civil law jurisdictions, leave of

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[68] *Supra* note 62 at 281.
[69] *Supra* note 64 at 42.
[70] *Ibid*.
[71] *Ibid.* at 45.

the court is required before the creditors can exercise their rights.[72] Bankruptcy proceedings in court can be very slow, and it may take *years* to settle a dispute. During this time, the risks associated with the aircraft object are calculated into the aircraft financing transaction cost which the debtor is directly affected.[73]

Since most airlines are owned or subsidized by their governments, the bankruptcy administrators may grant preferential treatment to the debtor or other creditors located in their jurisdictions, i.e. such creditors' interests may be given higher priority over others.[74]

However, this does not happen in every jurisdiction. The US Bankruptcy Code Section 1110 is a good example, as it adequately protects the rights of the owner and the creditors. Under Chapter 11, a bankruptcy court will supervise the "reorganization" of the debtor, which begins with an evaluation of the possibility of the debtor being able to stay in business, given its contractual and debt obligations. This Section is intended to prevent the bankruptcy court from unnecessarily meddling with the rights of the owner and the creditors under the security agreement, the conditional sale agreement, and the lease agreement. Still, not every Bankruptcy law is equivalent to the US's.

### 3.2. The General Concerns

The following risks are also vital. However, they arise only in some circumstances and the aircraft financiers are able to control them by negotiation or stipulation of the clauses in aircraft financing agreement.

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[72] *Supra* note 62 at 298.
[73] N.B. Cohen, "Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience" (1999) 20 U. Pa. J. Int'l Econ. L. at 423.
[74] *Supra* note 62 at 298.

*a. Lack of Registry Authority*

Assuming that the security or ownership interest is recognized, the next obstacle for creditors is the lack of an authoritative registration system. There is no guarantee whether the recognized aircraft mortgage can be recorded in a local authority in the state of registration. For example, in Australia, one does not have the registry authority specifying for the security interest retained in aircraft.[75] Thus, even though the creditors' interest is recognized, it may not be effectively enforced in the event of default by the debtor.

*b. Deregistration Risks*

Under Article 17 of the Chicago Convention 1944, an aircraft can have only one nationality in which they are registered; in other words, an aircraft cannot be validly registered in more than one country.[76] However, Article 18 allows that the nationality of an aircraft can be changed. The way to do so is by deregistration from one state and then re-registration in another. Accordingly, the creditor is allowed to deregister the aircraft from the debtor's state and re-register it in the creditor's state in the event of the default by the debtor or debtor's insolvency.

Arguably, there is no guarantee whether the local law governing aircraft deregistration state is well organized enough. The delay of deregistration process would render the aircraft unmarketable.[77]

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[75] *Supra* note 1 at 10.
[76] The Convention on International Civil Aviation (Chicago Convention1944) Article 18
[77] *Supra* note 64 at 45.

*c. Conflict of Law*

Unsurprisingly, conflicting laws across jurisdictions is one of the most significant issues in cross-border aircraft financing transactions. [78] There are diverse systems of law involved in cross-border transactions. The parties may choose to enforce a specific legal regime: *lex loci contractus* (the law in the jurisdiction where the contract was made), *lex loci solutionis* (the law in the jurisdiction where the contract is to be performed), or *lex rei sitae* (the law in the jurisdiction where the property is situated) as the Governing Law. Also, it is possible for contracting parties to adopt a *lex fori* approach, whereby the court will choose the law to be applicable to the proceedings and their legal and procedural consequences.[79]

The very nature of an aircraft (as a highly moveable object that flies to numerous jurisdictions) is a concern to creditors, and all involved parties must be keenly aware of the complications that it creates when contemplating an international financing transaction.

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[78] *Ibid.* at 47.

[79] For more details regarding the Latin legal phases, please see *Black's Law Dictionary* 7th ed., *s.v. "lex loci contractus", "lex loci solutionis", "lex rei sitae"*, and "*lex fori*"

**Chapter Summary**

The above circumstance of uncertainty could be avoided if there were more uniformity of secured transaction law across jurisdictions. The creditors assume a significant risk about whether their interests will be protected in other jurisdictions. The consequence is that the creditors calculate these risks in to the cost of the transaction, require greater security, and/or ask for more guarantees. Time will be wasted, money will be spent, and human resources will be needed to coordinate these efforts.

As long as people need to travel from one place to another, new models of aircraft with more fuel-efficient engines are needed, especially as fuel prices continue to increase. If this problem is not solved, it will impede the growth of the aviation industry around the world and passengers will be directly affected due to the increase of travel cost. The aviation professionals and lawyers are aware of the upcoming difficulty; therefore they have been trying to find effective ways to deal with the problem. The Cape Town Convention is expected to be one of their answers.

# The Cape Town Convention and Aircraft Protocol

## Chapter Introduction

In the early 1990's,[80] UNIDROIT initiated discussions around the creation of new legal framework dealing with security interests in mobile equipment, to be referred to as the Convention on International Interests in Mobile Equipment (the Convention) and an implementing protocol on Matters specific to Aircraft Equipment (the Protocol). These frameworks have been modified and improved through the cooperative work of UNIDROIT and the ICAO, and two non-governmental bodies representing the aviation industry, the IATA and the Aviation Working Group (AWG).[81] Consequently, the Convention has been considered and discussed by experts worldwide since its initial presentation.

The Convention is written in general terms to deal with commercial transactions involving mobile equipment, and the Protocol is specific to aircraft transactions. The Convention and the Protocol should be read and interpreted as a single instrument; however, if there is any inconsistency, the Protocol prevails.[82] There is also a "Consolidated Text" (which is an officially authorized consolidation of the texts of the Convention and Protocol), and it is a helpful tool that is broadly used in practice. The Convention and the Aircraft Protocol center on the significant aspects of buying, selling, leasing, and financing aircraft and engines, including issues relating to the concept of "international interests" in aircraft objects and associated rights, default remedies and insolvency, aircraft deregistration, priority, and international registry systems.

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[80] L. Weber, "Recent Developments in International Air Law", (2004) 29 *Air & Space L.* at 287.
[81] *Supra* note 5 at 463.
[82] Article 6.

This Chapter aims to analyze the core of the Convention and examine whether the Convention and the Protocol generally solve the long-existed problems of aircraft financing transaction as pointed out in Chapter 1. Also, it will examine whether the Convention and the Protocol create a clear rule governing aircraft financing as it promises in the Preamble. This Chapter will be divided into five parts which are the heart of the Convention: international interest, default remedy, international registration system, priority and assignment. The sets of international interest are the newly created tool used to solve the problem of non-recognition of the creditors' titles and the differences in forms of security interest. Their effectiveness is ensured by the system of International Registry. The International Registry functions as a registration center for the aircraft object and the international interest attached to such aircraft. The Convention also provides the regulations of competing interests in order to internationally protect the creditors' priority ranking. Moreover, the expeditious remedy in the events of default by the debtor is guaranteed under the Convention regime through the use of the self-help system and the limited timeline regarding insolvency matters. Last but not least, the assignment and its associated right also enjoy the same protection as the international interest conferred by the Convention legal framework.

It has been two years,[83] however, since the Convention came into force and the aviation industry is still waiting for their expectations to become reality. As a result, numerous criticisms are discussed as to why the Convention may not help in solving all of these problems. Therefore, each part of this chapter will

[83] The Cape Town Convention came into force 1 March 2006 online: UNIDROIT <http://www.unidroit.org>.

bring out the weaknesses of the Convention and the Protocol that lead to the criticism of whether the Convention and the Protocol could reach their goal and deliver the economic benefits to the aviation industry.

There are several weaknesses arising from the Convention. They include the political interference that could impede the transactions, the default remedy that could not be as speedy as it promises, the relevant documents that are still as lengthy and detailed as before and the unreliable priority ranking due to the exception of 'non-consensual right'. Moreover, there are concerns on the vague definition of 'default' coupled with the unclear terminology of 'commercially reasonable' and the disunity among the Contracting States caused by the opt-in and opt-out system. Also, this Chapter will examine the conflict between the Contracting State and non-Contracting State regarding the implication of the registration of international interest. In this section, Thai domestic law will be examined as the case study of how the conflict could arise. Last but not least, this Chapter will show the difficulties due to the absence of worldwide acceptance regarding the self-help remedy, registration system, and insolvency provisions. These criticisms will be analyzed in detail in Chapter 3.

It has to be noted at the outset that references in this thesis to "Articles" are to Articles of the Consolidated Text.

**Section 1: Creation of International Interest**

The creditors' title or security interest is tied to the local legislation; therefore their interest is not universally recognized across different jurisdictions. The creditors' main concern is whether their title or security interest (which is recognized and protected in one state) will be treated the same in another due to

the differences in legal systems and, in some cases, the inadequate and/or inefficient nature of some foreign legal systems. Obviously, it is impossible to change all secured transaction legislation in every jurisdiction, so the Convention purports to resolve the problem by creating five different categories of international interest, and provides protections and ensures their effective enforcement. These international interests will be treated the same among all Contracting States.

### 1.1 Interests in Aircraft Objects

There are five categories of interests which may be the subject of protection: the international interests, prospective international interest, national interest, registrable non-consensual right or interest arising under national law and non-consensual right or interest which is given priority without registration.

With respect to each interest, a "creditor" is the person who has the benefit of the interest.[84] A "debtor" is the person who either created the interest or the person who takes the aircraft object to the interest of the creditor or the person with the primary responsibility for payment of the debt secured by a lien.[85]

#### *1.1.1. International interest*

The first type is the 'interest in an aircraft object granted by the chargor under a security agreement'. In effect, the security interest of the aircraft object will be held by a chargee, with typical examples of security agreements being a mortgage or charge.

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[84] For example, a lessor, seller under a conditional sale agreement, chargee under a security agreement or the beneficiary of a lien (Article 1 (q))

[85] For example, a chargor under the security agreement, the purchaser under a conditional sale agreement or a lessee (Article 1 (r))

The second type is the ‘interest vested in a person who is the conditional seller under a title reservation agreement’. In effect, the ownership interest of the aircraft object will be held by the conditional seller. A conditional sale agreement can be described as the sale agreement between a buyer and seller such that the buyer is entitled to possession and use of an aircraft before the purchase price is fully paid, during which time the legal title of the aircraft is retained by the seller. The transfer of ownership is made subject to payment of the full purchase price.

The third type is the ‘interest vested in a lessor under a leasing agreement’. In effect, the lessor’s security interest in the aircraft object is subject to the leasing agreement. This interest does not need to be an ownership interest but can be the interest of a sub-lessor under a sub-lease agreement.

*1.1.2. Prospective International Interest*

The prospective international interest is the interest that has not yet become an actual international interest. Professor Sir Roy Goode gives the example of the prospective international interest in the following passage:

> *“The prospective international interest will be constituted in the case of, for example, the terms of a security agreement are still being negotiated or the prospective debtor who has not yet acquired an interest in the aircraft to be charged.”*[86]

For the purpose of ranking priority, the Convention ensures that the creditor’s future interest will be protected. Accordingly, the Convention states that a prospective international interest may be registered in the International Registry as well as an actual international interest. This does not have any legal effect, however, until a registered prospective international interest becomes an actual

[86] *Supra* note 6 at 9.

international interest. The legal effect of becoming an actual international interest is that its ranking priority is effectively backdated to the time of registration of the prospective international interest.[87]

The Protocol extends the application of the Convention to sales and prospective sales of aircraft objects[88] and specifies the provisions of the Convention that are to apply to these transactions, and how such provisions are to be read in the context of a sale or prospective sale.[89] It has to be noted that, in a prospective sale agreement, the debtor is the seller and the creditor is the purchaser. Accordingly, it is the seller that must be located in a Contracting State in order for the Convention and Protocol to apply to the transaction.

*1.1.3. National Interest*

This interest is an interest held by a creditor in an aircraft object that is created by an internal transaction and registered under a national registration system in respect of a declaration made by a Contracting State[90] to the effect that the Convention shall not apply to an internal transaction.

An internal transaction is a transaction between a debtor and a creditor where both reside in the same Contracting State. Also, at the time that the national interest is created, an aircraft object must be located in the same Contracting State where such creditor's interest has been registered in the appropriate national registry of the relevant Contracting State.[91]

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[87] *Ibid*
[88] Article 6
[89] *Supra* note 6 at 183.
[90] The declaration made under Article 66(1)
[91] P. Thorn, "The Cape Town Convention- Its Impact in Relation to Interests in Aircraft Object", online: Norton Rose <http://www.nortonrose.con> at 6.

The national interest cannot be registered as an international interest, notice of it can be registered in the International Registry, thereby securing its priority in the same way as if it were a registered international interest.[92] Hence, it is important to register even national interests, for the purpose of ensuring priority of the national interest over international interests subsequently registered.

*1.1.4. Registrable Non-Consensual Right or Interest arising under National Law*

A non-consensual right or interest arising under the law of a Contracting State that has made a declaration[93] listing such right or interest is registrable in the International Registry under the Convention. When such right or interest is registered, then it is treated as a registered international interest and that interest will have ranking priority from the date of registration. An example of such a right or interest might be a judgment or an order affecting an aircraft object or a repair or mechanics lien granted by law. [94]

*1.1.5. Non-Consensual Right or Interest which is given Priority without Registration*

These rights or interests are conferred under the law of a Contracting State on the provider of a public service to secure the performance of an obligation where the Contracting State has made a declaration[95] specifying that such rights or interest should have priority over any registered international interest, even though

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[92] *Supra* note 6 at 9.
[93] The declaration made under Article 53
[94] *Supra* note 6 at 9.
[95] The declaration made under Article 52

the right or interest may not itself be registered. An example of such a right or interest might be a lien for unpaid air navigation charges.[96]

### 1.2 Creation of the International Interest

There are several conditions that must be fulfilled in order to create or provide an international interest, as discussed below. First, the agreement between the creditor and the debtor must fall within one of four categories: a security agreement, a conditional sale agreement, a lease or sub-lease agreement[97], or a sales contract of an aircraft object[98].

Second, the aircraft object must fall within the definitions of one of three aircraft object types, as stated in the Convention: airframe, aircraft engine, or helicopter.[99] For most aircraft, helicopters or engines used in commercial operations, this will be true. Third, the debtor must be situated in a Contracting State at the time of conclusion of the agreement.[100] Another condition is that the creditor does not need to be located in a Contracting State and the debtor only needs to be located in a Contracting State at the time of the conclusion of the relevant agreement.

Regarding the requirements of the agreement, it must be expressed in writing and it must relate to an aircraft object over which the chargor, conditional seller, or lessor has power of disposal Also, it must enable the object to be identified by references to the name of the manufacturer (e.g., Boeing/Airbus), its model of

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[96] *Supra* note 6 at 9.
[97] Article 2.
[98] Article 6.
[99] Regarding the aircraft, it can carry at least 8 persons or goods in excess of 2750 kilograms when appropriate aircraft engines are installed thereon.
[100] The location of the debtor includes its registered office, administration centre, or principle place of business.

designation (e.g., 747-400 or A340-500) and the manufacturer's serial number. If the above conditions are satisfied then an international interest over an aircraft object will be created, even if not registered.

When the State ratifies the Cape Town Convention, the International Interest concept will become part of its local legislation. The result is that the financier's title or security interest is recognized and receives the same treatment among Contracting States. The drafters of the Convention believe that the creation of international interests and their associated rights will facilitate aircraft transactions and make life easier for the parties involved in such transactions.

**The Concern regarding the inefficiency of the Cape Town Convention**

However, the question is whether the Convention can solve the problems of ineffective and inefficient legislation in the blacklisted jurisdictions. Modifying and strengthening their legislation related to secured transactions, reducing the administrative procedures, and speeding-up the default remedy process so as to reflect the provisions of the Convention does not guarantee that the corruption (as well as the political interference) that impede commercial transactions will be resolved. In those blacklisted jurisdictions, these problems still exist and result in uncertainties for creditors.[101] For example, the process of aircraft repossession deregistration procedures may be delayed.

[101] B.J.H. Crans, "Analyzing the Merits of the Proposed UNIDROIT Convention on International Interests in Mobile equipment and the Aircraft Equipment Protocol on the Basis of a Fictional Scenario" (2000) 25 Air & Space L. at 51.

## Section 2: Default Remedies

Aircraft financing creditors have long faced problems with inadequate and unenforceable default remedies, since their businesses essentially depends on their ability to exercise a default remedy expeditiously in the case of non-payment.[102] Moreover, when the debtor is in a jurisdiction plagued by political instability, uncertain legal systems, and/or unreasonable administrative procedures, the creditors' rights to default remedies may be severely limited. It may take years for the court to settle a dispute, and even longer before the remedy is enacted. To alleviate these uncertainties, the Convention and Protocol require that creditors holding an international interest exercise certain agreed upon remedies in the event of a debtor's default.

### 2.1. Definition

A strict definition of default may lead to the problems of interpretation, so the Convention and the Protocol allow for the definition of terms to be determined by the parties.

Regarding *default*, the remedies are usually triggered by the occurrence of a "default", which is given a specific meaning by Article 17. In most cases it is left to the debtor and the creditor to decide what constitutes a default, and it will clearly be advisable in leases, conditional sale agreements, or mortgages for there to be a specific clause; in other words, the agreement itself will specify the "events of default" which will attract the remedies.

In the unusual case where the agreement does not specify the default or other events giving rise to remedies, Article 17 vaguely defines a default as the

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[102] *Supra* note 6 at 13.

event which substantially deprives the creditor of what he or she is entitled to expect under the agreement constituting the international interest. What the creditor is entitled to expect under the agreement is to be determined at the time the agreement is concluded, and not in light of subsequent events.[103]

Regarding *commercially reasonable*, article 19 establishes a standard for the exercise of remedies given by the Convention and Protocol, in that they must be exercised in a commercially reasonable manner. As long as the relevant provision is not manifestly unreasonable, exercise of remedies, in accordance with a provision of the applicable security agreement, lease or title reservation agreement, is deemed to be commercially reasonable. [104] The Convention does, of course, entitle the creditor to exercise any reasonable contractual provision in an international aircraft finance and leasing contract.

**The Concern regarding vague definition and unclear terminology**

Several criticisms have been voiced with regard to these provisions.[105] In respecting the freedom of contract principle, the Convention allows the parties to define 'default' according to the underlying goals and intentions of the parties. While the intention of the Convention drafters was good, such a provision is vague (to say the least), and in reality, no aircraft creditor would wish to rely on this provision alone. Another criticism is that the Convention uses unclear terminology such as 'commercially reasonable'. This may undermine the position of both the creditor and the debtor because either of them can easily prolong the

[103] *Supra* note 6 at 76.
[104] *Ibid.* at 71.
[105] *Supra* note 101 at 51 and *supra* note 91 at 11.

default remedy process by claiming that such a delay is still 'commercially reasonable'. Last but not least, it may be argued that by using vague terminology in the Convention, the aircraft financing documents will need to be complex, increasing the overall cost of the transaction.[106]

**2.2. Specific Enforcement Remedies**

Specific enforcement remedies are provided for in the Convention and Protocol depending on the category into which the enforcing creditor falls. The remedies available to a chargee under a security agreement are specified in Articles 12 and 13 and those available to a conditional seller or lessor are specified in Article 14.

*a. Remedies for chargees under security agreement.*

The Convention empowers the chargee, in the event of a default by the chargor, the right to (1) take possession or control of the charged aircraft object, (2) sell or lease the charged aircraft object, and (3) collect or receive any income or profits derived from management or use of the charged aircraft object.[107]

On the other hand, the chargee has an obligation to provide written notice to all "interested persons" regarding any proposed sale or lease of the charged aircraft object within a reasonable time prior to the sale or lease.[108] Accordingly, the interested persons are the debtor, any guarantor and any other person having rights in or over the charged aircraft object, who has given notice to the chargee of

[106] S. McGairl, "The proposed UNIDROIT Convention: international law for asset finance (aircraft)" (1999) 4 Unif. L. Rev. 439 at 459.
[107] Article 12
[108] Article 12 (3)

such rights.[109] Any notification must be reasonable prior written notice and, for this purpose, when a longer period has not been agreed to between the parties, at lease ten working days notice will be deemed reasonable.[110]

*b. Remedies for conditional seller or lessor*

The Convention contains the specific remedy available to a conditional seller or lessor. A conditional seller or lessor has, in the event of default under a title reservation agreement or a leasing agreement, the right to terminate the relevant agreement and repossess the relevant aircraft object.

The possession is only an extra-judicial (or self-help) right, unless the Contracting State has made a declaration at the time of ratifying the Protocol that leave of the court is required. [111] The conditional seller or the lessor may also apply to the court for an order for termination or repossession should he or she so wish.[112]

**The Concern regarding the concept of self-help remedy**

The concept of 'self-help' remedies typically applies in the UK or the US, both of which are Common law countries. This concept typically does not exist in Civil law jurisdictions[113], and it can be argued that there might be the substantial conflicts between the Convention and Civil law systems. The civil law countries might prefer to make a declaration to opt-out of the extra-judicial provision, with

[109] Article 1 (z) (i), (ii), and (iii).
[110] Article 12 (4).
[111] Article 14 (a) and Article 70 (2)
[112] Article 14 (b).
[113] R. Goode, "The preliminary draft UNIDROIT Convention on International Interests in Mobile Equipment: the next stage" (1999) 4 Unif. L. Rev. 265 at 269.

the effect that creditors would still need a court order to repossess the aircraft object.[114]

### 2.3. Remedy of Deregistration

The Chicago Convention 1944 prohibits an aircraft from being registered in more than one state at a time; in other words, an aircraft cannot have two different nationalities.[115] Therefore, on enforcement by a creditor, the relevant aircraft object will need to be deregistered from the nationality in which it has been registered by the debtor; however, the local government may not be willing to cooperate with the deregistration of aircraft registered in its nationality to a foreign creditor. In some jurisdictions, the deregistration procedures - the submission of deregistration forms and waiting until the form is approved by the local authority - may take several months, due to the unreliable processes which are often corrupted by political interference.[116]

Accordingly, the Convention and the Protocol prescribe the right of the creditor to deregister, export, and transfer an aircraft object from wherever it is located.[117] The specific forms of deregistration and export request authorization is set out in Article 25 and the form can be seen in the Annex to the Consolidated Text.[118]

The expeditious cooperation and assistance of the relevant registry authorities is required in the exercise of this remedies.[119] There is a time limit for

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[114] *Supra* note 9 at 649.
[115] Convention on International Civil Aviation (Chicago Convention 1944) Article 18
[116] *Supra* note 101 at 51.
[117] Article 15
[118] The form is called “Form of Irrevocable De-registration and Export Request Authorization”.
[119] Article 25 (4)

the registry authority to make these remedies available[120] – no more than five working days may elapse between the notification by the creditor that relief has been granted and when the creditor is entitled to exercise the relevant remedies.[121] Similarly, in cases where a foreign court has granted relief, the local court (in the Contracting State) must recognize that foreign judgment within five working days.

**The Concern regarding deregistration remedy**

With regarding to the deregistration remedy, the Convention enables the lessor to deregister the aircraft object and physically export it from the country where the aircraft is registered; however, the effectiveness of this remedy is questionable where an aircraft object is registered in a Non-Contracting State and the creditor is located in a Contracting State. Obviously, if the aircraft is not registered in the Contracting State, the deregistration procedure and the physical export are subject to the national rules and regulations of the State where the local deregistered regulations do not reflect the provisions of the Convention.

Furthermore, while deregistration of the aircraft object is governed by the Convention, there are other local requirements that may impede the deregistration and export procedures. For example, there may be approvals required by the local aviation authority, or there may be outstanding deregistration tax issues that need to be settled by the court.

**2.4. Interim Relief** *(Relief pending final determination of a claim)*

Court processes are typically very slow, and a court may take years to carry out hearings on a dispute between a creditor and a debtor over the creditor's

[120] Article 20 (7)
[121] Article 20 (7) (a)

right to exercise a default remedy. In the interim, the risk of loss or deterioration of the aircraft object remains with the creditor and such delays will influence the evaluation of the risk by a prospective creditor. Normally, the creditor calculates this risk into the aircraft financing transaction costs, which will directly affect the debtor. Thus, the Convention ensures the creditor the right to exercise interim relief during the settlement of dispute. There are two conditions the creditor must meet[122] and after these conditions are approved by the court, the relief will be granted in the form of a court order.[123]

However, the application of this provision is subject to an affirmative declaration made by a Contracting State at the time of ratification of the Convention and Protocol.[124]

**2.5. Remedies on Insolvency**

The inconsistent nature of insolvency law across national borders has long been a problem for creditors, in the event of a debtor's insolvency. The creditors require (among other things) a protection system that is equivalent to that afforded by Section 1110 of the US Bankruptcy Code. This requirement will often be a condition in the financing agreement, particularly in highly structured financial arrangements such as an enhanced equipment trust certificate (EETC structure). Therefore, the Convention and Protocol contain provisions which, arguably, meet the creditors' satisfaction.

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[122] Article 20 (1)

[123] Article 20 (1). The Convention and Protocol specify five categories of interim relief for the creditor These categories are: (a) preservation of the aircraft object and its value (e.g., storage); (b) granting of possession or custody of the aircraft object to the creditor; (c) immobilization of the aircraft object; (d) leasing out of the aircraft object or management of the aircraft object and its income; and (e) selling of the object and application of its proceeds pursuant to an agreement between the creditor and the debtor.

[124] Article 20 (10) and Article 71 (2)

Article 23 outlines the remedy for insolvency and introduces two alternative procedures - Alternative A (the "hard" alternative) and Alternative B (the "soft" alternative) - aiming to provide greater certainty in the protection and enforcement of the creditors' rights, notwithstanding the national insolvency laws of the relevant Contracting State. To apply the insolvency remedy provisions, the Contracting State has several options subject to a declaration made at the time of ratification of the Convention.[125]

First, the Contracting State may decide to make no declaration at all; in other words, the Contracting State may choose to opt-out of the insolvency remedy provisions. In this case, the result is that the national insolvency law applies. Second, the Contracting State may choose to opt-in. Once the Contracting State has decided to opt-in to the insolvency remedy provisions, it has to make a declaration as to whether Alternative A or Alternative B will be applied to the insolvency proceedings. The essentials of the two alternatives are described below.

*a. Alternative A*

Alternative A requires that the insolvency administrator of the debtor (or the debtor itself) give the possession of the aircraft object to the creditor before the conclusion of "the waiting period" as specified in the declaration made by the relevant Contracting State.[126]

The insolvency administrator or the debtor has an obligation to preserve the aircraft object and maintain it and its value in accordance with the agreement (i.e., relevant leasing agreement, security agreement or title retention agreement

[125] Article 71 (3).
[126] Article 23 Alternative A (2).

from which the creditor derives its international interest from). Under Alternative A, the creditor is also entitled to apply for any other forms of self-help remedies available under applicable law.[127]

In the event that the insolvency administrator or debtor has, no later than the end of "the waiting period", cured all defaults (other than the default which constituted from the commencement of the insolvency process which, of course, is not capable of being cured[128]) and agreed to perform all future obligations under the agreement, the insolvency administrator or debtor may retain possession of the aircraft object.[129]

*b. Alternative B*

Alternative B requires the insolvency administrator or the debtor, upon the request of the creditor, to give notice to the creditor, within a specific time specified in a declaration made by the Contracting State[130], whether it will (a) cure all defaults (other than the default which constituted from the commencement of the insolvency process) and agree to perform all future obligations under the agreement; or (b) give the creditor the opportunity to take possession of the aircraft object, in accordance with the applicable law.[131]

If the insolvency administrator or the debtor does not give such notice, the court may permit the creditor to take possession of the aircraft object by such

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[127] Article 23 Alternative A (5).
[128] *Supra* note 6 at 200.
[129] Article 23 Alternative A (7).
[130] Article 71 (3).
[131] Article 23 Alternative B (2).

terms as the court may order, and may require the taking of any additional steps or the provisions of any additional guarantee.[132]

According to the declaration made by the Contracting State, clearly Alternative A is to be preferred to Alternative B as it enables the creditor to seek and receive more satisfactory remedies without the need for court approval.[133]

**The Concern regarding insolvency remedy**

There is some criticism as to whether the remedies for insolvency provisions will effectively function.[134] In instances where the bankrupt debtor is not located in a Contracting State, the insolvency remedies for the creditor are subject to the national regulations. In this scenario, the Convention does not apply, and the insolvency remedy provisions are not available; the creditors' interest in this scenario is likely to be risky in these jurisdictions.

**2.6 Opting-In and Opting-Out**

As may be apparent from the above discussion, the Convention and Protocol provide a system of declarations allowing the Contracting States to make choices when ratifying the Convention about which parts of the Convention and Protocol will be applied within that jurisdiction. Some provisions in the Convention and Protocol may be "opted out of" (or not applied in a particular jurisdiction), while others may require an explicit "opt-in" to be effective.

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[132] Article 23 Alternative B (5).

[133] A. Saunders, A. Srinivasan & I. Walter, *Innovation in International Law and Global Finance: Estimating the Financial Impact of the Cape Town Convention*, online: UNIDROIT <http://www.unidriot.com> at 5 and Declarations deposited under the Cape Town Convention on International Interests in Mobile Equipment regarding Article XXX(3).

[134] *Supra* note 9 at 654.

In the case of an opt-out provision, the provisions in the Convention and Protocol will apply unless the Contracting State makes a declaration to opt-out of such provisions.[135] In the case of an opt-in, the provisions will only apply if the Contracting State makes an explicit declaration to opt-in to such provisions.[136]

The declarations made by a Contracting States will depend on the policy decisions made by the States.[137] Therefore, it is essential for the Contracting State to verify its chosen option as this will have a material impact on the rights and security of the relevant parties, and may also have implications on the forms and other documentation utilized in aircraft transactions.

**The Concern regarding the Opting-in and Opting-out options**

Self-help remedies support the goal of the Convention by facilitating speedy repossessions for creditors, but if the Contracting State declares to opt-out of the Convention[138], the result is that the self-help remedy is not available and repossession may be exercised only with leave of the court. [139] Thus, it can be argued that if leave of the court were required for the remedies to be exercised, the "speedy remedies" that the Convention promised would be in doubt.

Another primary purpose of the Convention is to unify the secured transaction law governing aircraft financing transactions; however, the Opt-in and Opt-out provisions create an environment of non-unification and potential disagreements among the Contracting States. The creditors must still concern

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[135] The opt-out provisions are Article 70 (1) – preventing lease as remedy, Article 70 (2) – extra-judicial remedies, Article 71 (2) – interim relief, and Article 66 (1) – the application of the Convention to internal transactions.

[136] The opt-in provisions are Article 52 (1) – non-consensual rights and interests which have priority without registration, Article 53 – registrable non-consensual rights or interest, and Article 76 - the application of the Convention's priority rules to pre-existing rights or interest.

[137] *Supra* note 6 at 28.

[138] Article 71 (2)

[139] *Supra* note 101 at 53.

themselves with the particularities of doing business with a party in a foreign Contracting State. Therefore, it can be argued that the creditors' interest, still, is different among Contracting States.

**Section 3: The International Registration System.**

In many cases, aircraft financiers have found that while the aircraft itself may be registered, their security interest retained in such aircraft cannot. This problem arises simply because there is a lack of aircraft security registers in several jurisdictions.[140] Accordingly, the Convention and the Protocol create a set of internationally recognized interests and ensures their value by establishing the International Registry for the tracking of such interests.

The International Registry is a computer-based system which operates 24 hours a day, 7 days a week.[141] The registration is electronic, simple, inexpensive, and available on-line without human intervention. The Convention and the Protocol allow the creditors to register their international interest online directly with the IR without any paper documentation requirements. Also, registered interests may be searched via the Internet by any person from anywhere in the world.[142]

**3.1 The international Registry**

Registration of an international interest with the International Registry serves as a creditor's "public notice" of the international interest held in the

[140] The example is the Australia jurisdiction where it has the register section for the aircraft but it lacks the register section for the security interest retained in such aircraft.
[141] Article 30
[142] Article 35

aircraft object, and establishes creditor ranking priorities - an essential element in the context the recognition of rights over such aircraft.

The Convention and Protocol establish specific types of international interests that can be registered with the International Registry. There are five categories of the registrable international interests.[143] The International Registry is established not only for the registration of international interests, but also for the amendment, extension or discharge of the registrable international interests.[144]

Creditors who have interests in existing and identified aircraft objects (for which financing transactions are still being negotiated) are able to register their prospective international interests with the International Registry. The legal effect is that when these prospective international interests become actual international interests, their priority ranking will be considered from the time of the registration of the prospective international interest.[145] No further registration will be required as long as the registration information provided initially is sufficient for registration of an international interest.[146]

National interests also could be registered in the registration system for the purpose of giving notice to relevant parties.[147] The legal effect of registering such notice is that it will give the national interest the same priority as if it were a registered international interest. Therefore, the relevant parties in the national

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[143] The first category includes international interests, prospective international interests and registrable non-consensual rights and interests. The second category includes assignments and prospective assignment of international interests. The third category includes the acquisitions of international interests by legal or contractual subrogations under the applicable law. The fourth category includes notices of national interests. Finally, the fifth category includes subordinations of interests referred to in any of the preceding sub-paragraphs. (Article 26 (1))

[144] Article 26 (2)

[145] Article 32 (4)

[146] Article 31 (3)

[147] Article 26 (1) (d)

interest should register their national interest with the International Registry in order to retain their priority under the International Registry system.

### 3.2 The Supervisory Authority and the Registrar

The ICAO agreed to be the Supervisory Authority of the International Registry and had appointed Aviareto to operate the Registry[148]. Aviareto is a joint venture between SITA SC, an air transport IT service provider, and the Irish government. It is located in Dublin, Ireland.[149].

### 3.3 Modalities of Registration

The International Registry is operated as an asset-based database, which means that the name of the aircraft's manufacturer, its manufacturer's serial number and its model designation are needed for the registration and the searches thereto.[150]

With respect to each registrable international interest, the international interest can be registered by either the creditor or the debtor. However, the registration will be effective only when the written consent of the other party is given to the IR.[151] This provides an important safeguard against improper registration. It is also possible to register international interest subordination agreements, subrogation agreements and assignments.[152]

Regarding the validity of the registration in the preceding paragraph, the registration will be complete upon entry of the required information into the

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[148] Article 28 (2)
[149] For more information regarding the Registrar – Aviareto, please see Aviareto's official website at http://www.aviareto.aero
[150] Article 32 (6)
[151] Article 32 and Article 33
[152] Article 33

database so as to be searchable.[153] Accordingly, a registration shall be searchable at the time when the International Registry has assigned to it a sequentially ordered file number and the registration information, including the file number, is stored in a durable form and may be accessed at the International Registry.[154] Any person may make or request a search of the International Registry from anywhere in the world where an Internet connection is available.[155]

### 3.4 Privileges and Immunities of the Supervisory Authority and the Registrar

As the Supervisory Authority, ICAO[156] and its officers and employees enjoy immunity from legal and administrative processes as is provided under the rules applicable to ICAO as an international entity.[157] The governing rule of ICAO as an international entity is the *1947 Convention on the Privileges and Immunities of the Specialized Agencies of the United Nations*[158]. On the other hand, the Registrar has no immunity of any kind.

### 3.5 Liability of the Registrar for errors, omissions and system malfunction

The Registrar is liable for compensatory damages for loss under two circumstances. The first one relates to losses incurred directly as a result of an error or omission of the Registrar's staff.[159] The second one relates to losses caused by a system malfunction which must be of an inevitable and irresistible nature such that it could not be prevented by using the best practices in current use

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153 Article 32 (2)
154 Article 32 (3)
155 Article 35 (1)
156 ICAO suits with the requirement of Article 40 (1) stating that the Supervisory Authority must has international legal personality where not already possessing such personality.
157 Article 40 (2)
158 *The Convention on the Privileges and Immunities of the Specialized Agencies of the United Nations*, 21 November 1947.
159 R. Goode, "The Cape Town Convention on International Interest in Mobile Equipment: a Driving Force for International Asset-based Financing" (2002) 7 Unif. L. Rev. 3 at 8.

in the field of electronic registry designs and operation, including those related to back-ups, system security, and networking. The Registrar is not liable for the factual inaccuracy of the registration information that it receives or transmits in the form in which it received.[160]

**The Concern regarding the International Registration System**

There are concerns about the implications of the registration of international interests relating to an aircraft engine, and questions on whether conflict could arise between Contracting and Non-Contracting State.[161] Under domestic law in a number of jurisdictions, when the aircraft engine is installed on the airframe, ownership of the engine is automatically transferred to the owner of the airframe.[162] In the scenario where the transaction - whether it will be an engine-lease contract, an engine-conditional sale agreement or another - is subject to the Convention and the international interest of such engine is registered with the International Registry, if there is any inconsistency between the Convention and the domestic law over the ownership of the registered engines, the Convention prevails.

For example, Thailand has a domestic law providing that the installation of an engine in an airframe taking place in Thailand results in the ownership of such engine automatically being transferred to the owner of the airframe.[163] Thus, it can be argued that this circumstance could give rise to a problem where, under domestic law, the owner of the airframe has the ownership interest over the engine

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[160] Article 41 (2)

[161] *Supra* note 91 at 11.

[162] For example, Thailand

[163] Thai Civil and Commercial Code Section 1316 Paragraph 2: If one of the things could be regarded as the principal thing, the owner becomes the sole owner of the composite thing, but he must pay the value of the other things to their respective owners.

but, under the Convention and the International Registry system, the ownership interest belongs to the engine's owner who registered his/her interest with the International Registry.

**Section 4: Priority**

The priority ranking of the financier's interest is not the same across different jurisdictions. One interest may be ranked as a first priority in one jurisdiction but a second or third priority in another. This creates both doubt and risk to a financier as to whether his/her interest will be ranked in first priority in the jurisdiction where the default or bankruptcy of the debtor occurred. Therefore, the Convention sets out the rules governing priority of competing interests.

The rules are reasonably straightforward. In order for an international interest to obtain priority, it must be registered in the IR. The rule of priority can be simply described as the registered interest having priority over a subsequently registered interest and over an unregistered interest.[164]

**4.1 Priority Rules of Competing Interests**

The rules of priority are as follow. First, priority is generally based on the order of registration, which is strictly time-based. An international interest will be ranked according to its time of registration; hence, a registered interest has priority over a subsequently registered interest.

Second, a registered international interest has priority over any other interest which is subsequently registered or is unregistered,[165] even if the registered

[164] Article 42 (1).
[165] Article 42 (1).

international interest was acquired or registered with actual knowledge of the other interest (i.e., unregistered interest or a national interest).[166]

Third, a buyer under a registered sale agreement takes its interest free of any interest subsequently registered or any unregistered interest, even if the buyer has actual knowledge of them.[167]

Fourth, a conditional buyer or lessee acquires its interest subject to an interest registered prior to registration of the international interest held by its conditional seller or lessor, but otherwise free from any unregistered interest, even if the conditional buyer or the lessee has actual knowledge of such interest.[168]

Fifth, priorities may be varied by agreement between the holders of interests on an aircraft object. It is advisable to register the relevant priority or the subordination agreement.[169]

### 4.2 Priority Rules for Prospective International Interests

It is important to note that a prospective international interest may be registered as well as an actual international interest.[170] This arrangement is very useful as it will ensure that all parties with an interested or involvement in the aircraft financing transaction (in which one or more international interests are being created) will be aware of their rights before the closing time of the whole transaction.

Where a prospective international interest is registered which subsequently becomes an actual international interest, then the time of registration (and hence

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[166] Article 42 (2).
[167] Article 42 (3).
[168] Article 42 (5).
[169] Article 42 (6).
[170] Article 26 (1) (a)

the ordering of priority) is effectively back-dated to the time of registration of the prospective international interest.[171]

**The Concern regarding Priority Rules**

However, there is criticism of the fact that these non-consensual rights or interests are given priority without registration.[172] The Contracting State may specify that non-consensual rights or interests have priority over registered international interests.

Accordingly, such provisions could cause concern for aircraft financiers and/or lessors about their position in the priority rank vis-à-vis the non-consensual rights. In this scenario, lessors must check whether the lessee's country (and any other relevant Contracting State) has made such declarations. Thus, despite the Convention's stated goal of uniformity (and thus identical priority rankings in different jurisdictions), this provision creates uncertainty for the creditors.

**Section 5: Assignment of International Interests**

The Convention and the Protocol not only deal with the creation of international interests, but also address the assignments of associated rights and of related international interests, as well as with subrogation.

"Associated rights" are defined as rights to payment or other performance by a debtor under an agreement which is secured by or associated with an aircraft object.[173] "Assignment" is widely defined as including the pledge or charge of

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[171] Article 32 (4)

[172] Article 1 (ff) and Article 52. For more information, please see *supra* note 9 at 646.

[173] The associated rights do not include (i) rights to performance by a third party, or (ii) rights to performance by the debtor itself under a separate contract.[173] In principle, only a creditor (i.e. a chargee, a conditional seller or a lessor) can hold and assign associated rights. (Article 1 (h))

associated rights and related international interests as well as transfers.[174] The most common form of the assignment in an aircraft financing transaction is the assignment of a lease.[175]

The assignment can be partial (e.g., it is possible to assign part of the rent under a lease, and this is frequently the case with the assignment of leveraged leases), it can take the form of a transfer of charge or pledge, it does not need to for the purposes of security (i.e. it can be absolute); and it should comply with the formal requirements of Article 45.

**5.1 Effect of Assignment**

Unless otherwise agreed by the parties, an assignment of associated rights transfers to the assignee: (a) the related international interest (i.e. that of the chargee, conditional seller or lessor); and (b) all the interests and priorities of the assignor under the Convention.[176]

This follow the common rule that security does not exist in the abstract, but it needs to be associated with the rights, and therefore travels with those rights.[177] Hence, it is not necessary to express the transfer of the assignment in the relevant contract as such transfer will be automatic unless otherwise agreed by the relevant parties.

The parties of an assignment are free to agree on an assignment of the associated rights that does *not* transfer the security or other international interest

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[174] *Supra* note 6 at 117 and Article 1 (g).

[175] Examples include (i) the assignment by an aircraft owner to its financiers of the benefit of a lease out of the aircraft object to its operator, or (ii) the assignment by a lessee of an aircraft object to the lessor of the benefit of a sub-leased agreement.[175]

[176] Article 44 (1)

[177] *Supra* note 6 at 118.

and, if they do so, then the Convention will not apply to the assignment.[178] For example, a conditional seller under a title reservation agreement providing for payment by installments could agree to assign its right to future installments without transferring ownership of the object to which the agreement relates.[179] The reason for this latter point is simply that the Convention and the Protocol are intended to deal with international interests and if the document and/or the contract in question does not directly relate to such international interests, then the Convention/Protocol should not apply to it.

**Chapter Summary**

The Cape Town Convention and the Aircraft Protocol represent a major step in the unification of complex, multi-jurisdictional legal concepts relating to aircraft financing transactions. Chapter 2 describes the core of the Convention and its system, discussing in turn the creation of international interests, default remedies, the registration system, priority rules, and assignment and its associated right. The international interest is a unique creation; so too is the International Registry. The Convention and the Protocol create the set of international interests and ensure their effectiveness through the use of the International Registry system. The Convention and the Protocol also embody a range of safeguards to creditors to ensure that their rights are protected in the event of default by a debtor. Moreover, the Convention provides a set of substantive rules allowing for quick relief pending final determination of the creditor's claim and the provisions relating to insolvency. The regulations pertaining to priority interests in aircraft

[178] Article 45 (3)
[179] *Supra* note 6 at 118.

objects and competing assignments of such interests are categorized in these two instruments.

At the same time, the Convention and the Protocol protect the debtors' right by embracing a set of provisions to ensure that creditors' remedies and obligations are exercised in a commercially reasonable fashion. Also, a debtor which is honoring its obligations is given the right of quiet possession against their creditors and third parities whose rights are subordinate to the debtors' rights. Thus, it is clear that the Convention establishes the clear rules governing cross-border transaction. These rules are simply direct and cover the main legal aspects in aircraft financing transaction as demonstrated above.

The Convention enables solutions to some of the problems which have traditionally plagued aircraft financing transactions, facilitates the creditors' life and simplifies the complexity of the transactions. Consequently, the risk to aircraft creditors is minimized; the cost of the transaction is decreased; and the credit opportunity for acquisition the aircraft is expended. The Convention is a key development for the future growth of the aviation industry.

The Convention is not without its weaknesses, however, and some argue that the Convention itself poses a number of problems to both creditors and debtors alike. The Convention cannot address inherently unreliable and ineffective legal systems in blacklisted jurisdictions, nor has it reduced the need for lengthy, detailed, and complex documentation. With respect to modalities of default remedy, very little provided by the Convention is novel. The exception of 'non-consensual rights' in the priority ranking and the vague definition of 'default' (coupled with the vague terminology of 'commercially reasonable') could

undermine the position of the creditors. The self-help remedy, the registration system and the insolvency provision cannot effectively function without universal ratification. Last but not least, the opt-in and opt-out provisions themselves create inconsistency among the Contracting States.

In sum, it may be argued that this Convention cannot truly attain its ultimate goal without universal ratification. The purpose of the Convention is to simplify aircraft financing transactions by unification of secured transaction law across jurisdictions. This purpose is, in and of itself, achievable only if the Convention itself is accepted universally worldwide, without the declarations which may complicate the transaction.

# The Impacts of the Cape Town Convention on Aircraft Financing Transaction

## Chapter Introduction

Having reviewed the challenges involved in aircraft financing transactions and completed our analysis of the Convention and Protocol in the abstract, this thesis now turns its attention to the practical, real-world implications of the Convention. The Convention establishes clear rules governing asset-base secured transactions; however, after two years of being in force, uncertainties about to both practitioners and scholars alike as to the effectiveness of the Convention in its delivery of its promise to simplify aircraft financing transactions, bolstering creditor confidence, and improving the position of the relevant parties.

This Chapter aims to analyze the consequences of the Convention to aircraft financing transactions through the consideration of a hypothetical transaction scenario. The consequences can be categorized into four main groups: the problem solved by the Convention, the new difficulties created by the Convention, the concerns on not yet universal ratification, and the Convention's economic effects on the aviation industry

First, many problems with aircraft financing transactions *have* been alleviated by the Convention. Concerns over political interference, delayed default remedies, unreliable priority ranking and countless relevant documents are problems that have historically impeded aircraft financing transactions. Part A will analyze the impact of the Convention on these issues and examine how the Convention has been successfully utilized to resolve these problems. It can be purposed that political interference is minimized, expeditious default remedy is

possible, priority ranking becomes reliable and the volume of required documentation has been reduced under the Convention legal regime.

The second group of consequences is the ‘cons,’ or the new and unique difficulties created by the Convention. Part B will analyze how the applicability of the Convention, default interpretations, insolvency remedies, the opt-in and opt-out system, and the international registration system create new uncertainties for the creditor. It may be asserted that, unless these weaknesses are resolved, the Convention only partially fulfills its goals and does not yet truly deliver on all its claimed benefits.

The third group of consequences arises because the Convention has not yet achieved universal ratification. The absence of worldwide acceptance as the biggest barrier for the Convention will be analyzed in Part C. In practical terms, the self-help remedy, deregistration and export provisions, and the insolvency remedy regime cannot fully function without worldwide acceptance.

Finally, Part D will examine the economic effects of the Convention. According to the previous Parts, the Convention only partially fulfills its goals and delivers only some of its benefits. However, this part will argue that the Convention confers many economic benefits to airlines, manufacturers, passengers and global community, even though the Convention itself is not yet truly delivering its promised benefits.

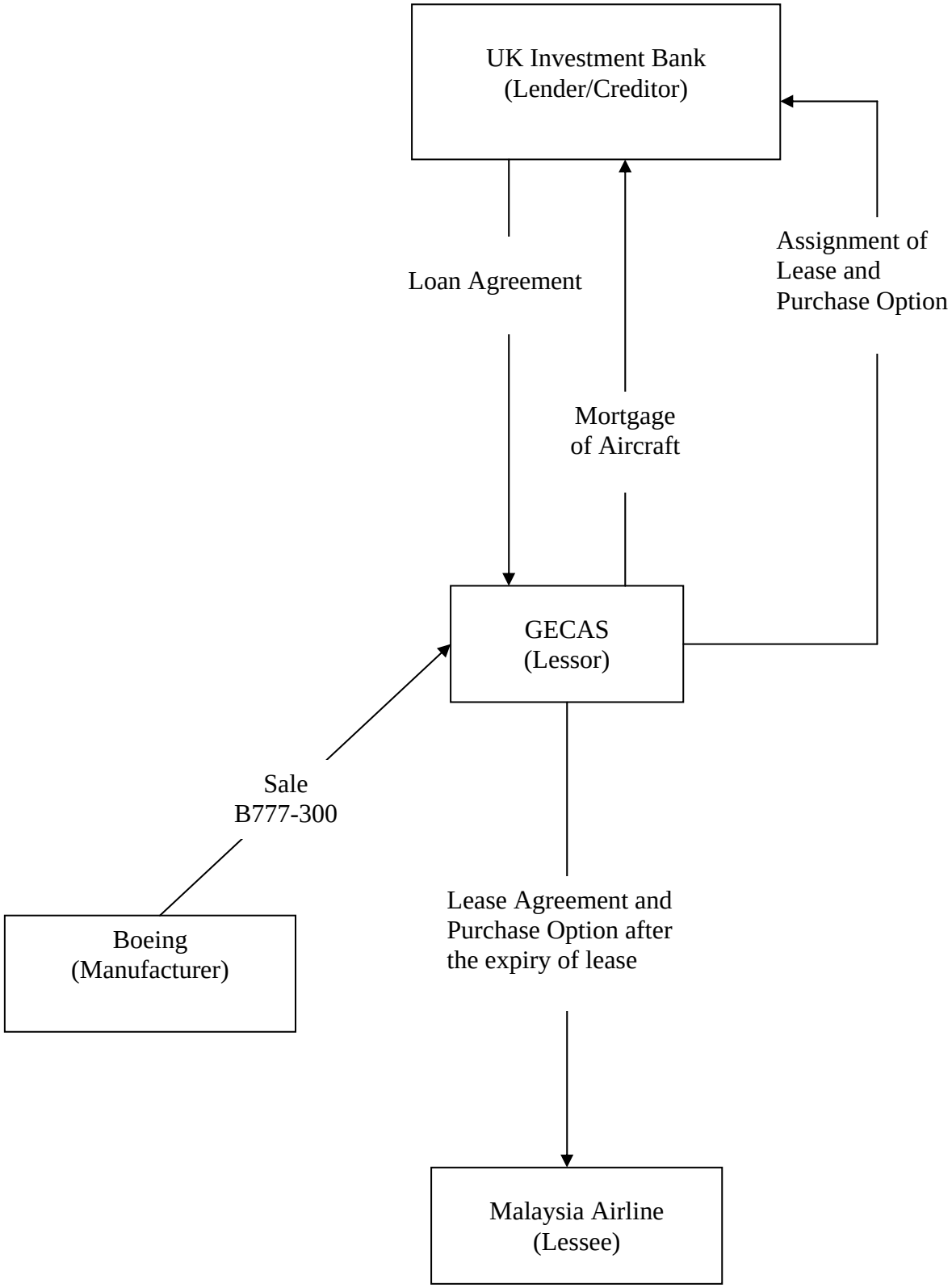
A practical example scenario will be analyzed in order to illustrate the impact of the Convention on aircraft financing transactions. Slightly different scenarios will be also examined in order to demonstrate the effect of small changes in the factual circumstances of a particular section.

*Practical Scenario*

This Chapter aims to analyze the legal impacts of the Convention to aircraft financing transaction and in order to do so, using a real transaction as an example is the best way to clarify the impacts.

The following scenario comes from the real aircraft financing transaction. This scenario will be used as an example of a typical aircraft financing transaction and will be examined in order to demonstrate the legal impacts of the Convention in real-world situations. This scenario represents one of the simpler forms possible, involving a minimum number of parties and a minimal number of interrelated agreements. In the scenario, Malaysia Airline will be used as a representative of the airlines situated in the Contracting States. Boeing represents a manufacturer. GE Commercial Aviation Services symbolizes the lessor and UK Investment Bank typifies the creditor.

According to the above scenario, the GECAS (the Lessor) enters into a loan agreement (the Loan Agreement) with a UK Investment Bank (the Lender) for the purpose of financing an aircraft. Under the conditions of the Loan Agreement, the Lessor grants a mortgage (the Mortgage) on the Aircraft as the security interest to the Lender. Then, Boeing (the Manufacturer) sells one Boeing 777-300 (the Aircraft) to the Lessor. The GECAS and Boeing are located in the United States (a contracting state), and the UK Investment Bank is located in the United Kingdom (which is *not* a Contracting state).


UK Investment Bank
(Lender/Creditor)
Loan Agreement
Assignment of
Lease and
Purchase Option
Mortgage
of Aircraft
GECAS
(Lessor)
Sale
B777-300
Boeing
(Manufacturer)
Lease Agreement and
Purchase Option after
the expiry of lease
Malaysia Airline
(Lessee)

Next, Malaysia Airline (the Lessee) leases the Aircraft from the Lessor under the Operating Lease agreement (the Lease Agreement) with an option to purchase the Aircraft, with approval of the Lender, at the end of the contract at the market price (the Purchase Option Agreement). The Lessee is located in Malaysia (which *is* a contracting state) and the Aircraft is registered in Malaysia. The Lessee has various operating routes, which take the plane through both contracting and non-contracting states.

Under these Loan Agreements, the Lessor grants the Lender the management authority to assign some or all of the Lease benefits and responsibilities. Regarding the registration of the interests, the security interest of the Lender under the Mortgage, the assignment of the Lender under the Assignment of the Lease, and the interest of the Lessor under the Operating Lease are duly registered in the International Registry.

For the sake of clarity, let me reiterate that the United States and Malaysia are both contracting states, but the United Kingdom is not.

**Section 1: The Problems Solved by the Convention**

There are numerous problems that impede aircraft financing transactions and create uncertainties for the creditors. One of the most concerning aspects for creditors is whether a situation of default could be resolved and how long would it take under national law. Other concerns include the unreliable priority ranking of creditor interests under domestic law, political interference, and exhaustive documentation requirements to complete the transaction. These problems were known to the drafters of the Convention, and efforts were made to reduce them. Having been in force for two years, some concerns remain as to whether the

Convention can enable an expeditious remedy and ensure a predictable priority ranking. However, it can be argued that these concerns are exaggerated and speedy remedies, predictable priority ranking, minimum political interference and fewer documents are possible under the Convention regime.

### 1.1. Political Interference

The Convention establishes the international registry system to ensure that international interests may be recognized across jurisdictions, even when faces with inefficient and deficient domestic laws. It assures the creditors an international standard of protection and treatment of their interest and enables such interest to be internationally recognized.

One criticism raised is that political interference in the debtor's jurisdiction may continue to undermine and nullify any advantages or certainties to the financing creditor and his interest, as promised by the convention.[180] Standardizing domestic law governing secured transactions, minimizing the administrative procedures, and providing the expeditious default remedies for the purpose of the Convention do not guarantee that the aircraft financing transaction will not be impeded by political influences. For example, there is a possibility that the local authorities may be reluctant to deregister and export an aircraft to a foreign creditor when it has been registered as its nationality.[181] Also, the deregistration and/or export procedures can be delayed by politicians in order to protect their popular vote in the parliament.

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[180] *Supra* note 101 at 51. and N. O'Keeffee, "Aircraft Financing in the Chinese market" (2005) Airline Fleet & Network Management 24 at 26.

[181] T.P. Rodrigues, "International Regulation of Interest in Aircraft: the Brazilian Reality and the UNIDROIT Proposal" (2000) 65 J. Air L. & Com. 279 at 12.

Regrettably, we must accept that the Convention does not, and cannot, avoid political interference and corruption, as both are external factors that influence airline economic performance.[182] However, the Convention does strive to offer some protection, by assuring the creditor that local authorities in a Contracting State are obligated to make the remedies available within five working days.[183] Similarly, the local court of the Contracting State, in cases where a foreign court has granted relief, is also obligated to recognize the foreign judgment within five working days.[184]

**1.2. Self-Help (Extra-Judicial Remedies)**

As pointed out in the previous chapter, the self-help concept is familiar to the Common Law world, and there is some criticism as to whether Civil Law countries may declare to opt-out of the self-help remedy provision in order to avoid an internal conflict in their legal system due to the differences between the Common law and the Civil law. Accordingly, there are questions of how the Convention's goal of simplifying the aircraft financing transaction and could be achieved if leave of the court is required. [185]

Quick, speedy remedies to conflict *are* realizable within the Convention legal framework. The intention of the Convention is to respect the autonomy of each State,[186] thus, the drafters of the Convention afford the Contracting State the

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[182] *Supra* note 16 at 83.

[183] See Chapter 2 Section 2 Default Remedy, above, for more on this topic.

[184] See Chapter 2 Deregistration and Export Remedy, above, for more on this topic.

[185] *Supra* note 9 at 649 and *supra* note 181 at 11-12. However, there is an argument that the above criticism cannot be accepted. (please see J. Wool, "The case of Commercial Orientation to the Proposed UNIDROIT Convention as Applied to Aircraft Equipment" (1999/2000) 31 Law & Pol'y Int'l Bus. at 79.)

[186] As stated in paragraph 5 of the preamble: 'Believing that such rules must reflect the principle underlying asset-based financing and leasing and promote the autonomy of the parties necessary in these transactions'

opportunity to make a variety of choices in which provisions they will adhere to, depending on what is acceptable according to their legal system and what will deliver the best benefits according to their commercial and economic objectives.[187] With respect to the self-help remedy provision, however, most of the Contracting States have opted in. Repossession of an aircraft object (in the event of a default) is much quicker and much simpler when leave of the court is not first required to be obtained.

According to the UNIDROIT declaration system, the contracting states which have opted in include Afghanistan, Albania, Angola, Cape Verde, Ethiopia, India, Indonesia, Ireland, Kenya, Luxembourg, Malaysia, Mexico, Mongolia, Nigeria, Oman, Pakistan, Panama, Saudi Arabia, Senegal, South Africa, United Arab Emirates, and United States of America.[188] Among them, United States of America, Ireland, and India are common law countries. Accordingly, it shows that even though most of the above Contracting States are Civil Law countries, they have accepted the self-help remedy provision. The result is that in the event of default by a debtor who is situated in the above countries, any remedies available to the creditor under the Convention may be exercised without court intervention and without leave of the court.

Colombia is the one Contracting State that has declared its intention to opt-out. Accordingly, in the event of default by a debtor situated in Colombia, any

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[187] *Supra* note 113 at 266.

[188] Declarations deposited under the Cape Town Convention on International Interests in Mobile Equipment regarding Article 54(2).

remedies available to the creditor under the Convention may be exercised only with leave of the court.

Some have argued that the Convention is too heavily influenced by the Common Law, for example, in its reflection of the self-help remedy.[189] However, one must remember that the purpose of the convention is *not* to present the common denominator between the Common Law and the Civil Law systems, but rather, to harmonize the secured transaction law and to offer the best solution to the problems in aircraft financing transaction as pointed out in Chapter 1. As observed by Prof. Roy Goode:

> *"The drafters address that it is important to keep in mind that it is necessary always to have in mind the purpose of harmonization projects, which is not to produce a text representing the lowest common denominator of the various legal systems represented but to offer the best solutions to the problems that are being addressed."* [190]

The Convention allows contracting states to opt-in to a self-help remedy approach, while stipulating that these self-help mechanisms must, in any case, be exercised in accordance with the national law in order to avoid the conflict which may caused by the differences in legal systems. The Contracting States that declare as stated above are Albania, Ireland, Luxembourg, Mexico, Saudi Arabia, and United States of America. Since the vast majority of contracting states have,

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[189] *Supra* note 181 at 4 and *supra* note 9 at 649.
[190] *Supra* note 113 at 266.

indeed, opted in to allowing these self-help remedies, the harmonization objectives of the Convention, and its purpose in ensuring that the interest of the creditor in the event of default is protected and can be exercised quickly without the intervention of the court remedy is fulfilled.

**1.3. Priority Ranking**

The Convention aims to harmonize the prioritization rules in order to ensure that the creditor's international interest will be ranked the same among Contracting State, and the International Registry is the key. Creditors who wish to have an international interest recognized and ranked under the Convention regime have to register the international interest in the International Registry. Once the international interest is registered, it will be given priority according to a first-to-register basis.

However, not every international interest is under this rule. The Convention provides that the Contracting State could declare the 'non-consensual rights/interests which is given priority without registration'. Accordingly, in the above scenario, GECAS must be aware of what Malaysia declares to be the 'non-consensual rights/interests which is given priority without registration under Article 52.

The non-consensual rights/interests of Article 52 are limited to those rights/interests that (a) under the law of the Contracting State have priority over the right of a secured creditor and (b) are the rights of public service providers. According to the declaration made by the Contracting States, most of the non-consensual rights/interests which are given priority without registration are

similar.[191] These can be categorized into 3 main groups: (1) liens in favor of airline employees for unpaid wages arising from the time of a declared default onward; (2) lines in favor of mechanics of an aircraft object in their possession; and (3) taxes, duties and/or levies from or related to the use of that aircraft. These rights/interests are confirmed by the Convention to have priority over registered international interests, whether or not they are registered.

There are criticisms that the Convention does not ensure the creditor a confirmed priority in his international interest because it could be another rights/interests that have priority over the creditor's interest without registration.[192] Thus, the Convention creates the disunity inside its system and brings uncertainty to the creditor yet again.

However, it can be argued that the creditor's position is indeterminate, as there may be the rights and interests which have priority, even without registration, over his registered international interest. Such rights/interests are not registrable in the International Registry; however, they are published on the website of UNIDROIT.[193] Also, the non-consensual rights/interests of Article 52 are predictable since they are limited and similar in each Contracting State.[194]

Moreover, the fundamental purpose of the International Registry is to entitle the holder of a registered international interest to certain and reliable information at the time of registration.[195] Although a Contracting State may modify its declaration from time to time, the registered international interest

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[191] Declarations deposited under the Cape Town Convention on International Interests in Mobile Equipment relating to Article 39(1)

[192] R. Lawrynowicz, "The final Stage" (2008) 228 Airfinance J. at 40 and *supra* note 9 at 646

[193] Online: UNIDROIT <http://www.unidroit.org>.

[194] According to the Declaration made by the Contracting State

[195] *Supra* note 6 at 139.

cannot be affected by such modification of the declaration. The Convention ensures the creditor his priority of registered international interest.

For the reason that the creditor *is* provided notice (by way of UNIDROIT) of the non-consensual rights/interests of Article 52 and, by virtue of the fact that his priority of registered international interest will not be affected if there are any changes of such rights/interests in the future, it can be said that the Convention ensures the creditor the certainty of its priority.

### 1.4. Detailed Documents

Aircraft financing transactions typically involve numerous parties from an equally numerous number of jurisdictions. For example, a recent aircraft purchase transaction by Qantas Airlines was reported in the Airfinance Journal of October 2004. This transaction involved a total of $1.9 billion in financing from the following financial institutions: ABN Amro, Barclays Capital, Citigroup, Commonwealth Bank of Australia, ANZ Investment Bank, BNP Paribas, Deutsche Bank, HSBC, Sumitomo Mitsui Finance Australia, Commercial Bank of China, JP Morgan Chase Bank and more than 16 other banks. Consequently, the comprehensive and detailed documentation is unavoidable.

The underlying purpose of the Convention, as stated in the Preamble, is to facilitate asset-based financing transactions, and one of many ways to do so is by establishing clear rules governing them.[196] The result is that the transaction is less complicated than it might otherwise be, as a due diligence process can be carried out more easily and more quickly within the context of the Convention.

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[196] Preamble of the Convention on International Interests in Mobile Equipment

It was established in a previous Chapter that the Convention does successfully establish clear rules governing aircraft financing transactions. However, apart from these clear rules, the Convention assists the creditor in the matter of deregistration and export, as the debtor is forced to expend significant labor contending with the detailed documentation required from the domestic civil aviation authorization and the export authority in the event of deregistration and export of the aircraft object. The 'Form of Irrevocable De-registration and Export Request Authorization' is provided in the Annex attached to the Convention. Significantly, as the confidence is ensured to the creditor, the promising benefit is at the debtor due to the deduction in borrowing costs and the enhancement in credit rating of equipment receivables.[197]

**Section 2: The New Difficulties Created by the Convention**

While several problems have been successfully solved by the Convention (as discussed in Part A), the Convention has several weaknesses which could lead to grater uncertainties for the creditor. They include uncertainties about the applicability of the Convention, vague default interpretations, insolvency remedies, opt-in and opt-out provisions, and issues surrounding the international registration system. This part will analyze the consequences of these problems to aircraft financing transactions and how they create new difficulties for the creditor. It may be difficult for the Convention to attain all its goals as long as these problems remain unresolved.

[197] *Supra* note 6 at 6.

## 2.1. The Applicability of the Convention to the Aircraft Financing Transactions

The Convention's stated goal is to unify the secured transaction law of aircraft financing and establish a clear rule governing it. In theory, these goals have been achieved; however, one has to keep in mind that there are numerous agreements which comprise a single aircraft financing transaction, and the Convention, as one of the potential rules, cannot possibly cover all of the agreements in aircraft financing transactions. For example, not all agreements constructed under the example scenario are subjected to the Convention, even though this practical scenario involves a minimum number of parties.

### *1. The Contract of Sale between Boeing and GECAS*

Boeing, as the seller, and GECAS, as the buyer, are located in the US which is a Contracting State. The Airframe of the Aircraft as well as the engines are deemed to be the "aircraft object," and Boeing has the power to dispose and transfer its ownership interest to GECAS; therefore, the Contract of Sale and the 'ownership interest' being provided by Boeing to GECAS are subject to the Convention.

### *2. The Lease Agreement between GECAS and Malaysia Airline*

Malaysia Airline, the debtor under the Lease Agreement, is located in a Contracting State and the leased Aircraft is registered in a Contracting State. The GECAS, as the creditor under the Lease Agreement, is also located in the Contracting State. The Lease Agreement is subject to the Convention as the debtor

is situated in a Contracting State. Thus, it vests the ‘international interest’ to the GECAS who is the lessor under the Leasing Agreement.

*3. The Purchase Option Agreement between GECAS and Malaysia Airline*

Malaysia Airline, as the buyer under a prospective sale agreement constituted by the Purchase Option Agreement, is located in a Contracting State. The GECAS, as the seller in the prospective sale agreement, is also located in a Contracting State. The airframe of the Aircraft as well as the engines constitute the ‘aircraft object’ and the GECAS has the power to dispose and transfer the ‘prospective ownership interest’ to Malaysia Airline. Thus, the Purchase Option Agreement and the ‘prospective international interest’ granted by the GECAS to Malaysia Airline are subject to the Convention.

*4. The Mortgage Agreement between the GECAS and the UK Investment Bank*

The UK Investment Bank, the chargee under the Mortgage Agreement, is located in a non-Contracting State. The GECAS, as the chargor under the Mortgage Agreement, is located in a Contracting State. The Mortgage Agreement, as a security agreement, is subject to the Convention as the debtor is situated in a Contracting State. Thus, it grants the ‘security interest’ to the UK Investment Bank who is the chargee under the security agreement.

*5. The Assignment of Lease and the Assignment of Purchase Option between the GECAS and the UK Investment Bank*

The GECAS, as the assignor, assigns its associated right of performance under the Lease Agreement to the UK Investment Bank. This Lease Assignment is subject to the Convention as the Assignment transfers to the UK Investment Bank

the international interest and Malaysia Airline, as the debtor whose duty to performance under the Lease Agreement is transferred, is located in a Contracting State.

However, as the provisions of the Convention do *not* apply to the assignment of sale/prospective sale, the Purchase Option Assignment assigned by the GECAS to the UK Investment Bank is *not* subject to the Convention.

Based on this hypothetical example, it is clear that not all of the transactions involved in this financing arrangement are subject to the convention. The consequence is that the interest of UK Investment Bank under this agreement is not protected under the Convention legal framework and the creditor continually faces the uncertainties.

**2.2. Default Interpretation**

Each transaction and agreement is unique in nature and adopting a strict meaning of 'default' may lead to unjustifiably narrow interpretations; consequently, the Convention allows the relevant parties to specify 'events of default' that may give rise to the remedies provided in Chapter III.

The essential purpose of the Convention is to harmonize secured transaction law governing cross-border aircraft financing. It aims to enhance the value of funds provided to the airlines by ensuring the confidence to the creditor that their supplied funds are well protected.[198] The relevant parties in the transaction, both the creditor and the debtor, are sophisticated players who know that they are dealing with high unit value equipment which is subject to the

[198] *Supra* note 181 at 16.

complexities and peculiarities of multiple legal systems. Many of them are State airlines which have plenty of experience and, undoubtedly, considerable negotiation power.[199] Therefore, the Convention did not specify the meaning of 'events of default' and instead left the negotiation of these terms to the contracting parties.

As a fallback, where the parties do not provide a definition for this term, the convention defines 'events of default' as events that substantially deprive the creditor of what the creditor is entitled to expect under the agreement.

Theoretically, the above definition should cover the majority of what could constitute the events of default; however, practically speaking, this is a vague definition upon which, certainly, no aircraft financier would wish to rely. Also, it can be criticized that this vague definition could undermine the creditor's position, as the debtor may raise the argument against the creditor claiming that events which have transpired do not 'substantially deprive' the creditor's expectation.

Another issue regarding the terminology is that the Convention requires the creditor to exercise his remedies in a 'commercially reasonable' manner. The underlying purpose of the Convention is to ensure that the creditor does not use any unlawful manners in order to exercise his remedy. As Prof. Goode notes in the Official Commentary:[200]

> *"A provision that is in line with accepted international practice will normally be regarded as not manifestly unreasonable'*

[199] *Supra* note 113 at 268.
[200] *Supra* note 6 at 71.

However, it can be argued that this unclear terminology could undermine the position of both the creditor and the debtor. For example, it could introduce a conflict between the relevant parties due to differing interpretations of what is ‘commercially reasonable’. In our hypothetical situation, Malaysia Airline could prolong default remedy processes by claiming against GECAS and/or the UK Investment Bank that their remedy had not been exercised in a ‘commercially reasonable’ manner.

Last but not least, more time will need to be spent on negotiation and compromise the “default” clause in the agreements, to define what would constitute an event of default, or which manners are commercially reasonable. From the practical scenario, there are at least five agreements that the relevant parties have to negotiate and compromise on and, in a real-world aircraft financing transaction; there are more contracts involved. Unsurprisingly, more time is spent, more money is wasted and the result is a more complicated and detailed agreement. Thus, it may be concluded that while the convention aimed to simplify the contracting process, it is possible that the contracts made under the Convention will be even more complicated and more detailed on account of the vague terms in the Convention.

**2.3. Insolvency Remedy**

In the case where the debtor is located in a Contracting State, the insolvency remedy applicable will depend on what declaration such Contracting State has made. For example, if Malaysia Airline were to become insolvent, the transaction will be governed by the Convention and the insolvency remedy is subject to the Convention. Then, the creditor should check whether Malaysia has

made any declaration regarding the insolvency remedy - whether it has declared to opt-out or choose either Alternative A or Alternative B. With respect to the declaration made by Malaysia, Alternative A is actually applicable. Accordingly, GECAS is ensured that its international interest will be protected and its insolvency remedy could be exercised under the regime of the Convention.

As of August 25, 2008, The Contracting States that have chosen to adopt Alternative A are Afghanistan, Angola, Cape Verde, Colombia, Ethiopia, India, Indonesia, Kenya, Luxembourg, Malaysia, Mongolia, Nigeria, Oman, Pakistan, Panama, Senegal, South Africa, and United Arab Emirates. Mexico has adopted Alternative B. The United States of America's existing bankruptcy law is equivalent to Alternative A (Section 1110 of the Bankruptcy Code). However, Ireland has made no declaration, thus its insolvency remedy remains with national bankruptcy law.[201]

One of the Convention's objectives is to provide the creditor effective and readily enforceable remedies in the event of insolvency of the debtor[202]: thus the Convention and Protocol provide the Contracting State two alternative choices – Alternative A and B – of the insolvency provision for the Contracting State to choose. The result is that the chosen alternative will override the domestic bankruptcy law. Alternative A is generally preferred by most Contracting States, as it enables the creditor to receive more satisfactory remedies within a clear timeline.

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[201] Declarations deposited under the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment regarding Article XXX(3)

[202] *Supra* note 6 at 13.

There are, at least, three efficiencies provided through the use of Alternative A.[203] First, it provides a clear timeline for the debtor (the airline) to cure all defaults or give possession of the aircraft to the creditor within the waiting period. Second, it will ensure a prompt and efficient insolvency administration processes, as it allows the insolvency officer to issue an order on whether the aircraft will remain with the debtor or be repossessed by the creditor (without the need of court approval). Third, it grants confidence to the creditor that the default will be expeditiously resolved within a specific timeline, which enhances the decision to grant credit from the creditor in the future.

The effectiveness of airline reorganization in the United States of America can be used as a good example of the result of Alternative A, as its bankruptcy code is in similar terms. The practical consequences of Section 1110 of the Bankruptcy Code are as follows. First, the airline lessors are confident that their interest will be protected within a documented and enforceable timetable, so there is very little attempt to take action or repossess the aircraft prior to Chapter 11 procedures. Consequently, airlines generally retain aircraft and continue to use them in order to operate the business. Frontier Airline is a good example as it announced on April 10, 2008 that it filed for Chapter 11 bankruptcy; however, its operation continues uninterrupted.[204] Second, Section 1110 of the Bankruptcy Code had not impeded the reorganization of the US airlines since there have been a number of successful airline restructuring projects undertaken while under

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[203] J. Wool & A. Littlejohns, "Cape Town Treaty in the European context: The case of Alternative A, Article XI of the Aircraft Protocol" (2007) 302 Airfinance Annual. at 1.

[204] G. Bowley, Frontier Airlines Files for Bankruptcy" *The New York Times* (12 April 2008), online: The New York Times <http:// www.nytimes.com>.

Chapter 11 (e.g. Continental Airlines, Delta Airlines, US Airways, and United Airlines).[205]

However, it can be criticized that the Convention leaves one major loophole in the insolvency remedy: the option for a contracting state to make 'No' declaration with respect of this remedy. The result of a lack of a declaration is that the insolvency procedures rely on domestic bankruptcy law and leave the creditor in the same positions as they would have been without the Convention.

As of August 25, 2008, Ireland has made no declaration. If the debtor in the hypothetical scenario were changed from Malaysia Airline to Ryan Air, Air Lingus, or Aer Arann (which are located in Ireland), and if there is any insolvency of the debtor, the insolvency remedies and procedure will be governed by Irish bankruptcy law. Having the option to make no declaration weakens the fundamental purpose of the Convention in granting effective and prompt insolvency remedies by creating the uncertainty to the creditor who believes that his interest will be protected under the Convention's system but, in fact, it's not.

### 2.4. The Opt-In and Opt-Out System

The opt-in and opt-out concept is a controversial issue among scholars and practitioners alike.[206] With respect to the opt-in and opt-out options, the drafters kept the sensitivity principle in mind while respecting the autonomy of the States. Consequently, the Convention enables the Contracting State to make decisions about whether to apply certain provisions in the Convention, taking into account its economic and political objectives (particularly in the economic benefits gained

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[205] *Supra* note 16 at 197.
[206] *Supra* note 101 at 51., *supra* note 9 at 644. and *supra* note 181 at 11-12.

by its airlines in the matter of acquisition of aircraft objects).[207] The Contracting State may make declarations to opt-out, in other words, not apply wholly or partly specified provisions that it finds unacceptable or incompatible with its existing legal culture. On the other hand, it may make declarations to opt-in to specific provisions that it considers beneficial to its economy. The drafters believed that such a concept will increase the number of ratifications, because States have the option to apply the provisions that are acceptable in its system while choosing to opt-out of ones that do not (without simply opting out of the Convention altogether).

However, it can be argued that opt-in and opt-out option will only create more uncertainty in the creditor's position, as the creditor's international interest will vary depending on the option chosen by the Contracting State.

Additionally, this concept merely leads to disunity among Contracting State which, arguably, is the converse of one of the primary aims of the Convention: harmonization of secured transaction laws governing aircraft financing. It results in uncertainty to the creditor whose international interest is not governed by the same standard, although its transaction is under the same Convention.

The above practical scenario can be used as a first example. Regarding the self-help remedy provision, Malaysia has opted-in[208], the effect being that GECAS can exercise its remedy without leave of the court. Under this scenario,

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[207] UNIDROIT, *The system of declarations under the Convention on International Interest in Mobile Equipment and the Protocol thereto on matters respect to aircraft equipment: an explanatory memorandum for the assistance of the States and Regional Economic Integration Organizations in the completing of Declarations*, online: UNIDROIT <http://www.unicroit.org>.

[208] Declarations deposited under the Cape Town Convention on International Interests in Mobile Equipment regarding Article 54(2).

the creditor is ensured by the Convention that his international interest is protected under the Convention's regime.

If the debtor had been Avianca Airline (situated in Colombia), the transaction would be governed by the Convention because Colombia is a Contracting State. However, Colombia has opted out of the self-help remedy. The result is that GECAS can exercise its remedy only with leave of the court. Thus, the creditor may find itself in a situation where the only applicable remedy is subject to the domestic law procedures, even if the transaction itself is supposedly covered by the Convention.

As demonstrated in the above examples, the opt-in and opt-out provisions create different standards for creditors and generate disunity inside the Convention's system itself.

Another good example is the relief pending final determination provision (or interim relief). As described in Chapter 2, the Convention aims to protect the international interest of the creditor in the events of insolvency by granting relief before final determination from the court which normally takes time. Moreover, the Convention grants the option to the Contracting State in making a declaration to opt-out of this provision. As of August 25, 2008, no Contracting State has declared to opt-out; however, there is no guarantee that there will not be an opt-out Contracting State where this provision is found to be unacceptable and incompatible with its national law. If this occurs, the creditor's remedies will be limited to national law. Obviously, this situation undermines the aim of the Convention to harmonize secured transaction law and generates uncertainty for

the creditor. These opt-in and opt-out provisions hardly help to simplify the transaction and increase creditor confidence.

**2.5. International Registration System**

The International Registry is a new tool, created by the Convention for the purpose of recognizing the international interests and allowing third parties access to that information. The function of the International Registration is to rank the international interests attached to an aircraft and its engines, and to facilitate the filing and retrieval of said documents. Also, it aims to harmonize the priority rules of interest vested in aircraft objects and override domestic law particularly in the effect of attachment of aircraft engines to an airframe.

However, it can be argued that not every international interest is able to be registered with the International Registry. The Convention specifies the specific registrable categories in Article 26. Before the registration of international interests, consent in writing from the relevant parties is required.[209] The theoretical example outlined earlier will be used to clarify the overall situation.

*1. The Ownership Interest vested in the GECAS under the Contract of Sale*

The ownership interest vested in both the airframe and the engines which constituted by the Contract of Sale between Boeing and GECAS is registrable. The consent from Boeing is needed for the GECAS to register its ownership interest with the International Registry. However, whether or not Boeing will grant the consent is not a concern for either GECAS or the UK Investment Bank

[209] See Chapter 2 International Registry, above, for more on this topic.

since the international interest vested in the Lease Agreement and the Mortgage Agreement can be registered just as the ownership interest can.

*2. The International Interest vested in the GECAS under the Lease Agreement*

The international interest of both the Airframe and the Engines vested in the GECAS, as the lessor under the Lease Agreement, is registrable because Malaysia Airline (the debtor) is situated in a Contracting State.

*3. The Prospective International Interest vested in Malaysia Airline under the Purchase Option Agreement*

The prospective international interest vested in Malaysia Airline under the Purchase Option is registrable in respect of both the Airframe and the Engines because the GECAS (the debtor) is located in a Contracting State.

*4. The Security Interest vested in the UK Investment Bank under the Mortgage Agreement*

The security interest granted to the UK Bank by the GECAS under the Mortgage Agreement is registrable in the International Registry with respect to both the Airframe and the Engines.

*5. The Associated Right vested in the UK Investment Bank under the Assignment of the Lease*

The associated right granted to the UK Bank by the GECAS under the Assignment of Lease is registrable in the International Registry because the

assignor is the creditor under the agreement that creates/provides the international interest which is being assigned.

From the above example, in the transaction where the debtor is situated in a Contracting State, the Aircraft financing transaction is governed by the Convention. Arguably, both the creditor and the debtor will enjoy the benefits and security conferred by the Convention.

In addition, the conflict of ownership over the engines could be another concern. According to the above scenario, GECAS has been registered its ownership interest over the Engines in the International Registry. The result is that the ownership interest registered under the International Registry system prevails if there is any inconsistency with Malaysia domestic law regarding the transfer of ownership over the Engines. However, it can be criticized that there could be a conflict between the Contracting State and the non-Contracting State regarding the transfer of ownership over engines.[210]

With regard to Thai domestic law governing the ownership of equipment, in a scenario that the debtor is Thai Airway located in Thailand where domestic law provide that once engines have been installed with airframe, the ownership of the engines automatically transfers to the owner of the aircraft.[211] Accordingly, there could be a conflict between the GECAS whose ownership interest over the Engines has been registered in the International Registry system and Thai Airway who could claim to have ownership interest over the Engines according to Thai law

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[210] *Supra* note 91 at 11.

[211] Thai Civil and Commercial Code Section 1316 Paragraph 2: If one of the things could be regarded as the principal thing, the owner becomes the sole owner of the composite thing, but he must pay the value of the other things to their respective owners.

Practically, aircraft financing practitioners use ‘engine agreements’ as the tool in order to recognize the interest of the engine lessor and engine mortgagees. In the engine agreement, the aircraft lessor declares to recognize and respect the interest of the engine lessor and undertakes to collaborate with the engine lessor the repossession of the engine in accordance with the term of the agreement. In addition, in the case of renouncement, the aircraft lessor shall pay the engine lessor the agreed value of the engine.

According to the above example, it can be concluded that the Convention partly facilitates the transaction, but that the creditor still has to rely on the contractual agreement. Essentially, the universal ratification is required or else the Convention would not effectively function.

**Section 3: The Concerns on not yet Universal Ratification**

Many practitioners and scholars believe that the Convention will effectively function and truly deliver its benefits to the aviation industry only if it receives worldwide acceptance.[212] This Part aims to analyze how the self-help remedies, deregistration and export provisions, insolvency remedies, and the international registration system cannot fully deliver their promised benefits in the absence of universal ratification and, indeed, may create a new form of uncertainty for creditors.

[212] B.J.H. Crans, “Analyzing the Merits of the Proposed UNIDROIT Convention on International Interests in Mobile equipment and the Aircraft Equipment Protocol on the Basis of a Fictional Scenario” (2000) 25 Air & Space L., G. Mauri, “The Cape Town Convention on Interests in Mobile Equipment as Applied to Aircraft: Are Lenders Better Off Under the Geneva Convention?” (2005) 13 E.R.P.L.

### 3.1. The self-help remedy

With regard to the self-help remedy, the creditor is able to expeditiously exercise his rights when leave of the court is not required. Presently, this provision is applied in 24 Contracting States.[213] Thus, the uncertainty continues to be with the creditor since leave of the court is required in non-Contracting States.

### 3.2. Deregistration and Export Provision

The Convention includes a deregistration and export remedial provision that is intended to bypass and overcome disparate domestic deregistration processes in contracting states, simplify the deregistration and export procedures, and reduce the required documents.[214] The Contracting State has a legal obligation to harmonize its domestic law governing aircraft deregistration in order to ensure compatibility with the Convention. Thus, the creditor is ensured that the deregistration and export of the aircraft object are subject to the Convention, increasing the creditor's level of confidence.

In the proposed scenario, if default or insolvency of Malaysia Airline were to occur, GECAS is confident that the deregistration and export procedures will be carried out expeditiously with the cooperation and assistance from the local authorities.[215] Also, GECAS is able to repossess the aircraft within a reasonable amount of time.[216]

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[213] Declarations deposited under the Cape Town Convention on International Interests in Mobile Equipment regarding Article 54(2).
[214] *Supra* note 1 at 14.
[215] See Chapter 2 Deregistration and Export Remedy, above, for more on this topic.
[216] See Chapter 2 Insolvency Remedy, above, for more on this topic.

However, in the absence of universal ratification, the effectiveness of this provision may be open to criticism. For example, if the debtor were Thai Airway (located in Thailand), the deregistration and export procedures are subject to national law because Thailand does not have obligation to alter its law in order to be compatible with the deregistration provision of the Convention. Thus, in the event of default or bankruptcy of Thai Airways, the creditor has to rely on domestic law which likely will not provide the same benefit and confidence conferred by the Convention.

Another example could be the liquidation of Ansett Australia in 2002.[217] Ansett Australia was the second largest airline situated in Australia (which is a non-Contracting state). When it entered into liquidation, it had 38 Boeing aircraft in its fleet of 117 aircraft.[218] The deregistration procedures for these aircraft were dictated by Australian law and the creditor had to duly comply with Australia administration requirements. This situation shows that although the Convention's objective is to protect the creditor's interest and speed up the deregistration and export of aircraft, its goal is hardly reachable without the worldwide acceptance from the States.

### 3.3. Insolvency Remedy

This uncertainty for the creditor continues to exist, since there is not as yet universal ratification by States. With only 25 ratification states[219], it is more likely to be the case that the debtor is *not* located in a Contracting State than otherwise,

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[217] "Australian Airline files for Bankruptcy" *The New York Times* (13 September 2001), online: The New York Times <http://query.nytimes.com>.
[218] Ansett Airline online: Wikipedia <http://www.wikipedia.org>.
[219] *Supra* note 12.

and then the insolvency remedy is subject to the domestic law. For example, in the scenario where the debtor is Thai Airways and the events of insolvency occurred, the interest of GECAS is subject to Thai bankruptcy law. The domestic bankruptcy procedures are normally long and onerous. Undoubtedly, this situation creates uncertainty for the creditor as to whether or not his remedy could be exercised and when.

The Convention is expected to generate more confidence to the creditor and facilitate and simplify the aircraft financing transaction, in turn reducing the overall cost of acquisition of aircraft objects.[220] Conceivably, as the demand for new aircraft objects increases (since airlines will have greater access to capital and purchasing power), the skies will be safer and cleaner thanks to the use of such new modern aircraft.[221] In order for these hypothetical benefits to be realized, however, universal ratification is compulsory.

**Section 4: The Cape Town Convention and its Economic Effects to Aviation Industry**

The legal consequences of the Cape Town Convention have been analyzed in the previous Parts. Now, this part aims to analyze the economic consequences of the Convention to the main actors in the aviation industry – airlines, manufactures, and passengers. Accepting, from the previous discussion, that the Convention only partially delivers on its promises and introduces new difficulties for the industry, this part aims to purpose that the Convention nonetheless confers

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[220] K. Swirsky & C. Younger, "The Cape Town Treaty – What it means for Business Aircraft Owners and Purchasers", online: < http://www.gkglaw.com>.

[221] *Position Paper on the Cape Town Convention by American Chamber of Commerce to the European Union*, online: American Chamber of Commerce to the European Union <http://www.eucommittee.be>, and *supra* note 3 at 94.

many benefits on the aviation industry as a whole. The airlines benefit from the reduction in borrowing costs and more flexible creditor requirements. The manufactures receive more aircraft orders due to greater demand from airlines. Lower airfares and rates with quality services are made possible for the passengers. Last but not least, the global community enjoys a safer and cleaner sky resulting from environmentally friendly aircraft.

### 4.1 Airlines

With regard to airlines, the consequences of the Convention differ for each airline. The reason is that airlines situated in a Contracting State could receive more benefits than airlines from a non-Contracting State. Thus, in order to see the differences, this part will categorize airlines into two main groups – airlines from a Contracting State and airlines from a non-Contracting State.

*a. Airlines from the Contracting States*

There are numerous airlines situated in the Contracting States. The major airlines are United Airlines, American Airlines, Delta Air Lines, Ryanair, Avianca, Mexicana, Air India, Emirates Airline, and Malaysia Airline.[222]

Several benefits and advantages of the Convention to airlines of the Contracting States have been identified. First, the borrowing cost in order to acquire new aircraft is reduced as the creditor is afforded greater confidence that his interest is internationally protected under the Convention regime. Furthermore, the legal risks associated with cases of default, insolvency, and repossession are

[222] For more details regarding airlines ranking, please see www.airlinequality.com

alleviated because the rules of the Convention as an international legal framework are applied to transactions.[223]

Additionally, the Export-Import Bank of the United States grants offer to reduce the exposure fee for airlines located in a country that ratifies the Convention. The reduction is up to one-third of the exposure fee charged by Export-Import Bank for its aircraft export financing. These favorable financing terms are also extended to airlines acquiring spare engines.[224]

Alternative choices of capital are available for the airline with more flexible borrowing requirements. Creditors are most likely to grant credit when they can be assured that their interest is well protected and is registered with the International Registry.[225] Recently, the U.S. Export-Import Bank offered preferential financing terms to Ethiopian Airlines for the acquisition of a commercial aircraft from Boeing Corporation on the basis of it being a Contracting State of the Cape Town Convention.[226]

The money saved is able to be put toward fleet upgrading with more recent model aircraft. Operational costs are lower as new aircraft consume less fuel and that, in turn, will generate more profit for the airlines.[227]

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[223] *Supra* note 180 at 26.

[224] Ex-Im Bank Offers Reduced Exposure Fee for Aircraft Buyers in Countries Ratifying the Cape Town Treaty, online: Export-Import Bank of the United States < http://www.exim.gov>.

[225] A. Saunders & I. Walter, "Proposed Unidroit Convention on International Interests in Mobile equipment as Application to Aircraft Equipment through the Aircraft Equipment Protocol: Economic Impact Assessment" (1998) 23 Air & Sp. L. at 339, T.J. Gallagher, "Assessment of the Anticipated Economic Benefits of the Unidroit Convention" (1998) 23 Air & Sp. L. at 294.

[226] Ex-Im Bank Supports U.S. Aerospace exports to Ethiopian Airlines, online: Export-Import Bank of the United States < http://www.exim.gov>.

[227] Boeing Corporation, *Current Market Outlook 2008-2027* (Seattle: Boeing Corporation, 2008), online: Boeing Corporation <http://www.bowing.com/commercial/cmo>.

*b. Airlines from the non-Contracting States*

A number of large, well-known airlines also operate from non-Contracting States, including Air Canada, British Airways, Air French, KLM, Lufthansa, Singapore Airlines and Thai Airways.

With regard to economic benefits, it is certain that airlines from non-Contracting States receive less benefit from the Convention than airlines from the Contracting States. However, there are several advantages that the Convention contributes to this group of airlines.

The airlines situated in the non-Contracting States are able to register the aircraft object and the international interest attached to it in the International Registry. In an aircraft financing transaction that an airlines and/or debtor do not situate in a Contracting State, the Convention does not apply to the transaction. However, the international interests arising from the transaction could still be registered in the International Registry since the registry does not limit itself to only the international interests arising from transactions completed under the Convention regime.

Also, even when transactions do not involve parties in Contracting States, it has become normal practice to require, as part of the aircraft financing agreement, that the airline and/or the debtor register the aircraft object in the registry, as a means to advising and informing third parties and ensuring the creditor’s priority.

### 4.2. Manufacturers

For commercial aircraft manufacturers and their suppliers, the orders of aircraft and engines will increase due to greater demand for aircraft worldwide. Both Boeing Corporation and Airbus Industry have predicted that the orders of aircraft will tremendously increase in next two decades and the Cape Town Convention will play an important role as a driving force.[228] The reason is simple: when airlines are able to upgrade their fleet due to more favorable financing agreements and a greater selection of choices of credit available in the current market, the airlines rarely hesitate to do so. As a result, the profit of the manufacturers will be higher and the level of employment will be increased.[229]

### 4.3. Passengers

Passengers ought to benefit from lower airfare as well as increased levels of service.[230] Emirates Airline offers passengers a London – Dubai route operated with an Airbus A 380 at a price of USD 389 while Qatar Airways offers at a price of USD 600.[231] Regarding the services, Emirates Airline is a five-star airline with reputation in both ground and onboard services.

Additionally, the safety of passengers onboard the aircraft is improved since newer model aircraft are operated by airlines. Many air accidents are correlated to the age of aircraft (such as the crash of American Airlines flight 191, a McDonald Douglas DC-10). Everyone onboard was killed including two

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[228] *Supra* note 228 and Airbus Industry, *Global Market Forecast 2006-2026* (Toulouse: Airbus Industry, 2006), online: Airbus Industry < http://www.airbus.com/en/corporate/gmf>.

[229] J. Shane, "Seminar on the Cape Town Convention's Role in Facilitating International Trade" online: U.S. Department of Transportation <http://www.dot.gov>.

[230] *Supra* note 12.

[231] Emirates Airline online: < http://fly.emirates.com>, Qatar Airways online: <http://www.qatarairways.com>.

persons on the ground.[232] The above problem could be avoided if the airlines have the purchasing power to upgrade their fleet appropriately.

Additionally, in April 2008, the Federal Aviation Administration (FAA) ordered safety inspections on all MD-80 model aircraft due to the age concern. This model had been operating since 1983 and there were problems reported with wiring bundles in the planes' wheel wells.[233] As the result, American Airlines canceled thousands of flights resulting in the loss of millions of dollars of revenue. The cancellations also affected passengers who were not able to travel in accordance with their original plans. Thus, these problems can be alleviated once the airlines replace the aging aircraft with newer one.

### 4.4. Considerable improvements for other parties

In developing and/or less developed countries, capital is more readily accessible at a reasonable price for airlines, where it perhaps has not been available historically.[234] Due to the reduction in financing cost, the debt levels of the governments who use their sovereign credit as the guarantee for their airline is reduced.[235]

For the global community, safety records in many jurisdictions are improved since airlines are operating with newer, more reliable aircraft.[236] Moreover, environmental problems caused by aircraft are reduced. Travel by air

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[232] The crash of American Airlines flight 191, online: Essortment Articles <http://www.essortment.com>.
[233] J. Bailey, "American Airlines Cancels 922 More Flights" *The New York Times* (10 April 2008), online: The New York Times <http://www.nytimes.com>.
[234] S. Scherer, "Point-to-Point: Financial Trends in Commercial Aviation" online: Boeing Corporation <www.boeing.com>.
[235] *Supra* note 12.
[236] UNDROIT, *Economic Benefits of the Cape Town Convention* online: UNIDROIT <www.unicroit.org>.

becomes the most convenient and fastest way for travelers who need to travel across borders within a short period of time. As a result, air traffic rates constantly increase, bringing with them increased noise and air pollution, although technology is always advancing to make for more environmental friendly aircraft with the lowest possible noise levels.[237] Examples of such aircraft include the Airbus A380 and the Boeing B787. Once the cost of acquiring new aircraft is decreased and the airlines are able to upgrade their fleet with newer model aircraft, the sky will be cleaner as there will be less air pollution.

In short, the Convention confers many benefits to the aviation industry and global community. The Airlines benefit from lower borrowing costs which increase their purchasing power of new aircraft. The manufacturers receive more orders from airlines that wish to upgrade their fleet. Passengers are provided with lower airfares and rates as well as quality services. Last but not least, global community benefits from safer and cleaner skies are the consequences of upgraded fleet. Thus, even though the Convention has several weaknesses and some of the provisions might not fully function due to the absence of worldwide acceptance, it still confers numerous benefits toward aviation industry and global community.

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[237] *Supra* note 229.

**Chapter Summary**

It can be concluded that the Convention partially delivers its promises, as there are a number problems solved amid the few new difficulties created by the Convention. Concerning the solved problems, the Convention bestows the least possible political interference, speedy default remedies, and reliable and predicable priority ranking as well as minimizing documentation requirements.

In our example scenario, political interference is an external factor and, while it is an issue, here is little that can be done to avoid it. The Convention does provide assurances to creditors that deregistration and export processes will be undertaken with the assistance of local authorities within a limited timeline.

On the subject of self-help remedy issue, The Convention facilitates the repossession of the aircraft object among the Contracting States that choose to opt-in the self-help remedy provision. Thus, the Convention enables the creditor to exercise his remedy expeditiously without the requirement of the court approval.

With respect to prioritization issues, the creditor is ensured that his international interest attached to the aircraft object is given priority according to the first-to-register basis and is ranked the same among all Contracting States. There is some criticism that the ‘non-consensual rights/interests which is given priority without registration’ could lead to uncertainty for the creditor on whose priority may be affected. However, these rights/interests are predicable since they are similar in each Contracting State and the creditor is, or ought to have, notification of them. Thus, the Convention brings certainty on priority matter to the creditor.

With regarding to the detailed document issue, the Convention simplifies the transaction by establishing clear rules which result in less complex agreement between the relevant parties. Also, it provides specific deregistration and export form which is used in the Contracting State in order to solve the problem of detailed documents required from local civil aviation authorities.

Regarding the newly created difficulties, the Convention has several weaknesses which could lead to greater difficulties for the creditor. In the applicability of the Convention issue, the creditor is ensured that most of his international interest vested in the aircraft financing transaction is protected under the Convention regime. However, the Convention addresses all but one aspect of the aircraft financing transaction, the exception being the assignment of sale/prospective sale agreement. Consequently, the creditor's interest regarding the assignment of sale/prospective sale agreement is not protected under the Convention framework.

Concerning the issue of 'default,' it is reasonable to state that the parties involved in a transaction are the ones best able to define what is meant by 'default', and the Convention accordingly affords them the opportunity to do so. However, a failure to do so in the contract results in the use of a definition from the Convention which is very vague in practical terms. This vulgarity is exacerbated by the use of further unclear terminology ('commercially reasonable') in the manner of exercising remedies which could lead to interpretation conflicts. Thus, the position of the relevant parties is undermined by this vague definition and the agreement may be more complicated as the relevant parties have to clarify what is commercially reasonable.

The effectiveness of insolvency remedies depends on the declaration made by the Contracting State. Alternative A has been established as the best choice for the relevant parties, if one accepts that the “best” results are obtained when insolvency situations are resolved in accordance with American bankruptcy law principles (which are equivalent to Alternative A). However, the insolvency remedy could be subject to domestic law in the case where a Contracting State has made no declaration in this regard. Thus, uncertainty for the creditor continues to exist in such situations.

With regard to the opt-in and opt-out issue, the Contracting State is able to declare its intention to apply and not apply specific provisions of the Convention, in light of its economic and political objectives. This necessarily leads to the non-unification of rules among the Contracting State and therefore creates a new uncertainty for the relevant parties.

The international registration system, a newly created tool used to recognize the international interest and publicly inform third parties of those parties, ensures the creditor that his international interest is internationally recognized and protected. Also, it facilitates the parties involving in aircraft financing transaction in filing and searching documents on the Internet. However, the Convention leaves the dubiety to the creditor since not every international interest is registrable with the International Registry. Additionally, the worldwide acceptance is required in order for the International Registry to truly simplify the transaction and facilitate the relevant parties.

Overall, nothing short of universal ratification will permit the Convention to truly deliver on its promises. The self-help remedies, deregistration and export

provisions and insolvency remedies satisfy the need of aircraft financing industry today; however, the above provisions will not deliver their highest efficiency without worldwide acceptance.

However, there *are* economic benefits bestowed by the Convention. Regarding the economic perspective, the Convention, which partially fulfilled its goal, provides greater certainty to the creditors that their interests will be internationally protected. As a result, the Export-Import bank of the United States offers a reduced fee for the debtors who situate in the ratifying States. The airlines located in the Contracting States enjoy the reduction of borrowing cost, while airlines based in the non-Contracting States benefit from the advantages of an International Registry. The manufacturers benefit from the increase of aircraft orders, and passengers profit from quality services that come with lower air fees and rates. Last but not least, the safety level of travelling by air is improved as old aircraft are replaced by more environmentally-friendly, fuel-efficient models.

In brief, the Convention slightly fulfills its goals of simplifying aircraft financing transactions. Its provisions partially function. However, there are numerous benefits that the aviation industry and global community benefit from, which are not directly contemplated by the Convention itself. Thus, it can be concluded that the Convention, while imperfect, is a necessary step for the aviation industry to start with in order to move further to the next level.

# Conclusion

## Aircraft Financing Instruments and Their Problems

The first chapter examined the aircraft financing instruments that are typically used in aircraft financing transactions. Leasing as the most widely used financing instrument was considered in detail and divided into two main leasing transactions: *operating leases* and *financial leases*. Then, leveraged lease, as the basic of all leasing structures developed for aircraft financing, was considered and examined to discover their practical function in today's aircraft purchase transaction. Also, the role of Export Credit Agencies was explored, as they have become another important source of aircraft financing in the increasingly global marketplace.

Regardless of the instrumentation used, legal concerns exist which can impede negotiations, increase transaction costs, and create uncertainty for the creditor. The root of the problem is the absence in uniformity of the law governing asset-based financing across jurisdictions. Consequently, creditors may be reluctant to grant credit to airlines (or may raise their interest rate), for fear of not having any recourse of enforcement ability if the airline should default with the aircraft in a foreign jurisdiction. These situations coupled with the legal concerns are the original root of the Cape Town Convention and the Aircraft Protocol.

## The Cape Town Convention and its Aircraft Protocol

The Cape Town Convention creates the set of international interests and protects them by ensuring international recognition and protection through the International Registry. The International Registry is a newly invented body which enables a creditor to secure his interests in an aircraft object by registration of the

interest in the IR. Accordingly, the registered international interest will have priority over any subsequently registered and unregistered international interests. Also, the Convention enables the creditor to expeditiously exercise his default remedy (without requiring lengthy court proceedings), as well as interim relief pending final determinations. In the event of insolvency by the debtor, the creditor is ensured that his interest is protected under the Convention regime and he is able to uphold his rights against third parties. Additionally, the Convention confirms the protection of the rights associated with an international interest.

With the adoption and ratification of this Convention, creditors stand to gain a great deal of security. The issue of non-recognition of the creditor's title or security interests is resolved by the creation of international interests and the establishment of the International Registry. The Convention unifies forms of security interest from various jurisdictions into 3 main categories: the interest in an aircraft object granted by the chargor under a security agreement, the interest vested in a person who is the conditional seller under a title reservation agreement, and the interest vested in a lessor under a leasing agreement. Also, the concern about priority ranking is alleviated by virtue of the international registry working on a "first-to-register" basis. Smooth and quick repossession is ensured as well as a more transparent deregistration process. Judicial procedures regarding insolvency issues are faster and more reliable due to the timelines established by the Convention.

**The Impacts of the Cape Town Convention on Aircraft Financing Transaction**

After two years of being in force, the Convention partially delivers on its promises. First, while political interference is an inherently uncontrollable factor that heavily influences some aircraft financing transactions, the Convention *does* strive to reduce this interference by obligating local authorities of the Contracting States to grant relief measures (such as deregistration and export remedies) to the creditor within five working days.

The Convention enables expeditious remedies for the creditor by means of the self-help option which the majority of the Contracting States have chosen to adopt. As a result, any remedies available under the Convention regime can be exercised without leave of the court. Also, reliable and predicable priority ranking is made possible by means of the international register system. The rule of priority is simple: registered interests have priority over subsequently registered interests and over any unregistered interests. There is a concern on the non-consensual interest which is given priority without registration. However, this type of interest is predicable since it is limited to two types and it is published on the UNIDROIT website.

Regarding the historically onerous documentation requirements, the Convention offers specific forms regarding the deregistration and export request in order to avoid the countless documents required from local authorities in the event of deregistration and export of the aircraft object. Also, the volume of documentation regarding the transaction in general is reduced due to the simplification of the transaction since the clear rules governing aircraft financing are established.

Despite these gains, several concerns arise from the Convention. The Convention is littered with vague, uncertain terminology which could undermine the position of the creditor and could lead to a more complicated agreement in the end.

Regarding the insolvency remedy, the Convention provides two options for the Contracting States to apply in the event of insolvency of the debtor. The Contracting States may make a declaration to apply either Alternative A or Alternative B. In this case, the creditor is guaranteed that his remedy will be quickly exercised under the efficient insolvency provisions provided by the Convention. However, the Convention also allows the Contracting State to make 'no' declaration in this matter. Consequently, the insolvency remedy is determined by domestic bankruptcy laws. This situation could lead to uncertainties for the creditor who believes that his interest is protected under the Convention regime but, in fact, it is not.

As individual signatories have the right to "opt in" and "opt out" of various aspects of the Convention, it is likely that there will still be a lack of uniformity among the Contracting States. This is not inherently compatible with the aim of harmonizing the legal rules regarding aircraft financing across jurisdictions, in order to eliminate some uncertainties for the creditors. Examples include the self-help remedy provisions (that Colombia chooses to opt-out of) and the insolvency remedy to which Ireland has made 'No' declaration

There could be a conflict between the Contracting States and the non-Contracting States over the ownership of engines where the domestic law regarding the transfer of ownership of the non-Contracting State is incompatible

with the Convention. Accordingly, this conflict creates the dubiety situation for the creditor who has to rely on the contractual agreement.

Without uniform ratification from the global community, a perfect implementation of the Convention can hardly be attained. The self-help remedy, deregistration and export provisions, and the insolvency remedy system are not able to be completely effective in the absence of worldwide acceptance. Accordingly, some uncertainty continues to rest with the creditor, since airplanes fly to anywhere in the world, including those countries which are non-Contracting States.

In sum, the Convention, as drafted, only partially fulfils its stated goals of transaction simplification; however, this partially functioning Convention confers many tangible benefits to the aviation industry (particularly for airlines located within Contracting States). Airlines are able to upgrade their fleets because of lower borrowing costs, and even airlines situated in non-Contracting states benefit from the advantages of the International Registry. The manufacturers receive more orders of both airframes and engines. The passengers enjoy lower airfares and rates coupled with quality services from the airlines. Most importantly, the global community benefits from the improvement in safety levels that comes when newer model aircraft are operated. The noise and air pollution from aircraft is alleviated since these newer models are more efficient and environmental friendly. In the lights of the above facts, the Convention

In the light of the above facts, it appears obvious that the Convention confers many benefits to the aviation industry and the global community; even it *does* have several weaknesses.

**The Proposed Solution for Current Situations**

At the end of the day, many of the problems outlined above will be resolved on a case-by-case basis, as negotiations result in a detailed agreement that is most satisfying for all interested parties.

An agreement is an essential instrument in any transaction, since universal ratification has not yet been attained. In the aircraft financing contract, the aircraft financiers and all interested parties should not depend on only legal instruments provided by the Convention but they should (and must) use their experiences and negotiation power in order to reach the most desirable result. Also, an awareness of the potential pitfalls of the Convention is absolutely necessary, since these weaknesses could lead to highly unsatisfactory outcomes if they are not heeded. For example, the definition of the ‘events of default’ and clarification of the meaning of words ‘commercially reasonable manner’ must be addressed in the agreement in order to guard against interpretation conflicts.

The greatest benefit from the Convention can only be realized through universal ratification. The opt-in and opt-out system may be a necessarily evil in order to gain greater acceptance from States, which are keen to benefit from the effectiveness and uniformity of the rules, but are afraid that the Convention will harm the existing laws in their respective countries. The opt-in and opt-out system is not a perfect solution but it is a must-adapted solution for all common interests. Last but not least, with regard to all addressed problems, they emphasize that the worldwide acceptance is the main obstacle that essentially limits the effectiveness of the Convention. Therefore, the universal ratification is necessary for the Convention to truly deliver its best benefits.

Although the Cape Town Convention and its Aircraft Protocol is not the perfect answer for all interested parties and the aviation industry, it is a necessary step toward even better solutions in the future.

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