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THE CAPE TOWN CONVENTION: Similar is not the Same and Says Who

By Elliot Gewirtz

The Cape Town Convention and related Protocol on Aircraft Equipment significantly alter the rules governing aircraft financing by establishing a new international framework for the creation, registration, recognition and enforcement of "international interests" in airframes, aircraft engines and helicopters. The Convention was adopted on November 16, 2001 in Cape Town, South Africa and together with a related Protocol on Aircraft Equipment came into effect on March 1, 2006.*

For ease of reference, the Convention as modified by the Protocol will be referred to as the Cape Town Treaty. The Cape Town Treaty is designed to facilitate the financing of mobile equipment through asset-based and lease financings. The central mechanism for accomplishing this objective is the establishment of an international registry for the registration of "international interests". The International Registry of Mobile Assets is located in Ireland and is accessible electronically to registered users twenty-four hours a day. International interests encompass (i) an interest granted by a "chargor" under a security agreement in favor of a "chargee", (ii) an interest vested in a conditional seller under a title reservation agreement, and (iii) an interest of a lessor under a leasing agreement. The Cape Town Treaty sets forth additional categories of registrable interests including contracts of sale, assignments of international interests, subordination agreements of international interests and prospective international interests. Interests are registered rather than documents recorded. The Cape Town Treaty adopts a "first-in-time, first-in-right" rule of priority similar to that of the Uniform Commercial Code (the "U.C.C.").

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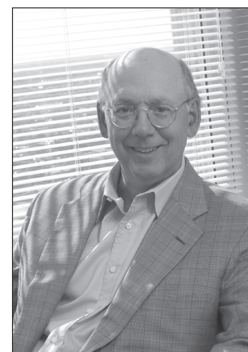

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*Formally, the Convention on International Interests in Mobil Equipment (the "Convention") as modified by the Protocol to the Convention on International Interests in Mobil Equipment on Matters Specific to Aircraft Equipment, signed and done on May 9, 2003 (the "Protocol").

The Cape Town Treaty applies whenever the chargor, lessee, or conditional buyer, as the case may be, is situated in a contracting state "at the time of the conclusion of the agreement creating or providing for the international interest" (Convention, Article 3(1)). The Cape Town Treaty also applies to an airframe or helicopter registered in a contracting state. The Cape Town Treaty is in effect in Angola, Ethiopia, Ireland, Malaysia, Nigeria, Oman, Pakistan, Panama, Senegal and the United States.

In adopting the Cape Town Treaty, the United States elected to have the F.A.A. act as the U.S. entry point to the International Registry for U.S. registered aircraft and helicopters. As a precondition to the F.A.A. providing an "authorization code" to effect registration of an "international interest" with the International Registry, the standard pre-Cape Town Treaty F.A.A. recording requirements of the Transportation Code (49 U.S.C. § 441 et seq.) must first be met. When adopting the Cape Town Treaty, the United States could have, but did not, elect in its Declaration to have the Cape Town Treaty not apply to "internal transactions" where the center of the main interests of all parties is situated and the object is located in the same contracting state. Accordingly, from and after March 1, 2006, the Cape Town Treaty applies to purely domestic aircraft financings such as a EETC for a U.S. airline. This creates the possibility of conflict between a complex but well established body of law and one newly created and thereby introduces a new level of uncertainty into U.S. domestic aircraft finance law.

Prior to March 1, 2006, U.S. domestic aircraft financing was governed by a well established body of law consisting primarily, at the state level, of Articles 2A and 9 of the U.C.C. governing personal property leases and secured financing and, at the federal level, the Transportation Code and the Bankruptcy Code (including Section 1110). Post March 1, 2006, the Cape Town Treaty creates a federal overlay. Articles 8 through 15 of the Convention (and related provisions of Chapter II of the Protocol), for example, set forth certain remedial provisions applicable to aircraft lease and mortgage financing. Certain of these remedial provisions are mandatory and not subject to modification by agreement of the parties. As the provisions are set forth in a treaty, the Federal courts have jurisdiction over questions arising thereunder. In interpreting the Cape Town Treaty, Federal courts may well create a Federal jurisprudence of aviation finance law not necessarily bound by analogous provisions of state law. Further, in the event of a conflict between a mandatory provision of the Cape Town Treaty and an analogous provision of state law, the Cape Town Treaty normally would be expected to prevail. Indeed, Article 9 of the U.C.C. expressly provides that the U.C.C. does not apply to the extent a treaty of the United States preempts its provisions. It is this interaction between similar but different provisions of the Cape Town Treaty and existing state law and the open question as to how potential conflicts will be resolved by the federal courts which creates the new uncertainty in U.S. domestic aircraft finance law. Quite

literally, U.S. domestic air finance law has now become a "Federal Question".

The manner in which courts will deal with these potential conflicts may well depend upon whether or not the Cape Town Treaty is deemed to be "self-executing." The distinction between self-executing and non-self-executing treaties is rooted in the idea that treaties are compacts between countries. Any rights arising under a treaty therefore accrue to the ratifying states rather than their citizens. In order to confer rights on individual citizens, Congress may enact implementing legislation to incorporate the provisions of a non-self-executing treaty into the body of domestic law. On the other hand, U.S. courts may conclude that the contracting states to the Cape Town Treaty intended the treaty to be self-executing either in whole or in part (that is, enforceable by individual citizens absent such implementing legislation). It is noteworthy in this regard that Congress, in enacting the Cape Town Treaty Implementation Act in 2004, stated that "[o]nly technical changes to United States law and regulations are required since the asset-based financing and leasing concepts embodied in the Cape Town Treaty are already reflected…in the Uniform Commercial Code." This lends credence to the view that, at a minimum, the remedial provisions of the Cape Town Treaty were intended to be self-executing.

The Cape Town Treaty itself provides some guidance as to how it should be interpreted in light of domestic law: Article 5(2) of the Convention states that questions "not expressly settled in [the Convention] are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the applicable law."

How then to reconcile the Cape Town Treaty with existing aviation finance law? Certain provisions of the Cape Town Treaty (notably those related to the registration of "international interests" with the International Registry) work in tandem with and supplement rather than conflict with existing provisions of the Transportation Code dealing with the recordation of "conveyances" with the F.A.A. and the perfection of security interests in Aircraft under the U.C.C. Under the U.C.C., perfection of a "security interest" in a U.S. owned aircraft requires an F.A.A. filing and an F.A.A. filing is a prerequisite to the registration of an "international interest" in such an aircraft with the International Registry. In short, the rules applicable to perfection of security interests and recognition of international interests co-exist and both sets of rules must be followed. The matter is rather more complex when dealing with other provisions of the Cape Town Treaty notably its remedial provisions. The statements in the Implementation Act to the contrary notwithstanding, similar but different provisions are found in the Cape Town Treaty and applicable state law. In a best case, Federal courts relying on Article 5 of the Convention, and mindful of the quoted statements set forth in the Implementation Act, will look to applicable state law to interpret analogous provisions of the Cape Town Treaty so as to avoid, to the extent possible, conflicts with existing state law. Real conflicts, however, are bound to arise precisely in those areas where the Cape Town Treaty and existing state law adopt similar but different provisions relating to the same subject matter. Three such potential areas of conflict relate to the standard of "commercial reasonableness", required notices of disposition and the debtor's right of redemption—all rather fundamental areas of aircraft finance law.

Article IX(3) of the Protocol provides that: "Any remedy given by the Convention in relation to an aircraft object shall be exercised in a commercially reasonable manner. A remedy shall be deemed to be exercised in a commercially reasonable manner where it is exercised in conformity with a provision of the agreement except where such a provision is manifestly unreasonable." This is a mandatory provision of the Cape Town Treaty, not subject to contractual modification. The provision appears to permit parties to define for themselves what constitutes "commercial reasonableness" unless the agreed provision is "manifestly unreasonable".

By contract, Section 9-610 of the U.C.C. provides that "every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable". Section 9-627 of the U.C.C. defines certain safe harbor standards (including a disposition in the usual manner in any recognized market or an enforcement approved in a judicial proceeding) none of which include the agreement of the parties. Time will tell whether the Cape Town Treaty's "agreement of the parties" safe harbor will be interpreted by the courts to supplement the U.C.C.'s safe harbors, or whether the courts will read established U.C.C. law into the Cape Town Treaty's "manifestly unreasonable" safe harbor so as to avoid conflicts. Similarly, the U.C.C. expressly provides that the obligation to proceed in a "commercially reasonable manner" runs to the benefit of a debtor, secondary obligor or other secured party (as each such term is defined in the U.C.C.). The obligations of the Cape Town Treaty are arguably not so limited. The difference could be quite meaningful to the holder of a subordinated tranche of an EETC. While the holder of a subordinated tranche is neither a "debtor", "secondary obligor" nor "secured party" (as defined, for example, in the N.Y. U.C.C. and as interpreted by its courts), the subordinated debt holder may be held by a Federal court to have sufficient "rights in or over the object" to have the benefit of the Cape Town Treaty's obligation to proceed in a "commercially reasonable manner".

Under 9-623(c) of the U.C.C., a debtor may redeem collateral at any time before the secured party has "entered into a contract for its disposition" by paying all secured obligations plus (or including) "reasonable expenses and attorney's fees". The Cape Town Treaty provides that any time "before sale of the charged object" the chargor may discharge the security interest "by paying in full the amount secured". This is a clear instance where Article 5 of the Convention should apply to interpret the Cape Town Treaty standard consistent with the U.C.C. standard so as to cut off an owner's right of redemption at the time of the entering into of a contract for sale rather than at the time of the actual sale and to harmonize the amounts payable under both standards. Whether courts will so hold only time will tell.

Under Article 8(4) of the Convention "a chargee proposing to sell or grant a lease of an object . . . shall give reasonable prior notice in writing of the proposed sale or lease" to certain specified "interested persons". Under Article IX(4) of the Protocol, a chargee giving "ten or more working days' prior written notice of a proposed sale to interested persons shall be deemed to satisfy the requirement of providing 'reasonable prior notice'". "Interested persons" include a debtor, surety or "any other person having rights in or over the object".

Under 9-611 of the U.C.C., by contrast, a secured party that disposes of collateral under 9-610 shall send to the debtor, any secondary obligor and any other secured party "a reasonable authenticated notification of disposition" and such standard may be met as respects a secured party if the secured party not less than 20 nor more than 30 days prior to the notification date did a U.C.C. search and thereafter notified the identified secured parties of the proposed disposition. As will be noted, the safe harbor notice period under the Cape Town Treaty and U.C.C. differ and more importantly, the class of persons to be notified of a disposition under the Cape Town Treaty and U.C.C. may differ as well (i.e., a debtor, secondary obligor or secured party (each as defined in the U.C.C. and interpreted by state courts) as compared with a debtor, surety or "any other person having rights in or over the object" as defined in Cape Town Treaty and as understood by a federal court). As the notice provisions under both the Cape Town Treaty and the U.C.C. are mandatory, the practitioner is left with no alternative but to attempt to comply with both.

Lease assignments are another area of potential conflicts. With specified exceptions, 9-407(a) of the U.C.C. provides that "a term in a lease agreement is ineffective to the extent that it . . . requires the consent of a party to the lease to the assignment or transfer of a security interest in [or of] an interest of a party under the lease contract". By contrast, under Article 31 of the Convention and Article XV of the Protocol, an assignment of "associated rights" (which would include the basic rent under a net lease of an aircraft) which transfers to the assignee the related "international interest" (which, in the case of a lease, is the lessor's interest under the lease) requires the written consent of the debtor (which, in the case of a lease, is the lessee under the lease) in order for the debtor to be bound by the assignment. Here too the Cape Town Treaty appears to override the U.C.C. Best practice would require obtaining a lessee consent.

The Cape Town Treaty impacts more than just the U.C.C. Choice of law and jurisdictional provisions of aircraft financings are affected as well. Article VIII(2) of the Protocol provides that "the parties to an agreement . . . may agree on the law which is to govern their contractual rights and obligations . . ." Similarly, Section 5.1401 of the General Obligations Law of the State of New York provides that parties to a contract (covering a transaction aggregating not less than $250,000) may specify the applicable governing law whether or not the contract bears a "reasonable relation" to the State of New York. The N.Y. G.O.L. provision has always been thought to be subject to Constitutional scrutiny whereas the Protocol provision would seem not to be. This is one area where the Cape Town Treaty would seem to have improved the practitioner's lot.

Similarly, Article 42 of the Convention provides that " . . . the courts of a Contracting State chosen by the parties to a transaction have jurisdiction in respect of any claim brought under the Convention, whether or not the chosen forum has a connection with the parties or the transaction". If read literally, the provision would appear to allow parties to confer jurisdiction on any court of the Contracting State to adjudicate any matter arising under, for example, the lease of an aircraft. This provision clearly calls for application of Article 5 of the Convention and an interpretation that reads applicable federal and state jurisdictional and venue criteria into Article 42. In the alternative, a court might conclude that these jurisdictional provisions of the Cape Town Treaty are not self-executing and, absent enacting legislation by Congress, are not effective in the U.S. Irrespective of the Article 42 grant of jurisdiction, under 28 U.S.C. §1331 (Federal question jurisdiction), Federal district courts would have jurisdiction to hear cases interpreting the Cape Town Treaty as such courts have "original jurisdiction of all civil actions arising under the Constitution, laws or treaties of the United States". As noted at the outset, this grant of jurisdiction may well lead to a federal jurisprudence of U.S. aircraft finance law.

Few would deny the utility of a central international registry for specified interests in mobile goods such as aircraft. Similarly, the adoption by the nations of the world of a uniform body of commercial law is surely of value (particularly from the perspective of one whose law is being exported). Whether the goal will be realized only time will tell as nations elect or not to bring the Cape Town Treaty into force. So far, the response has not been overwhelming. One must, however, question the wisdom of the U.S. election to apply the Cape Town Treaty and in particular its remedial provisions to purely domestic U.S. transactions. To the extent the Cape Town Treaty sets forth a body of rules which are, as the Implementation Act suggests, the same as the existing body of state law, one is left to wonder what was sought to be achieved. Making aviation finance law a "Federal question" raises not only questions of Federalism for those interested in such matters, but, in the author's view, adds needless uncertainty to an industry already plagued by an uncertain world.*

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