

Cape Town Convention

November 2011

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Introduction

The Cape Town Convention (as it is commonly known), as far as it relates to aircraft objects (which include airframes, aircraft engines and helicopters - please see below for further details), consists of the *Convention on International Interests in Mobile Equipment* and the *Protocol on Matters Specific to Aircraft Finance* (the “**Protocol**”) (they are together referred to as the “**Convention**”). This briefing paper is intended as a rough guide to the Convention as it applies to aircraft objects, and does not constitute legal advice.

The **five core objectives** of the Convention are:

1. to facilitate the acquisition and financing of internationally mobile assets by creating rights recognised in all Contracting States;
2. to give creditors recourse to basic default and insolvency-related remedies designed to offer rapid relief;
3. to establish an electronic registry of international interests which serves to give notice to third parties and ensures priority;
4. to ensure that the specific needs of the aircraft industry are met (the other protocols ensure the same for the rolling stock and satellite industries); and
5. to give prospective creditors a greater degree of confidence when extending credit to borrowers.

To meet these objectives, the Convention creates the following:

1. an “international interest” which is recognised in all Contracting States;
2. an electronic international register of interests; and
3. standard rights for creditors on default.

Contracting States

The Convention came into force on 1 March 2006, when the first eight contracting states signed and ratified the Protocol. Over sixty states have signed or acceded to the Convention. However, as it is ratification and signature or accession that brings the Convention into force in the relevant state, as of 01 November 2011 the Convention is in force in respect of the following forty-nine countries and regional economic organisations:

Afghanistan, Albania, Angola, Bangladesh, Belarus, Cameroon, Cape Verde, China, Colombia, Costa Rica (effective 01 December 2011), Cuba, Ethiopia, European Union, Fiji (effective 01 January 2012), Gabon, India, Indonesia, Ireland, Jordan, Kazakhstan, Kenya, Latvia, Luxembourg, Malaysia, Malta, Mexico, Mongolia, New Zealand, Nigeria, Norway, Oman, Pakistan, Panama, Russian Federation, Rwanda, Saudi Arabia, Senegal, Seychelles, Singapore, South Africa, Syrian Arab Republic, The Kingdom of the Netherlands, Tajikistan, Togo, Turkey (effective 01 December 2011), United Republic of Tanzania, United States of America, United Arab Emirates, Zimbabwe.

Whilst the UK has signed the Convention, it has not yet ratified it; at the time of writing, the UK government is considering whether to do so. The next stage in the current process is an economic assessment and the government is due to respond on this at the end of November 2011. There has been an indication from ministers that the government is committed to ratification. However, once a decision has been made, it will still be a lengthy process towards ratification. With the need to consult each of the overseas territories, it is estimated that it will take a further two to three years to ratify fully the Convention.

Registrable interests

There are several classes of registrable interest under the Convention, but the most important from a creditor’s point of view are “**international interests**” and “**prospective international interests**”.

Notably, registrations and searches are carried out in relation to **specific assets** (as opposed to documents), and it is not possible, for example, to register an interest in unidentified future property by reference to the provisions of a security agreement.

International interests

The creation of “international interests” is a central purpose of the Convention. Broadly, international interests are interests in uniquely identifiable aircraft objects:

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

- granted by the seller under an outright sale agreement; or
- held by an assignee.

In relation to sales, only certain provisions of the Convention will apply.

The Convention applies when, at the time of the conclusion of the agreement creating or providing for the international interest, the debtor/seller (though not necessarily the creditor/buyer) is situated in a Contracting State. Further, the relevant object must be located in the relevant Contracting State at the time of the conclusion of the agreement creating or providing for the international interest.

International interests must also satisfy certain formal requirements, including that the agreement creating or providing for the interest:

- is in writing;
- relates to an object of which the chargor/conditional seller/lessor/seller has power to dispose;
- enables the aircraft object to be identified; and
- in the case of a security agreement, enables the secured obligations to be determined (but without the need to state a sum or maximum sum secured).

Prospective international interests

“**Prospective international interests**” are interests that are intended to be created in an aircraft object at some point in the future on the occurrence of a stated event. The occurrence of the stated event need not be certain, and could, for example, be the acquisition of the aircraft object by the debtor.

Where a prospective international interest is registered, the stated event occurs and completion of the transaction takes place (subject to certain provisos), the Convention provides that no further registration is necessary to convert the prospective international interest into a full international interest.

What are aircraft objects?

Aircraft objects are:

1. **airframes** which can carry at least eight persons (including crew) or goods weighing at least 2,750kgs;
2. **aircraft engines** with at least 1,750lbs thrust (if jet

propulsion) or at least 550 rated take-off shaft horsepower (if turbine or piston-powered); and

3. **helicopters** which can transport at least five persons (including crew) or goods weighing at least 450kgs.

This means, in practice, that all but the very smallest commercial jet airframes will fall within the application of the Convention. For example, even the relatively small Gulfstream G100 aircraft which carries eight to nine persons falls within the Convention. An example of an aircraft which falls outside the Convention is the Cessna Citation Mustang, which can only carry six persons.

It is important to remember that the engines must be considered separately from the airframe, so that it is possible for the Convention to apply to the engines even if it does not apply to the airframe itself (or indeed *vice versa*). However, it is fairly unlikely that this will be the case, as an airframe capable of carrying eight persons will ordinarily have installed on it engines with over 1,750lbs thrust. If the airframe falls outside the Convention but the engines fall within it, then it would be necessary to make a registration within the national register of the state (to the extent that such a register exists) in relation to the airframe and a registration in the International Registry in respect of each engine.

International Registry

The International Registry of Mobile Assets (the “**International Registry**”) is maintained by Aviareto Limited in Ireland and supervised by the International Civil Aviation Organisation (ICAO). The International Registry operates 24 hours a day and is an entirely electronic system; registrations, searches and certificates are made and issued electronically.

How does registration take place?

Either party to a particular transaction can register an interest with the consent of the other party.

Strictly speaking, registration may only be effected on the International Registry’s website by an approved user. However, the Convention provides that Contracting States may at any time designate an entity or entities in its territory as a “designated entry point” through which the information for registration is submitted to the International Registry. For example, in the US, the FAA (Federal Aviation Administration) is the exclusive designated entry point for authorising the transmission of information to the International Registry.

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Broadly, the registration process is as follows:

1. Conditions applicable in a particular Contracting State are complied with.
2. Registering party logs onto the International Registry's website.
3. Registering party enters the relevant information (including the parties to the transaction and the description of the aircraft objects).
4. Registering party either claims or consents to an international interest in the aircraft objects.
5. The International Registry system automatically sends an electronic notice to the other party to the transaction asking it to consent to the registration of the international interest.
6. The non-registering party may then respond electronically to the International Registry either consenting or objecting to the registration of the international interest.
7. Finally, if consent is forthcoming, the registration is automatically completed.

Effect of Registration

The default remedies are available in respect of international interests, irrespective of whether the international interest has been registered or not. However, registration is vital in order:

- to give notice of the interest to third parties;
- to preserve the creditor's priority over unregistered interests; and
- to ensure the effectiveness of the interest in insolvency proceedings.

Registration of a purported international interest which does not actually exist will be of no effect. In practice, such a situation will arise very rarely, since registration requires the consent of both parties.

Discharge

Where the obligations covered by a registered international interest have been performed, the debtor may require the creditor to procure discharge of such registration. A registration may also be discharged by or with the written consent of the party in whose favour it was made.

Alternatively, the registration may specify an expiry date, in which case the registration will automatically expire on the date specified.

A registration in respect of a prospective international interest may be discharged if the intending creditor has not given value or contracted to give value.

Searches of the Register

Any person may search the Register – it is not necessary to be an approved user.

Following a search request, an electronic registry search certificate is issued. The certificate will state the date and time of the search and either provide all registered information or state that no registrations exist.

Where a search reveals an international interest or prospective international interest, the search certificate in both cases will simply state that the creditor "has acquired or intends to acquire an international interest in the object". Therefore, the search result will not indicate whether the interest is actual or prospective, so the searching party will need to find out the status of the interest from the creditor directly.

A registry search certificate is *prima facie* proof of the facts recited in it.

Priority of interests

A registered interest has priority over an unregistered interest and over a subsequently registered interest.

Priority can be varied by an agreement between the parties (such an agreement need not be registered in order to have binding effect between the parties to it, but it is advisable to do so as if not registered it will not be effective against third parties).

Some non-consensual liens (such as tax liens) may have priority over registered international interests even if the lien itself is not registered.

For prospective international interests, the date of registration of the international interest for priority purposes is deemed to be the date of registration of the prospective international interest.

Insolvency

Effectiveness

Generally, an international interest is effective in insolvency proceedings against the debtor if registered prior to the commencement of the proceedings. "Effective" means that the property interest will be recognised and the creditor will have a claim against the asset for obligations to be discharged, and will not be limited to a claim against the debtor's pool of assets with unsecured creditors.

Nothing in the Convention will impair the effectiveness of an international interest which is in any event effective under national law. One of the benefits of the Convention is that even if an interest is void due to a failure to attend to registration requirements under national law, it will nonetheless be valid and enforceable under the Convention (if properly registered). In practice, it is therefore advisable for creditors to register their interests in the aircraft objects with both the relevant national registry and the International Registry.

Insolvency procedure regimes

Under the Convention, the Contracting States can opt for the insolvency procedures under either the "**hard regime**" or the "**soft regime**". If neither option is selected, the Contracting State's national procedural rules will apply.

The "**hard regime**" is intended to facilitate structured financing transactions. Under it, on an insolvency-related event, the debtor or insolvency practitioner must give possession of the aircraft object to the creditor no later than the earlier of:

- the end of the waiting period; or
- the date on which the creditor would ordinarily be entitled to possession of the aircraft object.

The "waiting period" is specified by each Contracting State. The aircraft object may be used, but it and its value must be preserved and maintained.

Under the "**soft regime**", the debtor or insolvency practitioner must give notice to the creditor within the waiting period stating whether it will:

- cure all defaults and perform all future obligations; or
- give the creditor the opportunity to take possession of the aircraft.

If the debtor/insolvency practitioner does not give the

required statement or give up possession after stating it will do so, the court may permit the creditor to take possession upon such terms as the court may order.

Most of the Contracting States have selected the "hard regime".

To the extent that the Contracting State chooses not to make any declaration, **national insolvency rules** will apply. The creditor's rights on insolvency in these cases depend on how creditor-friendly the Contracting State's insolvency laws are. For example, Ireland, is a creditor-friendly jurisdiction, allowing self-help repossession, whereas in most civil law countries (e.g. in other European Union member states), self-help procedures are not available.

Default remedies

One major issue which the Convention sought to address was the difference between the remedies offered by common law jurisdictions (such as England and Wales) which are considerably more creditor-friendly and allow for **self-help remedies**, and those offered by civil law jurisdictions (such as France), where the concept of a creditor enforcing its remedies without a court order is simply not recognised. The compromise reached by the Convention was to base the rules on common law, but to allow civil law countries to make a declaration excluding extra-judicial remedies and requiring the creditor to obtain leave of court.

The standard default remedies provided by the Convention to a chargee under a security agreement are:

1. to take possession or control of the aircraft object;
2. to sell or grant a lease of the aircraft object; and
3. to collect or receive the income or profits arising from the management or use of the aircraft object.

Subject to various further requirements being met (including compliance with security laws and regulations, the debtor's consent and the issuance of an irrevocable de-registration and export request authorisation), further default remedies are:

1. to procure the de-registration of the aircraft object; and
2. to procure the export and physical transfer of the aircraft object from the territory in which it is situated.

The Convention provides that the above remedies may

be exercised by the creditor **without a court order provided that the debtor has at any time so agreed.**

However, as mentioned above, this right can be limited by a declaration made by a Contracting State to the effect that remedies may only be exercised with leave of the court. To the extent that the creditor is not entitled or does not wish to exercise the rights by way of “self-help”, the remedies are available by court order. The creditor is obliged to exercise any remedy in a “commercially reasonable manner”, meaning the remedy is exercised in accordance with the security agreement (unless the provision in such agreement is manifestly unreasonable).

It should be noted that the procedural requirements of the place in which a remedy provided by the Convention is to be exercised will need to be complied with.

Interim relief

A creditor who adduces evidence of default pending final determination of the creditor’s claim is entitled to “**speedy relief**” under the Convention. **Interim relief is only available to the extent that the debtor has agreed to it.**

Such relief may take the form of such one or more of the following orders as the creditor requests:

1. preservation of the aircraft object and its value;
2. possession, control or custody of the aircraft object;
3. immobilisation of the aircraft object; and/or
4. lease or management of the aircraft object and the income therefrom.

The court may add such conditions as it considers necessary to protect the debtor or other interested persons in the aircraft object.

Contracting States may make a declaration disapplying the provisions relating to interim relief.

In addition to the orders stated above, the creditor can request an order for a sale and application of proceeds, provided that the Contracting State has made a declaration to opt for this additional relief and it is specifically agreed by the debtor and creditor in the documentation.

As with the other default remedies, interim relief will only be available:

- where the aircraft object is in a Contracting State at the time of enforcement; and
- prior to the onset of insolvency.

IDERA

Irrevocable de-registration and export request authorisations (IDERAs) are only available in respect of Contracting States that have elected to apply these. IDERAs are issued by a debtor and recorded on the International Registry. The person in whose favour the authorisation has been issued shall be entitled to procure:

1. the de-registration of the aircraft object; and
2. the export and physical transfer of the aircraft object from the territory in which it is situated, provided that:
 - a. the debtor has so agreed at any time; and
 - b. the chargee has given reasonable prior written notice of the de-registration and export to interested persons (such as the debtor and the guarantor) unless pursuant to a court order (in which case prior written notice is not required).

As a practical point, in order to assist in the enforcement of a mortgage of an aircraft object, it is advisable for the financier to require an IDERA from the debtor as a condition precedent to the grant of a facility.

Relationship between remedies and insolvency provisions

Default and interim remedies apply to all international interests regardless of registration whereas the provisions providing insolvency protection only apply to registered international interests.

In the vast majority of cases, the creditor and the debtor will have agreed in the agreement giving rise to the international interest that “default” will include the debtor’s insolvency. Therefore, when insolvency proceedings are commenced against the debtor, this will normally constitute a default under the agreement which will therefore theoretically entitle the creditor to relief under the default remedies and interim relief provisions of the Convention, irrespective of whether the interest was registered.

However, in practice, the default remedies would not be applicable. If the interest **was not registered**, the availability of the default remedies would be subject to the national insolvency law of the Contracting State in

which the aircraft object was situated at the time of enforcement. As a result, it is likely that the creditor will be obliged to resort to specified remedies under local law.

If the interest **was registered**, then the remedies available will be determined by which, if any, of the two remedy regimes the Contracting State has selected from the Protocol. If the Contracting State has selected either the “hard regime” or the “soft regime” then the remedies set out in that regime will be available to the creditor. If the Contracting State has not selected either of the regimes, then the national insolvency laws will apply, but subject to the Convention caveat that a registered international interest is “effective” on the debtor’s insolvency, meaning that the international interest cannot be set aside or subordinated for the benefit of the debtor, insolvency practitioner or other claimants.

Quiet possession

The Convention establishes a **right of quiet possession**. The nature of this right depends on the agreement between the creditor and debtor. The debtor is given the right of quiet possession as against:

- its creditor; and
- the holder of any interest to which the debtor’s right or interest would be subject (provided such holder has so agreed).

The term “quiet possession” is not defined in the Convention, although it has been taken to denote freedom from interference with the debtor’s possession, use or enjoyment of the aircraft object.

Jurisdiction

The starting point is that the courts with jurisdiction in respect of any transaction are the courts of the Contracting State selected by agreement between the parties. Such courts shall have exclusive jurisdiction unless the parties agree otherwise. The Contracting State selected does not need to be related in any way to the parties or the aircraft object.

However, as regards **interim relief**, any such selection cannot exclude the concurrent jurisdiction of the Contracting State in which the aircraft object is situated and the Contracting State in which the aircraft object is registered.

The jurisdiction provisions of the Convention do not apply to insolvency proceedings.

Application of the Convention and transitional provisions

As a general principle, the Convention does not apply to any pre-existing right or interest, the priority of which will be governed by the law applicable to it prior to the entry into force of the Convention. Therefore, in the normal course of events, the ratification of the Convention by a state will not affect the priority of pre-existing rights and no action will be necessary in relation thereto.

However, it is open to a Contracting State to make a declaration which brings into play transitional provisions set out in the Convention. These provisions allow the Contracting State to specify a date (which must be not less than three years after the declaration) on which the Convention will become applicable, for priority purposes, to pre-existing rights or interests arising under an agreement made at a time when the debtor was situated in a Contracting State. The Contracting State must specify in its declaration the extent to which and manner in which the Convention will be applicable to such pre-existing rights.

This means that creditors in respect of interests already in existence at the date of the entry into force of the Convention will have a specified period (of at least three years) in which to perfect their interest under the Convention. At the expiry of that period, the priority of all international interests, whenever created, will be governed by the Convention and therefore registrable. Unregistered international interests will lose their priority.

The provision itself is unclear as to what interests will be affected by a particular Contracting State making a declaration in accordance with this provision. However, it has been suggested that the provision should be construed so that a declaration by a Contracting State will affect pre-existing interests or rights arising under an agreement made at a time when the debtor was situated in that declaring state.

If the parties to a pre-existing agreement wish to bring the transaction within the ambit of the Convention, it may be possible to novate or amend and restate the agreement. Detailed legal advice should be sought in this regard in relation to various issues, including tax and insolvency law.

Practical points

1. When determining whether the Convention applies to any given transaction, it is necessary to consider the engines and the airframe separately.
2. It would be beneficial for the aircraft financing documentation to reflect the language in the Convention, particularly in the context of remedies.
3. It is vital to include in any security agreement provisions whereby the debtor agrees:
 - a. that the interim remedies may be exercised by the creditor; and
 - b. that the default remedies may be exercised by the creditor without the leave of the court.

As discussed above, both of these aspects of the Convention may be excluded by the relevant Contracting State. However, if the Contracting State has not excluded their operation, it is necessary to have the debtor's consent before the creditor's rights may be exercised.

4. To take advantage of the full benefit of the Convention, parties should contract out of those parts of the Convention which are optional and which do not reflect their commercial agreement. For example, quiet enjoyment provisions can be excluded.
5. It is in the best interests of a creditor to register a prospective international interest as early as possible and to ensure that the registration contains all relevant information (i.e. a full description of the relevant airframe and engines in accordance with the Protocol). The creditor's priority will then run from the date of registration of the prospective international interest and no further applications or registrations will need to be made to the International Registry on completion of the transaction.
6. **On 01 October 2010 the US Federal Aviation Authority introduced a new rule requiring periodic re-registration. Under this new rule, all aircraft registrations issued on or after that date will be valid for three years only. Further, all aircraft registered before that date will need to be re-registered by the relevant deadlines that the FAA has set.**
7. **The ratification of the Convention in any state does not affect any security which is already properly registered in that state unless the transitional provisions are implemented. However, if any amendments are made to existing documents or any supplemental documents are entered into it would**

be prudent to seek the advice of a lawyer in the Contracting State as to whether a registration with the International Registry needs to be made.

8. The ratification of the Convention in a state will not render the state's national register of aircraft redundant. There are three reasons for this:
 - a. The first is that national registers will remain necessary for nationality, ownership and operational purposes. The International Registry is only concerned with interests in aircraft.
 - b. The second is that there is nothing in the Convention which excludes the creation of security interests under national law. In most cases, a security, title retention or leasing interest created under national law will simultaneously constitute an international interest, so that the two will co-exist. However, the international interest will generally give the creditor stronger rights than a purely domestic interest, primarily because an international interest registered with the International Registry will take priority over any unregistered domestic interest (whether registrable or not).
 - c. The final reason is the result of "designated entry points". As mentioned above, a Contracting State is entitled to designate one or more entry points to the International Register, and if it does so, may then specify any conditions which must be fulfilled prior to registration of interests with the International Registry.

It is accordingly possible for Contracting States to designate their existing aviation body as the entry point and to require registration or filing of documents with that body as a condition of registration with the International Registry (e.g. in the United States).

In practice, therefore, it is likely that the requirement to register with the International Registry will constitute an **additional** registration requirement rather than an alternative one: this is certainly the case in the US, where registration of an agreement with the FAA is a prerequisite to registration in the International Registry.

9. When dealing with a transaction which will fall within the ambit of the Convention, creditors should bear in mind the following points:
 - a. It is clearly beneficial to ensure that a prospective international interest is registered as early as possible in the transaction in order to preserve

the best possible priority situation. However, it must be remembered that the registration cannot be made without the consent of the other party. Therefore the timing of the registration will require commercial negotiation: the creditor obviously wants registration to take place as early as possible whereas the chargor is not likely to embrace the concept of a registered interest being lodged against its asset prior to completion of the transaction.

The main purpose behind the concept of a registrable "prospective interest" was to simplify international closings. Therefore it is envisaged that in almost all cases, a registration will be made at the latest a few days prior to completion.

- b. It is also important that registration of the prospective interest contains all of the information which would be required for the registration of a full international interest. One practical option in this regard is to seek a legal opinion from a lawyer in the Contracting State to the effect that all procedural and substantive requirements have been carried out to perfect the security under the Convention.
 - c. In order to assist in the enforcement of a mortgage of an aircraft object, it is important for the creditor to obtain an IDERA from the debtor. This is a form (which is annexed to the Protocol) which enables the holder to exercise the remedies set out in the Protocol which include the ability to procure de-registration and export of the aircraft to the extent that the debtor has agreed to this.
 - d. The documents should also have provisions that address:
 - i. the issue of an IDERA;
 - ii. recording the international interest(s) at the relevant aviation authority; and
 - iii. other registrations that are required to give effect to the priority, title and security that the transaction contemplates.
10. In a transaction to which the Convention does not apply, it is advisable that the relevant financing documents provide that if the Convention takes effect in that state, the parties will enter into new financing documents and take further actions so as to provide the creditor with rights under the Convention. Any international interests created should be registered with the International Registry to protect the priority of such interests. However, when deciding to invoke this provision a financier should consider the effect it may have on insolvency procedures, such as whether creating new

international interests will cause the insolvency freezing period to re-start and therefore prolong the time before which the creditor gets an enforceable security, and other possible tax consequences.

11. It is worth considering including wording in mortgage documents to prohibit the chargor from registering or consenting to the registration of any prospective international interests in the aircraft unless required by the lender.
12. One point which is worthy of note is that US aircraft title insurance providers are now offering insurance policies that not only provide traditional cover for FAA filings, but also cover convention filings by way of endorsements.

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