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President Obama Brings Transportation Center Stage

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In this Issue: Domestic Infrastructure & International Developments

Following the Money

Security in Aircraft Interests and the Utility of the Cape Town Convention

By Brian E. Foont

When a purchaser of real estate in the United States grants a mortgage to a bank to secure the loan with which a purchase is made, the bank gives notice of its security interest in a property via a filing with the applicable state agency. Before accepting that mortgage and granting the loan, the bank can conduct a title search to determine whether any other party has taken a security interest in the property that would come ahead of its interest. The resulting security interest is fully enforceable and, because the bank can rely on knowing both which court can enforce that interest and that it will be enforced, its risk is considered reliably mitigated. The bank can, therefore, offer a lower interest rate than if the security interest were not truly reliable or enforceable. The situation, however, becomes more complicated when movable assets are substituted for real property and even more so when the transaction is shifted to the international arena. A key source of difficulty arises from the law applicable to the object changing as it moves from one jurisdiction to another under the doctrine of *lex rei sitae* (lit. “the law of the place of situation”).¹

In the international arena, under *lex rei sitae*, an object could easily be moved from a place where the enforceability of security interests is reliable to a place with no effective enforcement mechanisms.² If the lender (or other party with a security interest, e.g., lessor, mechanic, etc.) can take possession of the object securing its loan, then the problem is solved. In practice, however, that is often impractical, particularly if the object serving as security is required by the borrower (or lessee or customer) to engage in its business so that it can pay its loan (or rent or amount due for services). Aircraft and aircraft engines are perfect examples of this and are the focus of this article. Costing a great deal to acquire, maintain and operate, aircraft and aircraft engines cannot reasonably be deposited with a creditor as security. Because the creditor cannot have possession of the object securing the debt, “[t]he cost of credit for high-value mobile equipment is exceedingly high because, under the conflict-of-laws rule of the applicability of the *lex rei sitae*, the creditor’s position is uncertain.”³

1 BLACK’S LAW DICTIONARY 913 (8th ed. 2004).

2 This difference between countries where title can be established and security interests can be enforced has been asserted by the famed economist Hernando de Soto as a key in determining the variation in economic prosperity across the globe. HERNANDO DE SOTO, *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE* 6 (2000). See also *Making the Law Work for Everyone, Report of the Commission on Legal Empowerment of the Poor* (2008), available at <http://www.undp.org/legalempowerment/reports/concept2action.html> (providing the findings of the commission co-chaired by Madeleine K. Albright and Hernando de Soto), and NIALL FERGUSON, *THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD* (2008) (arguing that the development of secured credit was fundamental to the ascent of human civilization and a differentiating factor between more and less prosperous areas of the world).

3 See *International Interests in Mobile Equipment – Study LXXII, International Institute for the Unification of Private Law*, <http://www.unidroit.org/english/workprogramme/study072/main.htm>.



The first convention to address security interests in aircraft was the Convention on the International Recognition of Rights in Aircraft (“Geneva Convention”).⁴ That convention, which, as noted in the first whereas clause, was recommended by the International Civil Aviation Conference that concluded the Convention on International Civil Aviation, commonly known as the Chicago Convention.⁵ The Geneva Convention accomplished several important goals. Among them, as one authority noted in a study of the state of the law prior to the Cape Town Convention (discussed below), is the “international

recognition of the inappropriateness of the *lex situs* as a source of law for determining the validity and efficacy of security interests in mobile equipment.”⁶

The Geneva Convention, which remains in effect with eighty-nine parties, leaves several problems unsolved. Among them are:

- registration of aircraft for the purposes of establishing security interests remains in the hands of each state in which a debtor resides;⁷
- the law governing the security interest are the laws of that state;⁸
- with respect to aircraft leases, it only applies to leases with a term of six months or more;⁹
- while the Geneva Convention defines “aircraft” as including “the airframe, engines, propellers, radio apparatus, and all other articles intended for use in the aircraft where installed therein or temporarily separated therefrom,”¹⁰ no provision is made with respect to such items not presently associated with an aircraft (e.g., a spare engine; and
- enforcement may be sought in the courts of the law where the aircraft is registered.

The Convention on International Interests in Mobile Equipment (“Convention”)¹¹ and the associated Protocol to the Convention on

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4 310 U.N.T.S. 151 (1948), available at <http://www.luftrecht-online.de/regelwerke/pdf/Geneva%20Convention%201948.pdf> and http://dgca.nic.in/int_conv/Chap_XIV.pdf (listing the current parties thereto and their respective reservations and declarations which is available at <http://www.icao.int/icao/en/leb/Genev.pdf>). This source is not to be confused with the series of better known treaties referenced commonly as the “Geneva Convention” that address issues related to the law of war.

5 15 U.N.T.S. 296, ICAO Doc. 7300 (1944), available at http://www.icao.int/icaoenet/arch/doc/7300/7300_9ed.pdf (listing the current parties thereto and their respective reservations and declarations which is available at <http://www.icao.int/icao/en/leb/chicago.pdf>).

6 Ronald C.C. Cuming, *International Regulation of Aspects of Security Interests in Mobile Equipment: Study*, UNIDROIT INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW, Study LXXII 16 (1989), available at <http://www.unidroit.org/english/documents/1989/study72/s-72-01-e.pdf>.

7 Geneva Convention, Art. III.

8 Geneva Convention, Art. I.

9 Geneva Convention, Art. I(1)(c).

10 Geneva Convention, Art. XVI.

11 ICAO Doc. 9793 (2001), available at <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm>.

Security in Aircraft Interests

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International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (“Protocol”),¹² commonly referred to collectively and herein as the “Cape Town Convention,” are intended to address a number of the shortcomings of the Geneva Convention. Both were complete on November 16, 2001, but did not enter force until March 1, 2006, with the United States as an original contracting party.¹³ Even now, they only have thirty-one and twenty-eight parties to the Convention and the Protocol, respectively.¹⁴

The Cape Town Convention improves on the Geneva Convention in several key areas, but falls short in others. Those fortes and foibles are the subject of the remainder of this article. With that purpose in mind, it must be noted that given the relatively recent entry into force of the Cape Town Convention, there are not yet any reported cases in which its subject matter has been addressed.¹⁵

The structure of the Cape Town Convention deserves particular mention both because it is unusual and because it likely operates as a barrier to its ease of use.¹⁶ As noted, it is comprised of two parts, *i.e.*, the Convention and the Protocol. The former might be thought of as a general terms agreement under which various specific agreements are anticipated. The Protocol is specific to aircraft equipment.¹⁷ Each protocol is intended to address issues specific



¹² ICAO Doc. 9794 (2001), available at <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm>.

¹³ The treaty was approved by the U.S. Senate on July 21, 2004, Treaty No. 108-10, and implemented by statute under the Cape Town Treaty Implementation Act of 2004, Pub. L. No. 108-297, 118 Stat. 1095 (2004). The copy of the Convention and Protocol, which was given consent and approval by the United States Senate, and the President’s Letter of Transmittal, Letter of Submittal, and summary is available at http://fwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_documents&docid=f:td010.108.pdf.

¹⁴ The International Institute for the Unification of Private Law (UNIDROIT) and The International Civil Aviation Organization (ICAO) both maintain a list of the member states to the Convention and the Protocol. For the Convention, the list can be found at <http://www.unidroit.org/english/implementation/i-2001-convention.pdf> and <http://www.icao.int/icao/en/leb/capetown-conv.pdf>, and for the Protocol, it can be found at <http://www.unidroit.org/english/implementation/i-2001-aircraftprotocol.pdf> and <http://www.icao.int/icao/en/leb/capetown-prot.pdf>.

¹⁵ It might also be noted that, because the Geneva Convention does not really do anything particularly unusual under U.S. law, *i.e.*, under common law, the enforceability of various forms of security interest has not been a problem. Hence, there is a paucity of case law in which it is referenced. *See, e.g., LAL Aircraft Holding v. FAA*, 206 F.3d 1042 (11th Cir. 2000); *Triad Intern. Maintenance v. Guernsey Air*, 178 F.Supp.2d 547 (M.D.N.C., 2001); *Hercaire Intern., Inc. v. Argentina*, 642 F.Supp. 126 (S.D. Fla. 1986); *Idabel Nat. Bank v. Tucker*, 544 P.2d 1287 (Okla.App. Div. 1 1975); *Corporacion Peruana de Aeropuertos y Aviacion Comercial v. Boy*, 180 So.2d 503 (Fla. App. 2 Dist. 1965) (referencing the Geneva Convention and its applicability).

¹⁶ Preliminary Draft Unidroit Convention on International Interests in Mobile Equipment and Preliminary Draft Protocol to The Preliminary Draft Unidroit Convention on International Interests In Mobile Equipment on Matters Specific To Aircraft Equipment: Preliminary Observations Submitted by the Government of Japan, at 1, January 1999, available at <http://www.unidroit.org/english/documents/1999/study72/s-72-49-e.pdf> (noting that having two separate documents covering the same types of equipment, *i.e.*, both the general convention and the specific protocol, is unnecessarily cumbersome).

¹⁷ There is another protocol to the Convention that addresses railway rolling stock that four countries have signed but is not yet in force, known as the Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock signed in Luxembourg on February 23, 2007. A list of the current parties to the Luxembourg Protocol is maintained by UNIDROIT and can be found at <http://www.unidroit.org/english/implementation/i-2007-railprotocol.pdf>. A third regarding space assets remains in progress. A current draft can be found at

to the particular assets covered, which includes modification of terms of the Convention as applicable to the particular types of property covered.¹⁸ Moreover, while the Convention and the Protocol prohibit reservations,¹⁹ the foregoing difficulty is compounded by the “declarations” that are permitted under ten provisions of the Convention and five provisions of the Protocol.²⁰ Certain declarations can substantially alter the value of an interest.

The Cape Town Convention addresses several of the shortcomings of the Geneva Convention. Perhaps the biggest advancement is the establishment of a single international registry for interests covered by the convention.²¹ Because the registry is operated via the World Wide Web, it can be accessed from anywhere and filings can be made at almost any time. This unified and centralized registry can allow those involved in transactions involving aircraft and other items covered by the convention to search in just one place for prior security interests in the object of their transactions and, because of Internet access, such searches can be done almost instantaneously.

The Cape Town Convention also addresses the choice of law issue. It does not, however, allow complete freedom to choose. Rather, Article 42 of the Convention provides:

1. Subject to Articles 43 and 44, the courts of a Contracting State chosen by the parties to a transaction have jurisdiction in respect of any claim brought under this Convention, whether or not the chosen forum has a connection with the parties or the transaction. Such jurisdiction shall be exclusive unless otherwise agreed between the parties.
2. Any such agreement shall be in writing or otherwise concluded in accordance with the formal requirements of the law of the chosen forum.

Thus, only the courts of a Contracting State may be selected.²² The phrase, “[s]ubject to Articles 43 and 44,” is important. While Article 44 applies only to orders against the Registrar, *i.e.*, the operator of the international registry discussed above, Article 43 effectively allows relief under the Convention to be granted by the “courts of a Contracting State chosen by the parties and the courts of the Contracting

<http://www.unidroit.org/english/documents/2004/study72j/s-72j-13rev-e.pdf>.

¹⁸ Your author has prepared an annotated version of the Cape Town Convention with annotations regarding cross-references between the Protocol and Convention and the various applicable declarations, and made it available at <http://www.FoontLaw.com/CapeTown>.

¹⁹ Convention, Art. 56; Protocol, Art. XXXII(1).

²⁰ While certain of the permitted declarations address technical issues, *e.g.*, Article XXIX of the Protocol allows a Contracting State to have the Protocol apply differently with respect to its different territories that are governed under different systems of law, others are substantive. By way of example, Article 39(1)(a) of the Convention permits a Contracting State to declare interests that will have priority over an interest registered in accordance with the Convention.

²¹ The registry is managed in Ireland by Aviation Working Group, <http://www.awg.aero>, and can be found at www.internationalregistry.aero. Documentation on its use is available there. *See* Cuming, *supra* note 6, at 23-24 (noting that the Fédération bancaire of the European Economic Community prepared a draft convention in 1970 that would have established a centralized supranational European registry for security interests, but that the effort did not succeed).

²² Notably, the UNIDROIT Convention on International Financial Leasing (1988) overrides national law otherwise applicable to the transaction, and provides that the applicable law with respect to aircraft is the law where the aircraft is registered as determined under the Chicago Convention of 1944, Art. 7(3)(b).

State on the territory of which the object is situated.” Thus, each party is, for example, free to select the law and courts of the United States because it is a Contracting Party, even if it has no connection to the United States. This is a positive development because the courts of some Contracting Parties are, or are at least perceived to be, more reliable than others. In any event, the ability to choose a country with a common law system is significant because, while common law systems can generally accommodate different and even creative forms of security interests, civil law systems are often less flexible.²³

While the Cape Town Convention improves on the Geneva Convention with regard to both choice of law and venue, it lacks a reliable enforcement mechanism. Such a fault, perhaps, is understandable. It is one thing for states to allow the courts of another state to have jurisdiction and issue rulings. It is entirely another thing to allow other state’s courts to enforce those rulings. For that, resort to local enforcement mechanisms remain the exclusive remedy against a recalcitrant opponent. Although this weakness likely limits the true economic value of a country joining the Cape Town Convention, it certainly does not render the value zero.²⁴

In a similar vein to the foregoing, enforceability is also somewhat contingent on whether the object against which enforcement is sought is located in the territory of a party to the Cape Town Convention. When this is not the case, the party seeking enforcement will be subject to whatever the local law is with regard to the enforcement of foreign judgments and/or the ability to enforce the applicable security interest independent of the Cape Town Convention (*e.g.*, as a matter of contract law). Because the Cape Town Convention applies, in particular, to mobile equipment, this is more than a theoretical issue.²⁵

23 Cuming, *supra* note 6, at 7 (referencing examples of Austrian and Swiss decisions under their civil law systems, in which they refused to recognize a German security interest that was not compatible with one under their own systems, and citing Theodor J. R. Shilling, *Some European Decisions on Non-Possessory Security Rights in Private International Law*, 34 INT’L AND COMP. L. Q. 87-114 (1985)).

24 By way of example, the Export-Import Bank of the United States offers a one-third reduction of the exposure fee charged by the bank for its aircraft export financing to foreign purchasers of U.S.-manufactured large commercial aircraft based in countries that sign, ratify and implement the Cape Town Convention. See <http://www.exim.gov/>, for various press releases of the Export-Import Bank of the United States. See Anthony Saunders et al., *Innovation in International Law and Global Finance: Estimating the Financial Impact of the Cape Town Convention*, NYU WORKING PAPER No. EC-06-30, available at <http://ssrn.com/abstract=1282523> (examining the financial impact of the Cape Town Convention).

25 Thomas J. Whalen, *Memorandum of Comments of Thomas J. Whalen dated February 7, 1994 to the Memorandum of Professor Cuming Dated November 5, 1993 Relating to a Proposed Unidroit Convention on Security Interest in Mobile Equipment*, at 1,2, available at <http://www.unidroit.org/english/documents/1994/study72/s-72-09-e.pdf> (citing Cuming, *supra* note 6, which states that the effectiveness of the convention will rely on equipment being in a country that is a member to the convention at the time enforcement is sought, and noting that “lenders will be encouraged to finance the purchase of capital equipment, and distributors will be encouraged to enter into

Another improvement of the Cape Town Convention over the Geneva Convention is the breadth of its coverage. For example, under the latter, with respect to aircraft leases it only applies to leases with a term of six months or more. The Cape Town Convention has no such limitation. Similarly, the Geneva Convention does not apply to aircraft engines that are not associated with a specific aircraft. Given that some aircraft engines can actually be more valuable than aircraft and often trade independently of aircraft, it is fortunate that the Cape Town Convention independently covers those with thrust exceeding 1,750 pounds or 550 horsepower. In a similar vein, the Cape Town Convention applies to helicopters that can carry more than five passengers or 450 kilograms (approximately 992 lbs.) of cargo. Finally, as specified in the Protocol, the Cape Town Convention extends to “contracts of sale and prospective sales” and, therefore, effectively allows substantial flexibility with regard to the types of security interests that can be registered and enforced. With those expansions, it should be noted that the population of aircraft covered by the Cape Town Convention is narrower than that under the Geneva Convention. Under the former, only aircraft that can carry at least eight passengers, including crew or cargo in excess of 2,750 kilograms (approx. 6,063 lbs.), are covered whereas there are no such limitations specified in the Geneva Convention.

The Cape Town Convention is a clear improvement over the Geneva Convention and its use may help mitigate some of the risk associated with engaging in international transactions to which it applies. Its structure, unfortunately, makes it somewhat complicated to use. Nevertheless, it is important to note that practitioners neglect the Cape Town Convention at their and their client’s peril. Because security interests registered with the International Registry take priority over all others (with a few exceptions), even those obtained in good faith but are not filed, failing to file a security interest can have substantial economic consequences, particularly when the seller/debtor goes bankrupt. Moreover, in contrast to, for example, the United Nations Convention on Contracts for the International Sale of Goods, which allows parties to an international agreement otherwise covered by the treaty to exclude its application to their agreement²⁶ (which is done routinely by practitioners), the Cape Town Convention provides no such allowance. Thus, while deviation from certain of its provisions via contract is permitted, much of its application is mandatory.

financing contracts if they know that the equipment may or will be transported to a country which will recognize and enforce their security interests in the equipment”).

26 United Nations Convention on Contracts for the International Sale of Goods, U.S. Treaty No. 98-9, Art. 6 (1980), available at <http://www.uncitral.org/pdf/english/texts/sales/cisg/CISG.pdf>.



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