DCME Doc No. 23
17/10/01

DIPLOMATIC CONFERENCE TO ADOPT A MOBILE EQUIPMENT CONVENTION AND AN AIRCRAFT PROTOCOL

(Cape Town, 29 October to 16 November 2001)

COMMENTS ON DRAFT CONVENTION AND DRAFT PROTOCOL

(Presented the Kingdom of the Netherlands)

General

1. The Kingdom of The Netherlands greatly appreciates the opportunity to formulate comments on the Draft [Unidroit] Convention on International Interests in Mobile Equipment (hereinafter referred to as: the Convention) and the Draft Protocol thereto on Matters Specific to Aircraft Equipment (hereinafter referred to as: the Protocol), with a view to the Diplomatic Conference for the adoption of these draft instruments, to be held in Cape Town from 29 October to 16 November 2001. The comments formulated hereinafter concern the Convention and the Protocol as communicated to the Embassy of The Kingdom of The Netherlands in Italy under cover of the Note Verbale of Unidroit of 6 April 2001 (DCME Doc. No. 3 of 6 April 2001 and DCME Doc. No. 4 of 6 April 2001), and the Explanatory Report and Commentary to the Convention and the Protocol as communicated to the Embassy of The Kingdom of The Netherlands in Italy under cover of the Note Verbale of Unidroit of 11 May 2001 (DCME –IP/2 of 11 May 2001, hereinafter referred to as: Commentary). With respect to aspects of private international law the comments are based on an advice of 16 July 2001 of the Dutch Government Commission on Private International Law, given at the request of the Minister of Justice.

2. The Kingdom of The Netherlands is convinced of the importance of the establishment of an international instrument aiming to facilitate the financing of the acquisition and the use of high value mobile equipment that is likely to move across State borders, by creating a legal regime for leases, conditional sales and security interests. The financing of aircraft equipment, of railway rolling stock and of space property are good examples of practices that need a uniform international legal regime that fits to the needs of different parties (e.g. manufacturers, users and financiers of aircraft) that are situated in different States.

3. This does not alter the fact that it remains to be seen how far the financing of the acquisition and the use of high value mobile equipment, e.g. aircraft equipment, indeed will be facilitated by the creation of an international interest associated with a range of sweeping, equipment-specific default remedies as embodied in the Convention and the Protocol. This depends on the ability of the new regime to grant intending creditors the confidence to extend credit (where, otherwise, unavailable) to debtors in developing countries or to (substantially) reduce financing costs for such debtors. It is worth noting that the efficiency, and even more so the integrity, of the International Registry are fundamental to the collateral value to be assigned to an international interest. Moreover the equipment repossession risk, which is reduced by the Convention, is only one key element of risk management. The other key

element can not be influenced by the Convention. This element is the debtor's (in)ability to generate sufficient cash flow in order to service its financial obligations as they fall due. Particularly so as inherent to developing economies certain factors like the foreign exchange mismatch between local currency revenues and dollar denominated carrying costs (fuel, finance, insurance etc.) would subsist, as well as factors like the airline's competitive environment and equipment maintenance standards and the monitoring of the latter.

4. Furthermore a critical success factor is the question if those certain Contracting States for which the Convention aims specifically to lower the thresholds to grant credit and / or to reduce finance costs will opt in (i.e. will refrain from making declarations to exclude or modify the exercise of certain key remedy provisions drafted into the Convention). In order for developing countries to fully benefit from the Convention it is crucial that they accept the creditor-focussed nature of the Convention, even if the some principles which underscore the Convention are incompatible with their respective legal cultures and traditions. Countries where the pre-eminence of the various default remedies provided for in the Convention is of a lesser concern in the context of their respective national commercial and bankruptcy laws and judicial systems could readily opt out.

5. It should be noted that by the various possibilities for Contracting States to make declarations (not) to apply certain rules of the Convention and the Protocol (e.g. Articles 52 and 53 of the Convention and Article XXVIII of the Protocol) the uniformity and thus the predictability and certainty, established by the legal regime of the Convention, can decrease. In each case the parties expecting protection under the Convention shall have to determine what kind of declarations have been made by the relevant Contracting State and what the implications thereof may be. Furthermore it seems obvious that the need to offer to Contracting States the possibility to make declarations in order to make the Convention and the Protocol acceptable for these States would be less if the Convention and the Protocol would have a less creditor-focussed nature than they have in their present version (e.g. the provisions of Chapter III of the Convention and Chapter II of the Protocol concerning default remedies).

6. It would be preferable if the present structure of the instruments (two-instrument approach existing of a base Convention which is to be applied with separate equipment-specific Protocols) would be maintained. This would enhance the uniformity the Convention seeks to achieve.

Articles

Convention

Article 1 Definitions

(nn) It should be noted that the word "indicates" is less strong than the word "identifies", that was used in an earlier draft.

Article 3 Sphere of application

Article 3 does not appear to deal with the typical leveraged lease scenario, where there is an investor/lessor, a lender and a lessee. If the lessee is situated in a Contracting State whilst investor/lessor is not situated in a Contracting State, one of the key elements of the entire transaction, being the lender's exposure on the lessor (in most cases secured by a security right in respect of the equipment), would fall outside the scope of the Convention. In that scenario, the lessor would, of course, still benefit from the Convention, in particular where it concerns repossession of the equipment following the occurrence of a default under the lease.

Article 5 Interpretation and applicable law

The more the Convention refers to the law that is applicable according to the private international law of the – occasionally – competent forum, the more the interpretation of the Convention in the way provided for in Article 5 will become illusory, and the greater the danger of "forum shopping" will be. References to the applicable law (as determined by the *lex fori*) as meant in Article 5 sometimes are inevitable to offer a solution in case negotiators cannot reach agreement about a rule of substantive law. Nevertheless the number of such references should be limited as much as possible.

An example can illustrate the above. The Convention acknowledges the distinction among various legal systems in respect of title reservation, security agreements and leasing agreements; the solution adopted in the Convention is to leave this matter to be dealt with under the applicable law as determined by the *lex fori*. Such approach, however, does not provide a satisfactory solution if under circumstances the equipment is leased (by the conditional buyer) or sub-leased (by the lessee) to, or if remedies are sought against the equipment at the time of its *situs* by chance in, another (third) jurisdiction, in case such *lex fori* rule would force upon the contracting parties to the head agreement an unexpected, and most certainly undesired, re-characterisation.

Article 6 Formal requirements

The Commentary concerning Article 6, under 2, says: "The constitution of the international interest derives from the Convention, not from national law. It follows that an international interest comes into existence where the conditions of Article 6 are satisfied even if these would not be sufficient to create a security interest under the otherwise applicable law and even if the international interest is of a kind not known to that law". For reasons of clarity a provision to this effect should be inserted into the Convention.

Article 17 Registration requirements

The absence of a requirement actually to provide for evidence that the consent of the party in whose favour a registration was made to discharge the same was given (Article 17, paragraph 2) makes the system unduly passive and fraud-sensitive. It is imperative that any such consent will be properly verified; there is an instrumental role to be played by the respective national entry points (if any). Without a decent verification system the procedure for the discharge of a registration should only be initiated by the party in whose favour it was made (and not merely with the consent of that party).

Article 23 Evidentiary value of certificates

A certificate issued by the International Registry is *prima facie* evidence of the facts recited in it, including the date and time of registration, but evidence is admissible to show that the certificate does not correctly state the facts. This rule of evidence makes the registration system for international interests a system with hardly any checks, the benefits of which are clearly outweighed by the quasi "positive system" presently entertained in The Kingdom of The Netherlands. It is suggested that a certificate issued by the International Registry shall be, absent manifest error, evidence of the facts recited in it, including the date and time of registration.

Whether the preferred "positive system" of some sort is attainable at all depends on factors like (a) the warranties for the completeness, accuracy and validity of the registration of international interests vis-à-vis interested parties, (b) the pro-active registration policy of the Registrar or any national entry points, (c) the registration of property rights (along with any international interests) and (d) the financial warranties provided by the Registrar (see under Article 27).

Article 27 Liability and insurance

The Registrar will, in principle, be strictly liable for compensatory damages for loss suffered from errors, omissions or system malfunction; reference should also be made to loss suffered from any delays in the registration or, as the case may be, de-registration of an international interest.

Article 31 Effects of assignment

According to paragraph 1 (b) of this Article the effect of the assignment of an international interest is inter alia the transfer to the assignee of all associated rights, being all rights to payment or other performance by a debtor under an agreement which are secured by or associated with the object (e.g. an airframe) (Article 1(c) of the Convention). As explained in footnote 2 to Chapter IX of the Convention, during the third Joint Session a proposal was discussed which was designed to bring Chapter IX more into line with those national legal systems under which an assignment of associated rights would carry with it the interest securing those rights. As also explained in the mentioned footnote, although substantial support was expressed for the approach taken in the proposal, it was agreed that the proposal required further careful study by experts.

The Kingdom of The Netherlands wishes to state its preference for the approach taken in the proposal meant above. The intention of Article 31, paragraph 1(b), is to ensure that an assignment of an international interest and a transfer of the associated rights go together, so that the associated rights cannot be assigned under the Convention independently of the international interest (Commentary under 1). This intention is right, but the solution should be the opposite: the international interest should be linked to the "secured obligations" as is the case in most civil law jurisdictions. This is also the solution chosen in Article 10 of the Draft Convention on the Assignment of Receivables in International Trade of UNCITRAL, which was adopted at the session of UNCITRAL from 25 June until 13 July 2001.

Article 52 Declarations regarding remedies
Article 53 Declarations regarding relief pending final determination

It should be noted that Article 52, paragraph 1, reads like it conditions the declaration ("while the charged object is situated within, or controlled from its territory"), whereas Articles 52, paragraph 2, and 53 do not. Furthermore, it is unclear whether the respective opt-out declarations relate to any aircraft object while at the time situated in the 'declared' Contracting State, even if the Contracting State in which the relevant debtor is situated has not made the same declaration. Conversely, the aircraft object of a debtor situated in a 'declared' Contracting State would be at risk of being subjected to certain default remedies if for the time being that object happens to be situated in a Contracting State which has not made the same declaration. The enforcement of default remedies would thus become a matter of 'forum-shopping'.

Article 55 Transitional provisions

Alternative A would have the consequence that, possibly for many years, a pre-Convention right or interest that has not been registered in the International Registry would have priority over an international interest that has been registered in the International Registry. This would have a very negative effect on the predictability and certainty that the Convention and the Protocol seek to achieve. Moreover, if one considers the new priority regime of the Convention as an important improvement, it would only be consistent to apply this improvement also to transitional cases, the more so, since the registration in the International Registry has been presented as a wholly electronic "notice-based" registry system which will not be expensive to use. Furthermore the period of ten years, mentioned in Alternative B, is more than long enough (perhaps even too long) to give holders of pre-Convention rights or interests the opportunity to register this right or interest in the International Registry. It

should be noted that a certain number of the pre-Convention rights or interests will end before the expiry of the ten year period; in these cases it will even not be necessary at all to register the right or interest in order to preserve its priority. For all these reasons the Kingdom of The Netherlands favours Alternative B.

Protocol

Article III Application of Convention to sales

It seems that the references in this provision to the debtor and the creditor should be references to the buyer and the seller respectively (and not vice versa as in the text of Article III).

Article VIII Choice of law

The words "Unless otherwise agreed" in paragraph 2 should be deleted, to prevent unnecessary discussions.

Article XXII Relationship with the Convention on the International Recognition of Rights in Aircraft

The ranking among any national interests and international interests upon enforcement at the time of the aircraft's *situs* by chance in a country which is not a "Cape Town Contracting State" but is a Geneva Contracting State is not solved and would inevitably result in disputes as to enforcement rights and / or priority rights in relation to any proceeds. The more Geneva Contracting States ratify the Convention and the Protocol, the less important this objection will be.

Article XXIII Relationship with the Convention for the Unification of Certain Rules Relating to the Precautionary Attachment of Aircraft

Article XXIII provides that the Convention shall, for a Contracting State that is a Party to the Convention for the Unification of Certain Rules Relating to the Precautionary Attachment of Aircraft (Rome Convention), supersede that Convention as it relates to aircraft, as defined in the Protocol, unless a Contracting State declares that it will not apply this Article. Article 9, paragraph 1, of the Rome Convention reads: *La présente Convention s'applique sur le territoire de chacune des Hautes Parties Contractantes à tout aéronef immatriculé dans le territoire d'une autre Haute Partie Contractante*. Contracting States will have to make such a declaration as far as necessary to act properly, as far as it concerns the law of nations, with respect to countries that are party to the Rome Convention but not (yet) to the Convention and the Protocol.

Article XXVI Entry into force

The Kingdom of The Netherlands feels that the number of ratifications should be congruous to the funds needed to establish a register. While finalising this provision the Conference should ensure that no undue financial burden falls on the registrar or supervisory authority. Thus the Kingdom of The Netherlands contemplates a possibility where 5 to 10 ratifications will suffice for entry into force.

Engines

According to the regime of the Convention and the Protocol the aircraft and its engines can be subject of separate international interests. If for example an engine lessor leases an engine to an airline and the engine is attached to the aircraft, the engine can, according to the Convention/Protocol regime, be subject to a separate international interest, e.g. an engine mortgage for the benefit of a lender (engine mortgagee). If the engine lessor defaults under the loan agreement with the engine mortgagee, the

engine mortgagee can to the extent that the engine lessor has so agreed, take possession of the engine and sell or lease the engine without leave of the court (Article 7, paragraph 1, of the Convention), provided that the relevant Contracting State did not make the declaration meant in Article 52, paragraph 2. Thus the engine mortgagee will arrest the aircraft in order to take the engine off-wing. Whether the airline as engine lessee is in default or not is not relevant. The arrest could nevertheless trigger a default under the aircraft lease agreement. It should be noted that the Convention is silent as to whether or not default remedies could be sought against an engine while installed on, and independent of any such remedies at the same time being sought against, the airframe. It seems that because of this kind of problems a form of engine agreement will remain necessary in order to avoid controversies between engine lessors and – mortgagees on the one hand and aircraft lessees, aircraft lessors and aircraft mortgagees on the other hand.

Registration of lessee's rights

According to Dutch law purchase options and rights of use of an aircraft under leases in excess of six months can have effect against third parties. This result can be reached by laying down such a right in a notarial deed, which must be entered into the public registers for registered property. Thus (e.g. in a three party relationship of lender/mortgagee (bank), mortgagor/lessor (leasing company) and lessee (airline)) a quiet enjoyment covenant given by a mortgagee of an aircraft is strenghtened to the effect that the lessee, as long as the lessee would not cause a default under the lease, will be protected against foreclosure under the mortgage following a default under the lessor's credit facility agreement.

It is not clear if on the basis of the Convention and the Protocol, registered purchase options and registered rights of lessees to use an aircraft can also have effect against the holder of an international interest. Dutch practice needs a clarification (perhaps in Article 40 of the Convention?) in order to be sure that the purchase options and rights of lessees to use an aircraft that have been registered earlier than (other?) international interests have effect against the holders of those (other) international interests. This would prevent unnecessary academic discussions and court proceedings.

– END –