

# A Historical Overview of the Basic Concepts of the Cape Town Convention (Part I): 'International Interest' and 'Internationality'

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## Abstract

*The Convention on International Interests in Mobile Equipment ('Cape Town Convention' or 'CTC') is on the verge of another expansion of its scope by virtue of a new protocol on mining, agricultural and construction equipment ('MAC Protocol'). The MAC Protocol raises important questions concerning the philosophy of the Cape Town Convention system. Is there a limit to CTC expansion? Has the principle of internationality been eliminated from the text of the CTC? Where do the 'gateway' provisions of Article 51 ('Future Protocols') come from? Why were some assets matching these criteria (eg ships) previously excluded? This paper is the first in a series of articles examining the history of development of the core concepts underlying the Cape Town Convention and focuses on two issues: 'international interest' and 'internationality'. It tracks the development of each concept from the early days of the CTC and argues that the 'international interest' has its roots in the gradual evolution of the idea of recognition of domestic security interests, and posits that despite the eventual elimination of the principle of 'internationality' from the text of the CTC, its echo has nonetheless remained an important part of the Cape Town Convention due to the state sensitivities that became apparent during the final stages of development of the treaty. These issues form the basis of the philosophy of the Convention, and must be considered prior to the adoption of any new protocol.*

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## I. Introduction

Over 16 years have passed since the adoption of the 2001 Convention on International Interests in Mobile Equipment (the 'Cape Town Convention', or 'Convention', or 'CTC') developed by the International Institute for the Unification of Private Law (UNIDROIT) in collaboration with other international organisations and various stakeholders. This treaty has been hailed as 'the most successful international secured transactions instrument ever implemented'<sup>1</sup> and as 'one of the most ambitious international commercial law instruments ever to have been fashioned in the field of private transnational law'.<sup>2</sup> In the area of commercial law, no other instrument has gone as far, and achieved as much.

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<sup>1</sup> Charles W. Mooney, 'Cape Town Convention's Improbable-but-Possible Progeny Part One: An International Secured Transactions Registry of General Application, The Essay' (2014) 55 Va J Int'l L 163, 166.

<sup>2</sup> See Roy Goode, *Official Commentary on the Convention on International Interests in Mobile Equipment and Protocol there-to on Matters Specific to Aircraft Equipment* (3rd edn, UNIDROIT 2013) 1.

The high ambition of the CTC stems from its Preamble, which reflects the desire of contracting states to facilitate asset-based financing and leasing transactions by establishing clear rules to govern them. To achieve this goal, the Convention creates a comprehensive international legal regime protecting secured creditors, conditional sellers and lessors in certain categories of high value mobile equipment. This new regime is based on unique CTC mechanics: the treaty provides for the creation of an entirely new type of proprietary interest (labelled 'international interest'), the existence and effects of which do not rely on the existence and validity of its counterparts arising through the application of national laws.

The new international interest is immediately integrated into a comprehensive system of priorities that supersedes existing domestic regimes. This system of priorities is triggered by the registration of the international interest in a dedicated central international registry<sup>3</sup> and gives international interests surprising reach: once registered, they rank ahead of their national law counterparts, even if the latter are not registrable in the international registry (with limited exceptions).

To ensure that the interests of financiers are adequately protected regardless of any differences between domestic legal regimes, the Convention establishes dedicated rules on remedies exercisable upon default of the debtor, providing creditors with peace of mind and lowering the cost of credit for their clients. In addition, the CTC contains a variety of provisions (eg articles on assignment of associated rights, or subordination of international interests) enhancing legal certainty, but at the same time offering sufficient flexibility for asset finance providers in dealing with their counterparties.

Currently the Cape Town Convention applies to three types of mobile equipment: aircraft objects (airframes, aircraft engines and helicopters), railway rolling stock and space assets. In the light of different physical characteristics of these asset types and varying financing techniques applied within the relevant industries, the Convention is supplemented by a number of protocols which contain asset-specific provisions (the 'Aircraft Protocol',<sup>4</sup> the 'Rail Protocol',<sup>5</sup> and the 'Space Protocol'<sup>6</sup>). The combination of a baseline convention and asset-specific protocols creates a two-level 'umbrella' structure, which ensures continuity of the 'core' provisions of the CTC, while at the same adding a degree of flexibility and potential for future expansion and providing states with the freedom to apply the CTC only to some, but not all types of mobile equipment covered by the Convention.

At the time of this writing, the Convention has been ratified by 74 contracting states, while the Aircraft Protocol has been ratified by 69 contracting states.<sup>7</sup> The success of the CTC within the avia-

<sup>3</sup> The international registry for aircraft equipment has had an enormous success among private actors: it has recorded over 700,000 registrations – see paragraph 3.3.2 in Appendix to ICAO, *ICAO A39-WP/422 LE/14* (2016). See also Ludwig Weber, 'Public and private features of the Cape Town Convention' (2015) 4 *Cape Town Convention Journal* 53, 53.

<sup>4</sup> 2001 Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (adopted on 16 November 2001).

<sup>5</sup> 2007 Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock (adopted on 23 February 2007).

<sup>6</sup> 2012 Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets (adopted on 09 March 2012).

<sup>7</sup> The EU has acceded to both instruments separately from its Member States under Article 48 of the CTC and Article XXVII of the Aircraft Protocol as a Regional Economic Integration Organisation. These articles were introduced at a late stage following a request by the EU, in order to address matters on which it had exclusive competence (such as jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, insolvency proceedings and law applicable to contractual obligations). Later, in 2014, the Rail Protocol was similarly approved by the EU in accordance with Article XXII.

tion industry<sup>8</sup> has recently prompted a further expansion of the scope of the Convention: the fourth (draft) protocol on agricultural, construction and mining equipment (the 'MAC Protocol') is now nearing adoption. If successful, this upcoming expansion will be unlike any other before it: the MAC Protocol will become the first instrument to test the application of Article 51 ('Future Protocols'), which allows the CTC to cover assets which are not listed in its Article 2(3).

In the light of this (as well as any other) upcoming expansion it is important not only to consider the three existing protocols, but also to revisit the history of the basic concepts underlying the Cape Town Convention to ensure that the new instruments are properly aligned with the CTC and do not repeat the mistakes of the past. As will be shown in this paper, even the fundamental notions underlying the Convention cannot be taken at face value: their complexity cannot be fully appreciated outside the historical context.

This paper is part of a series of articles examining the history of development of the core concepts of the Cape Town Convention. The first paper focuses on two issues: 'international interest' and 'internationality'.

## II. International interest: the origins

### A. Recognition of domestic security and quasi-security interests

The autonomous concept of international interest created by the CTC lays the foundation for all other provisions of the Convention. However, this idea emerged somewhat unexpectedly as an alternative to the initially dominant approach focusing on recognition of *domestic* security and quasi-security interests.

It was clear from the start of the work on the Convention back in 1988 that two key problems would need to be resolved: unpredictability<sup>9</sup> of *lex situs* (the law of the country where the object is located) as a connecting factor in relation to mobile equipment and the widely differing approaches to the regulation of security interests in different countries. However, harmonisation of substantive rules governing security rights was not considered realistic: the prospects of 'overcoming national parochialism' in this area of the law seemed highly unlikely.<sup>10</sup> The most logical step in the circumstances appeared to be in the direction of harmonising conflict of laws provisions of national legal systems, with a view to promoting uniformity: 'If the conflict of laws rules are substantially similar, there is no need to have substantive international law to secure uniformity of approach'.<sup>11</sup>

At the time, examples of displacement of *lex situs* existed both in international instruments and domestic laws of some states. The prevailing connecting factor in the US and Canada, as

<sup>8</sup> In terms of sheer number of ratifications, the Convention is the second most ratified substantive (as opposed to conflict of laws) commercial law treaty in the world, second only to the 1980 United Nations Convention on Contracts for the International Sale of Goods, which currently has 89 contracting states.

<sup>9</sup> Other problems included the issue of transposition (ie the need to find the most suitable domestic equivalent to the foreign security interest, either to establish its priority position, or to identify an appropriate remedy in situations when the law of the new *situs* does not provide for a corresponding remedy) and the application of domestic public notice requirements to foreign security interests (the absence of which would imply that the interests of foreign secured creditors are better protected compared to their domestic counterparts, as the former would not require public notice to become effective).

<sup>10</sup> UNIDROIT, *Study LXXII - Doc. 1* (1989) 5.

<sup>11</sup> *ibid* 6.

well as under the 1965 Convention on the Registration of Inland Navigation Vessels<sup>12</sup> (the ‘1965 Geneva Convention’) was *lex debitoris* (ie the law of the country in which the debtor is located or has its place of business), whereas the relevant international aviation<sup>13</sup> and maritime<sup>14</sup> conventions favoured *lex registri* (ie the law of the country of the relevant register in which the asset is registered).

Nevertheless, even a uniform conflict of laws approach was deemed unrealistic from the start, since a rather similar measure of legal certainty could be achieved by means of a system of recognition of security interests validly created under the domestic laws of other countries. This solution did not entail any mandatory unification of connecting factors, except for one scenario: since the ultimate objective was to ensure the recognition of validly created national security interests, it was necessary to provide for a uniform solution to the problem of identifying rules governing the *validity* of such security interests.<sup>15</sup> Such solution, according to Ronald Cuming, who prepared the initial exploratory study (‘Study’) for UNIDROIT, would lie in the abolition of the *lex situs* rule in favour of *lex debitoris*.<sup>16</sup>

The idea of a recognition system thus became the preferred approach: according to Cuming, the objective of the future convention ‘would *not* be to create a supra-national security interest’.<sup>17</sup> It was firmly supported by empirical evidence: in 1990 the UNIDROIT Secretariat distributed a questionnaire<sup>18</sup> to test the early conclusions reached by Cuming in his Study (‘Questionnaire’).<sup>19</sup> Despite the initial inference that the new convention would not create any kind of supra-national security interest,<sup>20</sup> the Questionnaire offered two alternative proposals by which future harmonisation could be achieved: (i) development of an ‘entirely new type of secured financing device for use where financing involves collateral in the form of equipment of a kind generally moved from one State to another’ or (ii) ‘recognition of a generic concept of security interest that encompasses all financing devices used in States... whether or not those devices are conceptualised as such under the laws of the State in which they are used’. The vast majority of respondents (44) supported the latter option, while only 14 sought an entirely different financing vehicle.<sup>21</sup>

## ***B. International interest as alternative to recognition***

In 1993 the study group established by UNIDROIT to develop the draft Convention (‘Study Group’)

<sup>12</sup> Although the convention formally applies the *lex registri* connecting factor (Article 10 of Protocol No 1), a vessel can only be registered in one state and only provided that this state is either (i) the territory from which the operation of the vessel is habitually directed, (ii) the country of nationality or habitual residence of the owner of the vessel, or (iii) the territory in which the owner of the vessel has its registered office or the principal place of business management (Article 3(1)). This generally results in the application of the *lex debitoris* connecting factor.

<sup>13</sup> See Articles I(1) and II(2) of the 1948 Convention on the International Recognition of Rights in Aircraft (the ‘1948 Geneva Convention’).

<sup>14</sup> See Article 1 of the 1926 International Convention for the Unification of Certain Rules Relating to Maritime Liens and Mortgages (the ‘1926 Brussels Convention’) and Article 1 of the 1967 International Convention for the Unification of Certain Rules Relating to Maritime Liens and Mortgages (the ‘1967 Brussels Convention’).

<sup>15</sup> In the absence of such uniform connecting factor courts tasked with recognising foreign security interests would have absolutely no guidance as to which system of law to analyse for compliance with and would have to search all jurisdictions for signs of compliance with their respective criteria or perhaps arbitrarily select such system of law.

<sup>16</sup> See Appendix A in UNIDROIT, *Study LXXII - Doc. 1* (1989) iii.

<sup>17</sup> *ibid* (emphasis added).

<sup>18</sup> UNIDROIT, *Study LXXII - Doc. 2* (1989).

<sup>19</sup> The Questionnaire was distributed between February and July 1990 in all UNIDROIT member states, as well as in Brazil, Iceland and New Zealand and among a number of international organisations.

<sup>20</sup> See Appendix A in UNIDROIT, *Study LXXII - Doc. 1* (1989) iii.

<sup>21</sup> UNIDROIT, *Study LXXII - Doc. 3* (1991) 9-10.

expressed its preference towards creation of a new international financing vehicle – an ‘international security interest’.<sup>22</sup> To accommodate the concerns of jurisdictions outside North America which did not recognise the functional approach to security, it was decided to refer to the new international security interest in a more neutral manner, by omitting the word ‘security’.<sup>23</sup> The resulting ‘international interest’ was nevertheless quite different from the same-name concept that can be found in the final text of the CTC: the former was not detached from its domestic law counterparts.

For this reason, early attempts to define ‘international interest’ were fraught with conceptual difficulties: this new notion was hard to integrate into the pre-existing international regime of secured transactions, which consisted of a multitude of domestic interests governed by national laws. As a result, the first drafts of the CTC made the legal nature of the international interest unclear.

In 1994, the Drafting Group<sup>24</sup> produced the first set of draft articles of the future Convention, which was based on the decisions previously adopted by the Study Group.<sup>25</sup> This draft distinguished between two different concepts: ‘interest’ and ‘international interest’. The former was defined as ‘an interest arising under a security agreement or a title reservation agreement’, whereas the latter was established as a result of registration of an ‘interest’ in accordance with the draft Convention.<sup>26</sup> The resulting duality raises a number of questions, particularly with respect to the legal nature of the ‘interest’ which has not been registered. Four different explanations are possible.

First, the ‘interest’ in this case identifies the domestic security interest arising by virtue of applicable law. Second, it could refer to the security interest which the relevant agreement purported to create (ie without regard to the applicable law). Third, it could be seen as a mere fiction established in the draft for the sole purpose of identifying that ‘something’ which could subsequently be registered with the result of creating an ‘international interest’. Fourth, it could as well be an entirely new type of security interest created by virtue of the draft Convention. The first of the above explanations is problematic, as it would ultimately make the ‘international interest’ dependent on the validity of the relevant interest under domestic law. The second and third options seem plausible, but do not strictly follow from the draft text, according to which the ‘interest’ should ‘arise’ (ie come into existence) from the relevant agreement. The fourth explanation seems the most conceptually coherent, but implies that the draft Convention creates two different kinds of interests completely independent from domestic law, only one of which is ‘international’.

Soon it became clear that no ‘new’ international interest was really considered. In October 1995, members of the Study Group’s subcommittee for the preparation of the first draft (‘First Draft Subcommittee’) agreed two different options to ensure the validity of the international interest against the debtor’s trustee in bankruptcy and unsecured creditors: (i) registration in the international register established by the draft Convention, or (ii) perfection of the same in accordance with the perfection requirements of the applicable law determined by the conflict of laws rules of the bankruptcy or attachment forum.<sup>27</sup> This approach did not separate an international interest from its counterpart arising out of national law, since it was one and the same interest registrable under the draft Convention and capable of also being perfected under national law. This duality, although attractive as a concept, created complications for the legal nature of the international interest, which was basically assimilated with the relevant national law counterpart. On the one hand, the international interest was supposed to be registrable in accordance with the applicable law. On the other hand, domestic

<sup>22</sup> UNIDROIT, *Study LXXII - Doc. 7* (1993) 4.

<sup>23</sup> UNIDROIT, *Study LXXII - Doc. 12* (1994) 5.

<sup>24</sup> In this paper, mentions of the ‘Drafting Group’ should be read as references to the specific drafting group established by UNIDROIT and operating at the time in question.

<sup>25</sup> UNIDROIT, *Study LXXII - Doc. 13* (1994).

<sup>26</sup> Article 1(2)(b) and 1(2)(c) in *ibid.*

<sup>27</sup> UNIDROIT, *Study LXXII - Doc. 21* (1995) 7.

laws did not (and could not, unless explicitly overridden by the Convention to that end) provide for the perfection of some kind of *sui generis* interest created by the Convention, even assuming that the Convention would purport to create one (which was not the case at the time). It follows that the ‘international interest’, as identified by the First Draft Subcommittee, was none other than a domestic interest capable of being registered under the Convention.

To overcome these conceptual problems, a change of course was required. Interestingly, it happened very soon – and quite unexpectedly. In December 1995 the Drafting Group (Goode, Kreuzer, Synvet), which met to incorporate the decisions taken by the First Draft Subcommittee two months earlier, ended up formulating the concept of ‘autonomous’ international interest,<sup>28</sup> which was incompatible with the duality of registration and perfection of a single interest. The resulting international interest was finally detached from its national law counterpart and neither affected the latter, nor depended on its validity. This follows from the new draft Article 1(1), which read:

This Convention provides for the creation and effects of an international interest in mobile equipment. The international interest shall be of an *autonomous* character and shall have effect throughout the territories of Contracting States.<sup>29</sup>

The new text was modelled on Article 2 of the Convention for the European Patent for the Common Market.<sup>30</sup> It eliminated the problem of lack of correspondence between an ‘interest’ and an ‘international interest’: the latter emerged directly out of the relevant agreement.<sup>31</sup> It also appeared as a seemingly less intrusive solution: instead of recognition of widely differing foreign security interests, states were invited to accept the creation of an entirely new and international category of *in rem* rights that was completely independent from its national law counterparts.

With time, the Convention lost express references to the ‘autonomous’ character of an international interest, without any substitute wording to take up its place.<sup>32</sup> Subsequent attempts to reintroduce this idea in the body of the Convention never made it into the final text,<sup>33</sup> resulting in a great deal of confusion due to coexistence of an international interest with various domestic interests.<sup>34</sup> Eventually the autonomous nature of the international interest was reaffirmed in the text of the official commentary prepared by Sir Roy Goode (‘Official Commentary’).<sup>35</sup>

### III. Internationality conundrum

#### A. Devolution of the concept of internationality

At the core of the concept of ‘internationality’ lies a presumption that development of an international convention is only justified when matters regulated by the future instrument involve some form of foreign element, and that a convention should not apply to legal relationships considered

<sup>28</sup> See Article 1(1) in UNIDROIT, *Study LXXII - Doc. 22* (1996) 1.

<sup>29</sup> *ibid* (emphasis added).

<sup>30</sup> Convention for the European Patent for the Common Market (Community Patent Convention) and Implementing Regulations [1989] OJ L 401/10.

<sup>31</sup> See Article 1(2) in UNIDROIT, *Study LXXII - Doc. 22* (1996) 1.

<sup>32</sup> See Article 1(1) in UNIDROIT, *Study LXXII - Doc. 30* (1996) 9.

<sup>33</sup> See, eg, Article 1(1) in UNIDROIT, *Study LXXII - Doc. 24* (1996) i; Article 2(4) in UNIDROIT, *Study LXXII - Doc. 39* (1998) 3.

<sup>34</sup> See the comments from the French Association of Banks, Professor Klein and Professor Stoufflet in UNIDROIT, *Study LXXII - Doc. 36* (1997) 4-5, 51; comments from the Federal German Association of Banks in UNIDROIT, *Study LXXII - Doc. 36 Add. 1* (1997) 1; comments by Isabel Collaco in UNIDROIT, *Study LXXII - Doc. 40* (1998) 27.

<sup>35</sup> See, eg, paragraph 2.42 in Goode, *Official Commentary* (n 2) 38.

genuinely 'internal' or 'domestic' from the national law perspective.

The proposal of the Canadian Government<sup>36</sup> underlying the UNIDROIT's decision to initiate a feasibility study relating to the future Convention in 1988 was prepared on the assumption that an international treaty would be justified because 'security interests in mobile equipment may involve *international* elements', such as cross-border dealings between the parties or movement of equipment used as collateral from one state to another.<sup>37</sup> After transition to the idea of international interest in 1993 (it will be recalled from the previous section that at that time the concept was not entirely autonomous), this new financing device was not expected to completely displace the domestic rules governing security interests in movables: 'it [was] clear that the Convention [was] to apply only to security agreements that give rise to or have the potential to give rise to situations which require *international* regulation.'<sup>38</sup> The new treaty was supposed to create a legal regime operating *in parallel* with the existing domestic regulation. However, in order for this regime to be effective, the future Convention had to contain clear rules permitting the parties engaged in financing transactions to determine *ex ante* which system of rules should apply: the new treaty or the domestic laws. A number of solutions were considered.

In 1993, the Study Group examined two alternative approaches to the test of 'internationality'. According to the first one, the future Convention was to apply to security interests in all types of 'mobile equipment' (ie by reference to the physical characteristics of the asset), regardless of whether or not any international element was involved, and even in a purely domestic situation.<sup>39</sup> The second one, favoured by the majority, involved bifurcation in the application of the Convention provisions depending on the existence or absence of an international factor: the application of the treaty *ab initio* would depend solely on the physical characteristics of the equipment (ie whether or not the equipment was of a kind normally moving between states), whereas the substantive rules would only come into play once the equipment has actually crossed national borders and a dispute emerged in the new jurisdiction. Prior to the emergence of the latter type of internationality (ie actual movement of the asset) the relevant rules of applicable domestic law would govern all matters relating to remedies or priority. This more conservative approach gathered greater support in view of perceived difficulties in persuading governments to accept an international convention governing transactions which had 'no international element other than that they involve mobile equipment that is capable of being moved from one State to another.'<sup>40</sup>

The separation suggested by the Study Group thus created two different concepts: 'potential internationality' (essentially limited to a simple test of mobility), necessary for the application of the future Convention to the relevant international interest immediately upon its creation, and 'actual internationality', required for the application of the relevant priority and remedy rules. The requirement of a second (actual) internationality, however, created uncertainty and complexity. First, lenders advancing funds secured by an international interest in essentially mobile assets could be discouraged from providing financing as their priority position (or available remedies) would change depending on the location of the asset controlled by the debtor: in such cases creditors would be inclined to limit the debtor's right to remove the asset from the jurisdiction. Likewise, debtors would prefer the freedom to use the asset without such restrictions.<sup>41</sup> Second, certain assets could frequently change the applicable regime, by shuttling between the 'home' state and other ju-

<sup>36</sup> The text of the proposal was prepared by Ronald Cuming and was kindly provided to the author by the UNIDROIT Secretariat as an attachment to *Letter from Malcolm Evans to Willem Vis* (22 July 1988).

<sup>37</sup> *ibid* (emphasis added).

<sup>38</sup> UNIDROIT, *Security Interests Study Group 1st session Misc. 5* (1993) 1 (emphasis added).

<sup>39</sup> UNIDROIT, *Study LXXII - Doc. 8* (1993) 18.

<sup>40</sup> *ibid*.

<sup>41</sup> See UNIDROIT, *Study LXXII - Doc. 6 Add. 2* (1993) 1-2; UNIDROIT, *Study LXXII - Doc. 10* (1994) 2.

risdictions, which would create monitoring issues and further increase complexity.<sup>42</sup> In the light of the difficulties arising from the proposed bifurcated internationality regime a number of alternative solutions emerged.

Charles Mooney proposed an alternative test to determine the situations which could be considered 'purely domestic' and thus warranted exclusion from the scope of the future Convention. According to the suggested approach, the Convention's registration and priority rules were not applicable to a scenario whereby (i) the debtor created a security interest in accordance with the law of a contracting state while located in that state and (ii) the debtor had its place of business in that state. The future Convention would be triggered only when the equipment actually moved to another state or the interest was registered in the international registry established by the future Convention.<sup>43</sup> This test narrowed the list of 'domestic' situations by excluding interests registered under the treaty even when the asset did not move outside the relevant jurisdiction: it was posited that as long as both the debtor and the secured party voluntarily chose the Convention regime and gave notice to the world, the decision to apply the treaty should control. The solution had two key benefits: first, it reflected the key commercial concept of party autonomy; second, it could greatly enhance predictability, giving financiers the opportunity to avail themselves of the Convention protections from day one in cases when the laws of the *situs* did not provide enough assurance to the creditor.<sup>44</sup> The downside of this approach is that any third party wishing to protect itself would inevitably have to check the international registry for existing registration (and register its own interest first) even in a purely domestic scenario, although this concern is obviously less acute in commercial financing involving sophisticated parties.

Jan-Hendrik Roever proposed two alternative criteria of internationality: (i) internationality of transaction and (ii) location of places of business of the parties in different countries.<sup>45</sup> The second alternative was conceptually similar to the test of 'mobility' applied by the Study Group in the sense that it did not guarantee that the equipment would eventually move between states, and can thus be considered another type of 'potential internationality'.

Ronald Cuming, on the basis of a number of case scenarios, proposed a different test, which would involve consideration of a subjective element, namely ascertaining the actual *intention* of the parties to the relevant security agreement. In his view, the enforcement rules of the future Convention were supposed to apply, even if the equipment remained within the same jurisdiction, in situations when the circumstances of the case evidenced the intention of the parties to the security agreement to use the equipment primarily outside the country of its original *situs*. In contrast, the Convention's protections were not supposed to be available to the secured party in a similar fashion if the intention of the parties was to use the equipment primarily within the same country, disregarding occasional instances of use in other states.<sup>46</sup> The apparent difficulty associated with this approach is its lack of predictability, as any attempt to apply it would inevitably involve factual disputes and an element of court discretion.

A fourth, and more radical solution, was suggested by The Boeing Company: 'given the futility of separating domestic from international aircraft finance transactions, the convention would apply even in a purely domestic context'.<sup>47</sup>

Having considered the different options, the First Draft Subcommittee significantly expanded the

<sup>42</sup> See United Nations, *Report of the Secretary-General: study on security interests (A/CN.9/131)* (1978) 210; UNIDROIT, *Study LXXII - Doc. 9* (1994) 1.

<sup>43</sup> UNIDROIT, *Study LXXII - Doc. 10* (1994) 2-3.

<sup>44</sup> *ibid* 3-4.

<sup>45</sup> UNIDROIT, *Study LXXII - Doc. 11* (1994) 6.

<sup>46</sup> UNIDROIT, *Study LXXII - Doc. 8* (1993) 29.

<sup>47</sup> UNIDROIT, *Security Interests Study Group Sub-committee 1st session Misc. 3 Add.* (1994) 2.

list of 'non-domestic' situations which made possible the application of the Convention's priority and remedy rules.<sup>48</sup> Two new scenarios giving rise to the Convention's protections were envisaged, in addition to the actual movement of the equipment: (i) a situation when at the time of conclusion of the security agreement both parties had their places of business in different states and (ii) a situation when the security agreement expressly provided that the relevant equipment would move between different states.<sup>49</sup> The latter scenario differed significantly from the solution suggested by Cuming earlier<sup>50</sup> in that the subjective element (ascertaining the actual intention of the parties) was replaced with reference to the express terms of the contract for the purposes of enhanced predictability. It is critical to stress the importance of this additional criterion, as it created the only opportunity for a secured party located in the same country as the debtor to guarantee its priority over foreign creditors in a situation when the equipment did not move outside its *situs* at all: absent this proviso the draft Convention would create a legal mechanism clearly favouring foreign creditors to the prejudice of the domestic ones (as the latter would not be in a position to protect their priority vis-à-vis competing creditors located abroad).

The 1994 report of the First Draft Subcommittee<sup>51</sup> does not make it clear whether, in order to satisfy the internationality requirement, the equipment needed only to cross national borders or was also required not to return back into the country of its initial *situs*. Nevertheless, the first set of draft articles prepared later the same year adopted the latter, more restrictive approach: the situation was considered 'non-domestic' only when at the time of the proceedings the equipment ended up in a state different from the *situs* of such equipment at the time of conclusion of the agreement.<sup>52</sup> The result of this approach was that (in a situation when neither of the other two internationality criteria applied) even an aircraft regularly travelling two times a day between two bordering countries (and remaining in each state for an equal amount of time), one of which was the country of its original *situs* at the time of the security agreement, would satisfy the internationality requirement necessary for the application of Convention's protections only fifty percent of the time.

As can be seen from the above example, the internationality requirement in the first set of draft articles of the CTC remained rather strong, despite the revisions proposed by the First Draft Subcommittee. The only effective way for the financier to control the fulfilment of the test of internationality (and, as a result, obtain the Convention's protections) was through the terms of the relevant agreement. In addition, the rules concerning the effects of international interests were drafted as prohibitive provisions which completely blocked the application of the relevant rules, unless one of the 'non-domestic' exceptions applied.<sup>53</sup>

This position was reversed during the second session of the First Draft Subcommittee in late 1994, which considered Article 4 of the draft articles (where the 'non-domestic' criteria were listed) obsolete in the light of the inherently 'international' character of mobile equipment.<sup>54</sup> This decision was expected to provide greater certainty for third parties, which would be in a position to determine *ex ante*, simply by looking at the type of equipment, whether or not it might be subject to the effects of the Convention, without the need to know the place of business of the parties to the relevant financing arrangements. In addition, financiers located in the same country as the debtor would no longer have to rely on the express terms of the agreement<sup>55</sup> to guarantee the application of the Convention's

<sup>48</sup> This decision was later reflected in the first set of draft articles of the Convention – see Article 4 in UNIDROIT, *Study LXXII - Doc. 13* (1994) 3-4.

<sup>49</sup> UNIDROIT, *Study LXXII - Doc. 12* (1994) 4.

<sup>50</sup> See n 46.

<sup>51</sup> See n 49.

<sup>52</sup> See Article 4(2)(c) in UNIDROIT, *Study LXXII - Doc. 13* (1994) 4.

<sup>53</sup> See Articles 4 and 5 in *ibid* 3-4.

<sup>54</sup> UNIDROIT, *Study LXXII - Doc. 15* (1995) 6.

<sup>55</sup> cf Article 4(2)(b) in UNIDROIT, *Study LXXII - Doc. 13* (1994) 4.

protections in order to protect themselves against competing interests of foreign creditors, who automatically satisfied the international requirement by virtue of their location in another country.<sup>56</sup>

At the same time, the First Draft Subcommittee was not yet prepared to abandon the idea that entirely domestic transactions were to be excluded. It was felt that governments would have a particularly strong interest in the application of their own domestic laws in a situation when (i) both the secured party and the debtor were carrying on business in the same state, (ii) the equipment never left that state and (iii) enforcement proceedings were instituted in that same state. It was agreed that in this situation the Convention's remedy provisions would not apply, but only as between the parties to the relevant agreement: the Convention itself would continue to be effective in relations involving third parties.<sup>57</sup> Three important observations must be made. First, the very logic of the Convention's internationality rules was thus reversed: the prohibitive rules of Article 4 requiring specific 'non-domestic' exceptions were effectively being replaced with a generally permissive rule allowing automatic satisfaction of the internationality requirement, subject only to a substantially limited 'domestic transaction' rule. Second, the text of the UNIDROIT report suggests that, in order to avoid the application of the 'domestic' exception, it was sufficient for the equipment to leave its original jurisdiction at least once: even upon return to that initial jurisdiction the situation would no longer be considered 'domestic'.<sup>58</sup> Third, the First Draft Subcommittee considered a special exemption from the 'domestic transaction' rule (essentially constituting an exception to what already served as an exception), which would permit the Convention protections to apply in a domestic scenario with respect to particularly high cost assets: it was feared that without access to the Convention's remedies financiers in countries with unsophisticated secured financing laws would be left without adequate protection.<sup>59</sup>

Before the Drafting Group had an opportunity to implement the above changes, in 1995 UNIDROIT received a memorandum prepared jointly by a newly formed association of major aircraft financing market participants, the Aviation Working Group ('AWG'), represented by Airbus Industrie and The Boeing Company, and strongly suggesting the abolition of *any* internationality requirement whatsoever in respect of aircraft due to the fact that aviation financing transactions were *per se* international. Four reasons were given for such proposal: (i) high mobility of aircraft, (ii) high complexity of aircraft financing, (iii) the need for commercial certainty and predictability and (iv) the need to eliminate prejudice towards domestic financiers who could find themselves unable to tap into the Convention regime.<sup>60</sup>

Perhaps as the result of the position taken by the aviation industry, the next draft set of articles of the future Convention<sup>61</sup> prepared later in 1995 did not contain any rules concerning internationality, particularly with respect to the 'domestic transaction' exceptions agreed by the First Draft Subcommittee. Nevertheless, the discussions concerning the test of internationality did not stop and subsequently three different lines of thought emerged. The first one was expressed by the increasingly active aviation industry represented by the AWG and the International Air Transport Association (IATA), which supported the idea of total abolition of the test of internationality in relation to aircraft equipment, essentially on the basis of the earlier assertion that aircraft equipment was *per se* international.<sup>62</sup> The second one suggested a more cautious approach, stressing the need to account for the possible reluctance of governments to relinquish the application of their domestic laws to

<sup>56</sup> See Article 4(2)(a) in *ibid* 3.

<sup>57</sup> See paragraph 10(xvi) UNIDROIT, *Study LXXII - Doc. 15* (1995) 6-7.

<sup>58</sup> *ibid* 6.

<sup>59</sup> *ibid* 7.

<sup>60</sup> UNIDROIT, *Study LXXII - Doc. 16* (1995) 7.

<sup>61</sup> UNIDROIT, *Study LXXII - Doc. 18* (1995).

<sup>62</sup> UNIDROIT, *Study LXXII - Doc. 32 Add. 2* (1997) 7-8.

essentially internal transactions, even if the latter covered mobile equipment.<sup>63</sup> The third one noted the vital importance of the 'validation' principle whereby failure to register an international interest should not subordinate the relevant domestic interest to the trustee in bankruptcy in a purely domestic situation,<sup>64</sup> but was effectively resolved via the concept of 'autonomous' international interest (see section II(B) above).

The subsequent drafts<sup>65</sup> of the future Convention did not include any specific rules on internationality, and the Study Group eventually confirmed the established *status quo*, without any reference to the 'purely domestic' exception: 'it should be sufficient that the equipment was mobile as defined in Article 2 of the Convention, because essentially this meant equipment that by its nature moved regularly from one country to another.'<sup>66</sup> The principle of internationality was coming to its end, but soon reappeared in the limited form of declarations on 'purely domestic transactions'.

### **B. Declarations on purely domestic transactions**

Despite the apparent end of the 'internationality' requirement, state sensitivities remained a cause of concern for the developers of the Convention. In 1997 the draft CTC was supplemented with a new Article W permitting states to make a declaration that they would not apply the Convention in relation to a 'purely domestic transaction'.<sup>67</sup> As was later explained by the Chairman of the Study Group, this new provision was introduced to deal with a case of eg 'a train in one State running round a circle in such a way that it would never leave that State's boundaries'.<sup>68</sup> In other words, a purely domestic transaction was one in which 'there was never any movement across... national frontiers'.<sup>69</sup> At the time the idea of a 'domestic' exception was not, strictly speaking, novel: as noted earlier,<sup>70</sup> in 1995 the First Draft Subcommittee considered the same issue and came up with a three-prong test.<sup>71</sup> Nonetheless, the new provision did not establish any particular criteria that had to be satisfied in order to constitute a 'purely domestic transaction': the decision was left to the governmental experts, despite several proposals to abolish this concept altogether.<sup>72</sup>

Limited progress was achieved during the first<sup>73</sup> and second<sup>74</sup> sessions of deliberations among governmental experts in 1999,<sup>75</sup> where no attempt to identify purely domestic transactions (which were renamed to 'purely internal transactions') was made. The draft produced at the end of the second session left the matter of identifying such transactions in the hands of contracting states, as the latter were given the authority not only to declare that the Convention would not apply to a purely internal transaction, but also to specify the types of transactions falling under this category.<sup>76</sup> Such a broad provision carried with it the danger that states, in the absence of clear criteria defined in the Conven-

<sup>63</sup> See UNIDROIT, *Study LXXII - Doc. 17* (1995) 9; UNIDROIT, *International Interests Study Group Sub-committee 3rd session Misc. 3* (1995).

<sup>64</sup> See UNIDROIT, *Study LXXII - Doc. 26 Add. 1* (1996) 6; UNIDROIT, *Study LXXII - Doc. 32 Add. 3* (1997) 2; UNIDROIT, *International Interests Study Group Sub-committee 3rd session Misc. 3* (1995) 3.

<sup>65</sup> See UNIDROIT, *Study LXXII - Doc. 22* (1996); UNIDROIT, *Study LXXII - Doc. 24* (1996).

<sup>66</sup> UNIDROIT, *Study LXXII - Doc. 27* (1996) 7.

<sup>67</sup> UNIDROIT, *Study LXXII - Doc. 37* (1997) xvi.

<sup>68</sup> UNIDROIT, *Study LXXII - Doc. 40* (1998) 26.

<sup>69</sup> *ibid.*

<sup>70</sup> See n 57 above.

<sup>71</sup> See UNIDROIT, *Study LXXII - Doc. 15* (1995) 6.

<sup>72</sup> See UNIDROIT, *Study LXXII - Doc. 43 / Study LXXIID - Doc. 4* (1998) 6; UNIDROIT, *Study LXXII - Doc. 49 / Study LXXIID - Doc. 9* (1999) 2.

<sup>73</sup> UNIDROIT, *Unidroit CGE/Int.Int./Report ICAO Ref. LSC/ME-Report* (1999) 17.

<sup>74</sup> See paragraph 5:37 in UNIDROIT, *ICAO Ref. LSC/ME/2-Report Unidroit CGE/Int.Int./2-Report* (1999) 5-7.

<sup>75</sup> A total of three consecutive sessions of governmental experts took place in 1999 and 2000 in the run-up to the Cape Town Diplomatic Conference to adopt the Convention and the Aircraft Protocol.

<sup>76</sup> See Article V of Attachment F in UNIDROIT, *ICAO Ref. LSC/ME/2-Report Unidroit CGE/Int.Int./2-Report* (1999) F-29.

tion, would use it as a loophole to exclude whole classes of transactions, regardless of whether or not they were truly devoid of a genuine international element.

The problem of internationality was one of the most difficult issues during the Third Joint Session held in 2000.<sup>77</sup> The discussion was opened by the proposal of the French delegation, which aimed to reintroduce the test of internationality in a very strong form.<sup>78</sup> To address this matter, a special working group was created to examine the relevant provisions in more detail and provide recommendations. Its deliberations<sup>79</sup> helped to shape the Convention's internationality provisions. First, the test of internationality was met if the relevant (security, title reservation or leasing) agreement related to the types of equipment to which the Convention applied. Second, states were permitted to make declarations in respect of internal transactions,<sup>80</sup> but could not freely determine which transactions were considered 'internal'.<sup>81</sup> Third, the test to determine what constitutes an 'internal transaction' involved two elements: (i) location of both parties to the agreement in the same contracting state and (ii) location of the relevant object in the same contracting state, each at the time of conclusion of the transaction.<sup>82</sup> Fourth, declarations made by contracting states with respect to internal transactions did not prevent the application of certain provisions of the Convention to such transactions (including rules on priority).<sup>83</sup>

The issue of internal transactions was subsequently considered during the Cape Town Diplomatic Conference in 2001. These discussions added two principal changes. First, the ability of contracting states to make a declaration on internal transactions was limited to situations when such contracting states had in place the registration machinery by which notices of national interests could be transmitted to the international registry.<sup>84</sup> This change resulted from the fact that a declaration on internal transactions by a contracting state effectively made it impossible for the relevant parties to register an international interest under the Convention and thus it was considered prudent to require some assurance that parties to internal transactions would be able to protect their priority should the need arise. This echoes the previous concerns about the need to avoid jeopardising the position of domestic financiers.<sup>85</sup> Second, although contracting states could not redefine what constituted an 'internal transaction', it was agreed that they should nevertheless be given the opportunity to choose whether to exclude the application of the Convention to all such transactions or only with respect to certain objects.<sup>86</sup> This was a departure from the 'all or nothing' approach, which emerged at the conclusion of the third session of governmental experts in 2000.

Nonetheless, the added flexibility of this provision has not been utilised by states to this date: each of the existing declarations under Article 50(1) of the CTC excludes the application of the Conven-

<sup>77</sup> See UNIDROIT, *Unidroit CGE/Int.Int./3-Report ICAO Ref. LSC/ME/3-Report* (2000).

<sup>78</sup> UNIDROIT, *Unidroit CGE/Int.Int./3-WP/17 ICAO Ref. LSC/ME/3-WP/17 12/03/00* (2000).

<sup>79</sup> See UNIDROIT, *Unidroit CGE/Int.Int./3-WP/27 Corr. ICAO Ref. LSC/ME/3-WP/27 27/03/00* (2000).

<sup>80</sup> See Article S(1) Attachment C Appendix I in UNIDROIT, *Unidroit CGE/Int.Int./3-Report ICAO Ref. LSC/ME/3-Report* (2000).

<sup>81</sup> See Article I(q) Attachment C Appendix I in *ibid.*

<sup>82</sup> *ibid.*

<sup>83</sup> See Article S(2) Attachment C Appendix I in *ibid.*

<sup>84</sup> See Article I(n) of the CTC.

<sup>85</sup> See n 49 and the relevant discussion in section III(A) above.

<sup>86</sup> See Article 50(1) of the CTC.

tion to all internal transactions in their entirety.<sup>87</sup> Furthermore, the possibility of limiting the list of objects to which the internal transaction exception applies could not override the aforementioned 'gateway' requirement that interests under all internal transactions should be registered in the relevant national registries. As a result, objects for which no domestic registration systems were in place, could not be excluded even pursuant to a declaration under Article 50(1) of the CTC. The lack of local registration systems for rolling stock made this concern particularly relevant for the rail industry<sup>88</sup> and later resulted in the implementation of an alternative test for 'internal transactions' based solely on physical characteristics of the asset, to which the requirements of mandatory national registration did not apply. This new test was based on a single factor: whether or not the object was only capable, in its normal course of use, of being operated on a single railway system within the contracting state concerned.<sup>89</sup> Interestingly, a similar 'immobility' test was not reproduced in the recent drafts of the MAC Protocol,<sup>90</sup> even though the assets covered by the latter may be even less transportable compared to rolling stock.<sup>91</sup>

#### IV. Concluding remarks

The ongoing development of the draft MAC Protocol and the cautious optimism regarding the feasibility of expanding the CTC to cover ships at some point in the future require a clear understanding of the very important tradeoffs that had to be made in order to establish a successful international regime of secured transactions in mobile equipment. As a first step in this direction, this paper has briefly examined the history of development of the two core concepts forming the basis of the Cape Town Convention mechanism: 'international interest' and 'internationality'.

The concept of international interest was formed as a less intrusive alternative to the initially dominant preference towards a system of recognition of domestic security interests. Over the years of development, the Convention got rid of the concept of internationality, but nevertheless allows states to disapply its provisions to transactions that remain entirely domestic – although the opportunities for selective application of the relevant exception in Article 50(1) of the CTC have not been

<sup>87</sup> See paragraph 4 in UNIDROIT, 'Declarations Lodged by The People's Republic of China (PRC) under the Cape Town Convention at the Time of the Deposit of its Instrument of Ratification' <<http://www.unidroit.org/status-2001capetown?id=463>> accessed 02 June 2017; paragraph 3 in UNIDROIT, 'Declarations Lodged by the United Mexican States under the Cape Town Convention at the Time of the Deposit of its Instrument of Accession' <<http://www.unidroit.org/status-2001capetown?id=476>> accessed 02 June 2017; paragraph 3 in UNIDROIT, 'Declarations Lodged by the Republic of Panama under the Cape Town Convention at the Time of the Deposit of its Instrument of Ratification' <<http://www.unidroit.org/status-2001capetown?id=484>> accessed 02 June 2017; paragraph (iv) in UNIDROIT, 'Declarations Lodged by the Republic of Turkey under the Cape Town Convention at the Time of the Deposit of its Instrument of Ratification' <<http://www.unidroit.org/status-2001capetown?id=492>> accessed 02 June 2017; paragraph 1 in UNIDROIT, 'Declarations Lodged by Ukraine under the Cape Town Convention at the Time of the Deposit of its Instrument of Accession' <<http://www.unidroit.org/status-2001capetown?id=493>> accessed 02 June 2017.

<sup>88</sup> See footnote 58 in UNIDROIT, *Study LXXIIIH - Doc. 8* (2003) 52.

<sup>89</sup> See Article XXIX(2) of the Rail Protocol.

<sup>90</sup> UNIDROIT, *Study 72k - CGE1 - Doc. 2 corr.* (2017); UNIDROIT, *Study 72k - CGE2 - Doc. 2* (2017).

<sup>91</sup> A quick look at the pre-selected equipment categories shows that certain stationary equipment might indeed be covered by the draft MAC Protocol: examples include HS code 847432 (machines for mixing mineral substances with bitumen) and HS code 847982 (mixing, kneading, crushing, grinding, screening, sifting, homogenizing, emulsifying or stirring machines). See Annex 2 to UNIDROIT, *Study 72k - CGE1 - Doc. 2 corr.* (2017) 25; Annex 2 to UNIDROIT, *Study 72k - CGE2 - Doc. 2* (2017) 26; UNIDROIT, *Study 72k - CGE1 - Doc. 5 corr* (2017) 12. A similar matter was previously discussed within the MAC Protocol study group: one of the members suggested an opt-out rule for 'purely stationary' equipment. It appears to have been dismissed on the grounds that it 'would cause additional issues and would require the term "stationary" to be defined'. See paragraph 65 in UNIDROIT, *Study 72k - SG3 - Doc. 5* (2015) 9.

fully utilised by states.

The second paper in the series will follow the genesis of the concept of 'mobile equipment' and the corresponding historical challenges, such as the odd treatment of helicopter engines, exclusion of ships from the scope of the CTC and the origins of the 'gateway' criteria for future expansion of the Convention in Article 51(1).