

# Assignment and Assumption or Novation: Cape Town Convention Implications for the Still Unwary Drafter

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## Abstract

*This paper considers how a practitioner should treat, in the context of the Cape Town Convention, an assignment and assumption under the laws within various states of the United States and novation agreements governed under the law of England and Wales. It considers the treatment of such in the Official Commentary and the experiences of practitioners in this particular field.*

## I. Introduction

In 2008 one of the authors of this article, Phillip Durham, addressed the American Bar Association's Aircraft Financing Subcommittee on the differing treatment of assignment and assumption agreements and novations under the Cape Town Convention and its Aircraft Protocol. The presentation attempted to aid the practitioner in understanding and appreciating the interplay between the Cape Town Convention and applicable national law. Mr. Durham concentrated his analysis on the impact of the characterization of an outright transfer of a lessor's interest in an aircraft operating lease as either an assignment or a novation under the laws of certain of the States of the United States and under English law and the impact that such characterization would have on the characterization under the Cape Town Convention and its Aircraft Protocol.

In the nine years since that presentation the Cape Town Convention and its Aircraft Protocol have expanded greatly and are now in force in sixty-eight contracting states.<sup>1</sup> Furthermore, the body of jurisprudence surrounding the Cape Town Convention has continued to grow with its expanded geographic reach and its increasing use and familiarity.<sup>2</sup> Those intervening years have also seen an update to the Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol thereto on Matters Specific to Aircraft Equipment (the 'Official Commentary'),<sup>3</sup>

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<sup>1</sup> UNIDROIT, 'Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment – Status' <<http://www.unidroit.org/status-2001capetown-aircraft>> accessed 15 January 2018.

<sup>2</sup> See, eg, Jeffrey Wool and Rafal Zakrzewski, 'Editorial' (2015) 4(1) Cape Town Convention Journal 1, 1-2.

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

which, as we will see below, has resulted in a change of view on a key aspect of the treatment of novation agreements under the Cape Town system.

It should also be recognised that in this intervening period there has been a massive growth in portfolio sales between lessors of aircraft subject to existing aircraft operating leases,<sup>4</sup> which has occasioned a large increase in the number of assignment and assumption agreements and novation agreements being dealt with by practitioners in this field. As more and more of these agreements are subject to the Cape Town Convention and its Aircraft Protocol, the correct treatment of these agreements by the practitioner under the Cape Town Convention and its Aircraft Protocol is vital.

In an attempt to assist the practitioner in determining the correct treatment of these agreements, this article's analysis begins with a description of how the aviation industry in each of the United States and England has traditionally handled the outright transfer of a lessor's interest in an aircraft operating lease. Section III then proceeds to offer an account of the characterization by the Restatement (Second) of Contracts and the courts of the States of California, Washington and New York of the outright transfer of a lessor's interest in a lease as either an assignment or a novation. Section IV offers a similar account of the characterization under English law. The analysis continues in Section V with an explanation of how the Cape Town Convention separately handles the outright transfer of a lessor's interest in an aircraft operating lease by way of an assignment and also by way of a novation. Section VI concludes by proposing a practical solution to handling the outright transfer of a lessor's interest in an aircraft operating lease under the Cape Town Convention.

## II. Traditional Industry Practice in the Transfer of an Interest in an Aircraft Operating Lease

The aviation industry in the United States has traditionally favored a tripartite instrument for the outright transfer of a lessor's interest in an aircraft operating lease in connection with the sale of an aircraft to an unrelated third party called, among other names, an assignment and assumption agreement.<sup>5</sup> The four key elements of the traditional US law assignment and assumption agreement are that as of the agreed effective time of the agreement (i) the assignor assigns to the assignee all of its rights, interests, obligations, duties and liabilities in, to, and under the aircraft operating lease, (ii) the assignee assumes all of the assignor's rights, obligations, duties and liabilities under the aircraft operating lease agreement, (iii) the lessee consents to the assignment and assumption and (iv) the assignor and the lessee each releases the other from such party's obligations, duties and liabilities under the aircraft operating lease agreement owing to the other that arise out of or pertain to the period from and after the agreed effective time of the agreement.<sup>6</sup> Thus, the assignment and assumption agreement effectively substitutes a new party to an aircraft operating lease while attempting to preserve the continuity of the underlying aircraft operating lease.

The aviation industry in England has, however, traditionally favored another tripartite agreement to achieve the same end called a novation agreement. The key elements of the traditional English law novation agreement are that (i) there is, from and after the agreed effective time of the agreement, a new agreement by the new lessor and the lessee with substantially the same obligations, duties and

<sup>4</sup> Shamshad Ali and Neil Hampson, 'Aviation Finance: Fasten Your Seatbelts' (2013) 32-35 <<https://www.scribd.com/document/365358427/pwc-aviation-finance-fastern-your-seat-belts-pdf-pdf>> accessed 19 February 2018.

<sup>5</sup> While merely speculation on the part of the author, one possible explanation for the adoption of the assignment and assumption form for the transfer of a lessor's interest in an aircraft operating lease in the United States may be that in the heavily New York law focused world of aviation finance, the affirmative defense historically afforded by a novation under New York law was incompatible with the realities of the subject transaction. See Section III(C) below.

<sup>6</sup> These factors are, of course, not intended to be exhaustive nor are they intended to be concrete expressions of the necessary contractual arrangement between the parties to effectuate the transfer of the lessor's interest in the operating lease. These factors are merely intended to reflect the most common contractual arrangement that the authors have observed in their practice.

liabilities as under the aircraft operating lease agreement that is the subject of the novation, (ii) the prior lessor and the lessee each releases the other from such party's obligations, duties and liabilities under the aircraft operating lease agreement arising out of or pertaining to the period after the agreed effective time of the agreement and (iii) there is no new transfer of possession as the lessee will continue to retain possession at the time that the new agreement becomes effective.<sup>7</sup>

### III. State Law Approaches to Characterizing the Outright Transfer of a Lessor's Interest in an Aircraft Operating Lease Pursuant to a Traditional US Law Assignment and Assumption Agreement

Having reviewed the traditional industry practice in documenting the transfer of an interest in an aircraft operating lease, we now turn our attention to how applicable law in the United States characterizes the outright transfer of a lessor's interest in a lease via a standard US law assignment and assumption agreement.

#### A. *The Restatement (Second) of Contracts Approach*

Section 280 of the Restatement (Second) of Contracts defines a novation as a 'substituted contract that includes as a party one who was neither the obligor nor the obligee of the original duty'.<sup>8</sup> A substituted contract is further defined by the Restatement (Second) of Contracts as a 'contract that is itself accepted by the obligee in satisfaction of the obligor's existing duty' and that 'discharges the original duty [so that] a breach of the substituted contract by the obligor does not give the obligee a right to enforce the original duty'.<sup>9</sup> Thus, the Restatement (Second) of Contracts provides for three elements that must be present before an agreement would constitute a novation: (i) the addition of a new party to the agreement, (ii) the agreement to discharge the original duty of the substituted party, and (iii) the creation of a new contractual duty by the substitute party. But how would the outright transfer of a lessor's interest in a lease via a standard US law assignment and assumption agreement be treated under the Restatement (Second) of Contracts? The analysis necessary for this query sheds light on the somewhat peculiar nature of the standard US law assignment and assumption agreement that hinders its simple classification as a novation.

Since it is clear that the standard US law assignment and assumption agreement results in the inclusion of a new party to the aircraft operating lease agreement and creates a new contractual duty on the part of the substitute party, the focus of the analysis must revolve around the discharge of the original duty. Given the fact that the standard US law assignment and assumption agreement contains an agreement on the part of the assignor and the lessee to release one another from such party's obligations, duties and liabilities under the aircraft operating lease agreement owing to the other that arise out of or pertain to the period from and after the agreed effective time of the agreement,

<sup>7</sup> See n 6.

<sup>8</sup> Section 280 of the Restatement (Second) of Contracts is based on Section 424 of the Restatement (First) of Contracts. Section 424 of the Restatement (First) of Contracts defines a novation as a 'contract that (a) discharges immediately a previous contractual duty or a duty to make compensations, and (b) creates a new contractual duty, and (c) includes as a party one who neither owed the previous duty nor was entitled to its performance'. See § 71.1(2) in Sarah Howard Jenkins, Joseph M. Perillo (ed), *Corbin on Contracts* (13th Vol, res edn, LexisNexis 2003). See also Section 328(1) of the Restatement (Second) of Contracts (2007) ('However, as noted in comment (a) to this section and recognized by all courts, an assignor's intention that the assignee be substituted for him or her is not completely effective unless the obligor of the assigned rights (the lessor) assents, thus creating a novation').

<sup>9</sup> Section 279 of the Restatement (Second) of Contracts (2007). While a novation can occur by either the substitution of the obligor or the obligee, for purposes of this article it will be assumed that the novation will occur with the substitution of the obligee.

the question of whether the standard US law assignment and assumption agreement ‘discharges the original duty [so that] a breach of the substituted contract ... does not give ... a right to enforce the original duty’ turns upon how one defines ‘original duty’.<sup>10</sup> It is hardly debatable that from and after the effective time of the agreement, a breach by the assignee operating lessor of its quiet enjoyment covenant would not give rise to a claim by the lessee against the assignor operating lessor for such breach. Conversely, it is equally clear that the parties do not intend to discharge any previously owed obligations arising out of or pertaining to the period prior to the effective time of the agreement (eg a lessee indemnity obligation). So just what exactly is an ‘original duty’?<sup>11</sup> Is it only duties arising out of or pertaining to the period from and after the acceptance of the substitute contract or does it encompass all duties owing under the substituted contract? Let us turn our attention to how certain state courts have answered this question.

### ***B. The ‘Gold Clause’ Cases: The California and Washington Approach***

In 1995 the Court of Appeal for Division 2 of the Second District of California rendered a decision in *Wells Fargo Bank, N A v Bank of America NT&SA* addressing head on whether or not the assignment and assumption of a ground lease constituted a novation under California law.<sup>12</sup> *Wells Fargo* centers on whether or not the assignment by a lessee in 1981 of its leasehold interest in a ground lease containing a ‘gold clause’<sup>13</sup> constituted a novation, thereby creating a new obligation to perform the ‘gold clause’ following Congress’ action to repeal the 1933 prohibition on ‘gold clauses’<sup>14</sup> for obligations created on or after October 28, 1977.<sup>15</sup> Ultimately, and much to the chagrin of the lessee, the court ruled that the 1981 assignment by the lessee of its leasehold interest constituted a novation under California law. However, the more interesting aspect of *Wells Fargo* is just how the court reached its decision.

The court in *Wells Fargo* began by paying lip service to the ambiguous codification of a novation under the California Civil Code.<sup>16</sup> The court, however, quickly moved to a standard a bit closer to the Restatement (Second) of Contracts noting that a novation is a ‘new contract which supplants the

<sup>10</sup> *ibid.*

<sup>11</sup> Illustration 3 to comment (d) to Section 280 of the Restatement (Second) of Contracts offers an opportunity, albeit imprecise, for reasoning by analogy:

A owes B a duty to service B’s machine for a year. A sells part of his business to C, who promises A that he will assume A’s duty to B if B promises to accept it immediately and in substitution for A’s duty. B so promises A. There is a novation under which B’s and C’s promises are consideration for each other, and A’s duty to service B’s machine is discharged.

While this illustration seems to somewhat approximate the end result of a standard US law assignment and assumption agreement by clearly reinforcing the above stated analysis of the post-substitute contract discharge of duties, it still leaves open the question of whether the assumption of A’s duty by C also included duties that related to the time period prior to the date of the substitute contract. For example, did C assume and discharge A’s duty to have actually serviced B’s machines in a workmanlike manner prior to the date of the substitute contract? The illustration is unclear on this point.

<sup>12</sup> *Wells Fargo Bank N A v Bank of America* (2005) 32 Cal App 4<sup>th</sup> 424.

<sup>13</sup> A ‘gold clause’ is a ‘price-indexing contract clause used to adjust for inflation’ by ‘mandating payment in gold coin or its equivalent’, which were rather popular in the United States prior to the Great Depression: see *ibid* 428.

<sup>14</sup> H J Res No 192 73d Cong, 1<sup>st</sup> Session (June 5, 1933) ch 48, 48 Stat 112, 113 (formerly codified at 31 USC §463).

<sup>15</sup> Pub L No 95-147 (Oct 28, 1977) §4(c) 91 Stat 1229, former 31 USC §463.

<sup>16</sup> ‘Novation is the substitution of a new obligation for an existing one’ – see Californian Civil Code §1530 (2008). See also *ibid* §1531:

Novation is made: (1) By the substitution of a new obligation between the same parties, with intent to extinguish the old obligation; (2) By the substitution of a new debtor in place of the old one, with the intent to release the latter; or (3) By the substitution of a new creditor in place of the old one, with intent to transfer the rights of the latter to the former.

original agreement and “completely extinguishes the original obligation”.<sup>17</sup> In finding itself in line with the Restatement (Second) of Contracts standard, the court found itself wrestling with the same question posed in Section III(A) of this article above – what exactly does it mean to say that an original obligation has been completely extinguished or discharged in the context of the assignment of a leasehold interest.

The court, in its analysis, quickly concluded that the assignment of all of the assignor lessee’s right, title and interest into the lease and the assumption thereof by the assignee lessee was sufficient to create a new contractual duty.<sup>18</sup> Interestingly, the *Wells Fargo* court when faced with the question of what constitutes an extinguishment or discharge of the original obligation decided with little written exposition that an assignment by a lessee of its leasehold interest in a ground lease which by its terms relieved the assignor lessee of ‘liability accruing under [the] lease from and after the date of any assignment’ was a sufficient discharge or extinguishment of the assignor lessee’s obligations to establish a novation of the ground lease.<sup>19</sup>

The progenitor of the ‘gold clause’ cases, *Fay Corporation v Bat Holdings I Inc*,<sup>20</sup> is equally noteworthy. While factually similar to *Wells Fargo*, the court in *Fay* applied Washington State law to the question of what constitutes an extinguishment or discharge of the original obligation. Like in *Wells Fargo*, the court in *Fay* easily reached the conclusion that the assignor lessee’s assignment of its leasehold interest in a ground lease and assumption thereof by the assignee lessee is sufficient to establish the creation of a new contractual duty.<sup>21</sup> The court in *Fay* also concluded, as did the court in *Wells Fargo*, that the express terms of the agreement providing that the party ‘assigning or conveying the leasehold estate hereby created shall thereby be forever released and discharged from any and all obligations arising or accruing under the covenants and agreements in this lease contained subsequent to the date of such sale, conveyance or assignment’ was an adequate discharge and extinguishment of the assignor lessee’s obligations to create a novation of the lease.<sup>22</sup> Again we see a court amenable to the view that a less than complete discharge of obligations arising under a lease is effective to establish the necessary predicate for a novation.

What then do the holdings in *Wells Fargo* and *Fay* tell us about the potential treatment of a standard assignment and assumption agreement governed by the laws of California or Washington? It appears that both *Wells Fargo* and *Fay* establish, at a minimum, a baseline standard by which a less than full release of the assignor is sufficient to establish a novation. Compare now the standards set forth in *Wells Fargo* and *Fay* with the release provision in the standard US law assignment and assumption agreement set forth in Section II above. It would seem that the ‘accrues after’ standard in *Wells Fargo* and the ‘arises out of or accrues after’ standard in *Fay* are arguably broader releases than the release provision in the standard US law assignment and assumption agreement set forth in Section II above. Thus, while it may be unclear whether or not a well drafted release provision in a Washington State or California law governed assignment and assumption agreement would be found sufficient to constitute a novation, it does appear rather clear that a poorly drafted release provision that is broader than the respective standard in *Wells Fargo* or *Fay* would be sufficient for the courts in California or Washington State, as the case may be, to find that a novation has occurred.<sup>23</sup>

<sup>17</sup> *Wells Fargo* (n 12) 431 (quoting Witkin, *Summary of Californian Law* (9<sup>th</sup> edn, 1987).

<sup>18</sup> *ibid* 432.

<sup>19</sup> *ibid* (emphasis added). See also *United Security Corp v Anderson Aviation Sales Co Inc* 532 P 2d 545 (AZ Ct App 1975) (holding that a failure by an aircraft lessor to pursue claims against the assignor lessee arising out of post-assignment payment defaults by the assignee lessee was sufficient to establish a novation of the operating lease).

<sup>20</sup> *Fay Corporation v Bat Holdings I Inc* 646 F Supp 946 (WD Wash 1986).

<sup>21</sup> *ibid* 951.

<sup>22</sup> *Fay Corporation* (n 20) 949, 951 (emphasis added).

<sup>23</sup> One example of a poorly drafted release provision in an assignment and assumption agreement would be one that releases the parties ‘from all liability from and after the effective time’.

### ***C. Heightened Scrutiny: The New York Approach***

Having discussed a few examples of the more liberal views on novations under the laws of California and Washington State, we now turn our eye to the laws of what is arguably one of the most important legal jurisdictions in aviation finance – New York. The courts in New York have held consistently that the four elements necessary for a novation are (1) a previously valid obligation; (2) agreement of all parties to a new contract; (3) extinguishment of the old contract; and (4) a valid new contract.<sup>24</sup> Immediately one recognizes the similarity between these four factors and those present in the ‘gold clause’ cases and the Restatement (Second) of Contracts. However, under the laws of the state of New York the new agreement must extinguish the old *contract*. If the old contract must be extinguished, does this mean that a novation will result in a full release of any and all liability under the old contract? The courts in New York have with a fair amount of consistency answered this question in the affirmative by asserting that a novation is an absolute defense by the assignor of all liability under the novated agreement.<sup>25</sup> Accordingly, the New York courts ‘have a stringent standard for novation’ and place the burden of proving that the parties intended a novation on the party asserting the defense.<sup>26</sup>

Comparing the release provision in the standard US law assignment and assumption agreement set forth in Section II above, it seems relatively clear that the limited nature of such a release is not sufficient to satisfy the burden of an intended full and complete release. It also seems that the party asserting the defense of novation would be hard pressed to construe the limited release as expressing an intention that is directly contrary to the written text. Thus, the practitioner runs less risk of creating an ‘accidental novation’ under New York law than it does intentionally drafting a full release provision under the laws of California or Washington State without appreciating the fact that what the practitioner has done in that instance is transform the assignment and assumption agreement into a novation.

### **IV. English Law Approach to Characterizing the Outright Transfer of a Lessor’s Interest in an Aircraft Operating Lease Pursuant to a Traditional English Law Novation**

The difference between the traditional English law novation and the traditional US law assignment and assumption agreement is that instead of an assignment by the current lessor of all of its rights, interests, obligations, duties and liabilities in, to, and under the aircraft operating lease as is the case in the traditional US law assignment and assumption agreement, the traditional English law novation agreement contains an agreement by the new lessor and the lessee to create a new aircraft operating lease between one another. Thus, whereas the traditional US law assignment and assumption agreement attempts to preserve the continuity of the underlying aircraft operating lease, the traditional English law novation agreement is intended to sever the underlying aircraft operating lease and create a new substitute aircraft operating lease between the new lessor and the lessee in its place. According to the learned authors of *Chitty on Contracts*, ‘There is a new contract and it is therefore essential that the consent of all parties shall be obtained: in this necessity for consent lies the most important difference between a novation and assignment.’<sup>27</sup>

<sup>24</sup> See *Holland v Fahnestock & Co Inc* 210 F R D 487, 498 (SDNY, 2002); *Atlantic Mutual Ins Co v Balfour MacLaine Int’l Ltd* 85 F 3d 68, 82-83 (2d Cir 1996).

<sup>25</sup> *Citibank N A v Benedict* 97 Civ. 9541, 2000 WL 322785, 88 (SDNY March 28, 2000). See also *Grupo Sistemas Integrales de Telecomunicacion de C V v AT&T Communications Inc* No 92 Civ 7862, 1996 WL 312535 (SDNY June 10, 1996).

<sup>26</sup> *ibid.* See also, eg, *Callanan Indus Inc v Micheli Contracting Corp* 508 N Y S 2d 711, 712 (3d Dep’t 1986).

<sup>27</sup> Hugh Beale and Joseph Chitty, *Chitty on Contracts* (1st Vol, 31st edn, Sweet & Maxwell 2012) para 19-086. See *Rasbora Ltd v JCL Marine* [1977] 1 Lloyd’s Rep. 64; *The Blankenstein* [1985] 1 WLR 435.

As a new contract is in place it is also necessary that consideration should be provided in the new contract.<sup>28</sup> As it is sometimes difficult to see how consideration moves from the promisee in an English law novation agreement, these agreements are often executed as deeds where a requirement for valid consideration is not needed.

## V. The Differing Treatment of an Assignment of an Aircraft Operating Lease and a Novation of an Aircraft Operating Lease Under the Cape Town Convention

By providing that an operating lease<sup>29</sup> for certain aircraft objects creates an ‘international interest’ in such leased aircraft objects in favor of the lessor under such aircraft operating lease, the Cape Town Convention not only introduced a new phrase, the ‘international interest’, into the legal lexicon of attorneys practising in the area of aviation finance, but it also introduced a new conceptual framework within which the practitioner must evaluate each step in the life of an operating lease to which the Cape Town Convention is applicable. For example, prior to the Cape Town Convention’s entry into force, if a lessor and US lessee agreed to amend the term of an aircraft operating lease for a US registered airframe, the practitioner prepared the appropriate amendment documentation and arranged for the same to be filed with the Federal Aviation Administration. In the post-Cape Town Convention world, however, the practitioner must, in addition to the previously enumerated steps, undertake an analysis of what effect, if any, that the amendment of the term of the operating lease will have under the Cape Town Convention.<sup>30</sup> This analysis is not without its own particular pressure for the practitioner either as, unfortunately, there are only two possible answers under the Cape Town Convention – the right answer and the wrong answer. The right answer preserves priority under the Cape Town Convention, while the wrong answer jeopardizes that priority. This is none truer than in the case of the Cape Town Convention’s divergent treatment of an assignment and assumption of an aircraft operating lease and a novation of an aircraft operating lease.

### A. The Treatment of an Assignment of an Aircraft Operating Lease under the Cape Town Convention

Article 31 of the Cape Town Convention provides that an assignment of associated rights by an assignor made in a writing that enables the associated rights to be identified under the contract from which they arise also transfers to the assignee of such associated rights the (i) ‘related international interest’ and (ii) ‘all the interests and the priorities of the assignor under’ the Cape Town Convention.<sup>31</sup> The term associated rights is defined by the Cape Town Convention to mean ‘all rights to payment or other performance by a debtor under an agreement which are secured by or associated with the object.’<sup>32</sup> Thus,

<sup>28</sup> See *Tatlock v Harris* (1789) 3 T R 174.

<sup>29</sup> Unless otherwise noted herein, the term operating lease or aircraft operating lease is assumed for the sake of simplicity to refer to an aircraft operating lease whereby the Cape Town Convention applies to both the airframe and engines leased thereunder.

<sup>30</sup> For example, the practitioner must be cognizant that the extension of the term of an aircraft operating lease creates a new international interest in respect of the extension period, whereas a reduction in the term of an aircraft operating lease alone does not. See Aviation Working Group, *Practitioners’ Guide to the Cape Town Convention and the Aircraft Protocol* (Legal Advisory Panel of the Aviation Working Group 2015) 50. See Goode (n 3) 41.

<sup>31</sup> Cape Town Convention, Article 31. See also *ibid*, Article 32 (providing that the assignment of associated rights must be in writing and must enable the associated rights to be identified in the contract under which they arise). It is worth mentioning that in the case of an aircraft operating lease, the lessee cannot hold and assign associated rights under the Cape Town Convention except in the role of a sublessor. See Goode (n 3) 347. Thus, an assignment by a lessee of its leasehold interest in a lease is outside of the purview of the Cape Town Convention. See *ibid*.

<sup>32</sup> Cape Town Convention, Article 1(c).

under the Cape Town Convention the assignment alone by the assignor to the assignee of all of the assignor's rights and interests in and to the aircraft operating lease would also transfer to the assignee the international interest created in the aircraft being leased by the aircraft operating lease agreement and all of the interest and priorities that the assignor may have therein under the Cape Town Convention.<sup>33</sup>

By way of illustration consider the following two examples in the context of Chapter IX of the Cape Town Convention:

Example 1

- a) A enters into an aircraft operating lease with C prior to the Cape Town Convention coming into force; and
- b) (In connection with the sale of the aircraft by A to B) A, B and C enter into a Cape Town Convention assignment after the Cape Town Convention has come into force whereby A assigns to B all of its rights and interest in and to the aircraft operating lease.

Example 2

- a) A enters into an aircraft operating lease with C after the Cape Town Convention has come into force and A and C register the international interest created thereby at the International Registry; and
- b) (In connection with the sale of the aircraft by A to B) A, B and C subsequently enter into a Cape Town Convention assignment whereby A assigns to B all of its rights and interest in and to the aircraft operating lease.

Under Example 1, the interest created under the aircraft operating lease in favor of A is a pre-existing interest and thus there is no international interest created by the aircraft operating lease to assign and register.<sup>34</sup> Under Example 2, however, the international interest created by the aircraft operating lease in favor of A would be transferred to B under the agreement, together with all of the interests and the priorities of A in the aircraft under the Cape Town Convention, and A and B would need to register the assignment of such international interest at the International Registry.<sup>35</sup>

### ***B. The Treatment of a Novation of an Aircraft Operating Lease under the Cape Town Convention***

Having examined the treatment of an assignment of an aircraft operating lease under the Cape Town Convention, this article now turns its attention to the treatment of a novation of an aircraft operating lease under the Cape Town Convention. The key to analyzing the treatment of a novation under the Cape Town Convention can be found in the most significant difference between a novation agree-

<sup>33</sup> While Professor Goode indicates that it is theoretically possible for a lessor to assign the international interest arising under an aircraft operating lease without also assigning the associated rights, the authors have assumed for purposes of this article that such an assignment by the lessor will be done by way of the assignment of all of the associated rights. See Goode (n 3) 356:

The position is otherwise in the case of an international interest held by a conditional seller or lessor, who could, in theory at any rate, sell the object subject to the rights of the conditional buyer or lessee under the conditional sale or leasing agreement without assigning to the purchaser its rights of payment under the conditional sale or leasing agreement.

<sup>34</sup> Aviation Working Group (n 30) 21.

<sup>35</sup> It should be noted that as a technical matter an outright assignment of an international interest on the International Registry currently reverts back to the assignor upon discharge by the assignee despite the language in the Cape Town Convention to the contrary. As such, one would be advised to transfer the right to discharge such international interest to the assignee at the time that the assignment is registered.



ment and an assignment—namely, that a novation agreement creates a new aircraft operating lease between the new lessor and the lessee, while an assignment and assumption merely passes along the rights of the lessor in the existing lease. Thus, the novation of an aircraft operating lease falls outside of the scope of Chapter IX of the Cape Town Convention and the novated aircraft operating lease is treated by the Cape Town Convention just as any new aircraft operating lease.<sup>36</sup> As such, the novated lease creates a new international interest in the airframe and engines leased thereunder in favor of the new lessor and the new lessor and lessee must register this new international interest at the International Registry to preserve priority on the International Registry.<sup>37</sup>

Consider again the two examples set forth in Section V(A) of this article, substituting a novation agreement for an assignment as follows:

Example 3

- a) A enters into aircraft operating lease with C prior to the Cape Town Convention coming into force; and
- b) (In connection with the sale of the aircraft by A to B) A, B and C enter into a Cape Town Convention novation agreement after the Cape Town Convention has come into force whereby the aircraft operating lease is novated in favor of B.

Example 4

- a) A enters into an aircraft operating lease with C after the Cape Town Convention has come into force and A and C register the international interest created thereby at the International Registry; and
- b) (In connection with the sale of the aircraft by A to B) A, B and C subsequently enter into a Cape Town Convention novation agreement whereby the aircraft operating lease is novated in favor of B.

Unlike in Examples 1 and 2, under Examples 3 and 4 the result is the same, the novated aircraft operating lease creates a new registerable international interest in favor of B regardless of whether the original aircraft operating lease between A and C was entered into before or after the Cape Town Convention came into force.<sup>38</sup> Thus, even in a slightly revised version of Example 4 where A and C fail to register the registerable international interest created by the original aircraft operating lease, such failure would have no bearing on the new international interest created in favor of B by the novated aircraft operating lease.

### ***C. Novation or Assignment and Assumption: A Sui Generis Approach***

Having examined the differing treatment of assignment and a novation under the Cape Town Convention, the question remaining is how a practitioner is to determine whether an agreement documenting the transfer of an interest in an aircraft operating lease is an assignment or a novation

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<sup>36</sup> See Goode (n 3) 40: ‘... [a novation] is a new agreement for an international interest [that] is separately registerable...’. Thus Professor Goode has laid to rest the uncertainty as to whether a novation would also constitute an assignment for purposes of Chapter IX of the Cape Town Convention. Similarly, Professor Goode is clear that an assignment does not constitute a new international interest. See Goode (n 3) 40, 42: ‘[a]n assignment of rights does not constitute an amendment, since it does not change the agreement or the parties in any way, it merely entitles the assignee to exercise the assigned rights given by the assignment.’

<sup>37</sup> See n 34.

<sup>38</sup> Since the novated lease would create a new international interest in favor of B with respect to the subject aircraft, B would be advised to require that the international interest in favor of A be discharged.

under the Cape Town Convention. The prior editions of the Official Commentary seemed to support a reading that whether an agreement was an assignment or a novation for purposes of the Cape Town Convention was a matter to be determined by national law. However, the third edition of the Official Commentary attempts to clarify this issue by stating that:

whether a transaction is an assignment or a novation is to be determined from its nature as a matter of interpretation of the Convention and without reference to the applicable law. This is necessary to preserve the unity of the Convention, because a new agreement for an international interest is separately registerable, so the want of registration affects third parties and cannot be left to depend on the law governing the assignment, particularly when national laws differ so significantly.<sup>39</sup>

In order to reach the conclusion that the characterization of an agreement documenting the transfer of an interest in an aircraft operating lease is to be determined with reference to the Cape Town Convention only and not to national law, one must first accept a reading of Article 2(4) of the Cape Town Convention that requires a two-step analysis. The first step in that analysis is to determine whether an interest falls within the Cape Town Convention by reference to the Cape Town Convention itself.<sup>40</sup> The second step would then be to look to national law to determine whether or not the interest should be reclassified as a security agreement, a title reservation agreement or a leasing agreement.<sup>41</sup> If the analysis under Article 2(4) of the Cape Town Convention were to start by determining whether an interest was a leasing agreement under national law, then one would need to make a determination as to whether the agreement documenting the transfer of an interest in an aircraft operating lease created a new leasing agreement under national law, which invariably leads you directly down the path of determining whether or not it is a novation under national law. If, however, the analysis starts with a *sui generis* characterization, then the determination as to the whether the agreement documenting the transfer of an interest in an aircraft operating lease creates a new leasing agreement must first be answered by the Cape Town Convention. What then of the explicit national law analysis required by Article 2(4) of the Cape Town Convention following an affirmative determination that such agreement was a novation for purposes of the Cape Town Convention? In order for a *sui generis* only analysis to hold it must then be accepted that Article 2(4) of the Cape Town Convention would only allow re-characterization across one of the three enumerated classes (ie security agreement, title reservation agreement and leasing agreement) and not a re-characterization out of Article 2 altogether.<sup>42</sup>

While the argument starts with the 'two-step' reading of Article 2(4) of the Cape Town Convention, it also requires the practitioner to grapple with the formal requirements of an assignment under Article 32 of the Cape Town Convention since the question is whether one is dealing with an assignment or a novation. Unlike Article 2(4) of the Cape Town Convention, there is no express reference to national law in Article 32 of the Cape Town Convention. Instead, one must read the

<sup>39</sup> Goode (n 3) 40.

<sup>40</sup> *ibid* 45.

<sup>41</sup> *ibid*.

<sup>42</sup> Professor Goode makes clear that the application of Article 2(4) cannot result in an expansion of the Cape Town Convention: Goode (n 3) 267. However, a scenario whereby an interest falls within one of the enumerated categories by reference to the Cape Town Convention in the first instance, but would then fall outside of one of those enumerated categories when analyzed under national law is a different scenario. That being said, the text of Article 2(4) would appear to make quite challenging a reading that an agreement could be re-characterized outside of a category enumerated in Article 2(4) since the text of Article 2(4) only references subparagraphs (a) – (c) of Article 2(4).

lack of such a reference as a negative inference that no such analysis was intended.<sup>43</sup> This reading is quite easy to accept as correct since an assignment by way of subrogation, as opposed to an outright assignment covered by Article 32 of the Cape Town Convention, has an express national law component.<sup>44</sup>

#### ***D. Novation or Assignment and Assumption under the Cape Town Convention***

But if the characterization of an agreement documenting the transfer of an interest in an aircraft operating lease is to be determined with reference to the Cape Town Convention only, then how do we determine how the Cape Town Convention characterizes novations and assignments? The characterization of an assignment has the benefit of a defined term for 'assignment' in Article 1(b) of the Cape Town Convention itself. Thus, an agreement that confers any associated rights would be an assignment for purposes of the Cape Town Convention.<sup>45</sup> The fact that a conferring of any associated rights, as opposed to all associated rights, constitutes an assignment per its definition in Article 1(b) of the Cape Town Convention means that the analysis must turn on the granting language rather than on the release language as was the case under the US law analysis. Does the agreement purport to assign or otherwise confer any associated rights? If so, it should be characterized as an assignment for purposes of the Cape Town Convention.

But how should a novation be determined under the Cape Town Convention? In adhering to the interpretational guidelines in Article 5 of the Cape Town Convention, a novation should, for purposes of the Cape Town Convention, require features that would distinguish it from an assignment under the Cape Town Convention.<sup>46</sup> The Official Commentary sets forth the following test:

It is clear that a new agreement between all three parties- debtor, creditor and assignee – which replaces the original agreement is not an assignment but a novation. It is also clear that a transaction where a creditor simply transfers its associated rights and the related international interest without reference to its obligations is an assignment. But there is also hybrid transactions in which the creditor assigns its rights under the agreement and also, with the consent of the debtor, transfers its obligations, wholly or in part. Such a transaction is an assignment for purposes of the Convention, whether or not the elements of the transactions relating to the creditor's obligations result in characterization of the agreement as a novation under national law.<sup>47</sup>

However, the references in the aforementioned test to obligations is a red herring. The distinction should not be between a transfer of associated rights and a transfer or retention of obligations. Rather, the distinction should be solely between whether the agreement in question transfers associated rights or whether it creates a new agreement. This would provide a more bright-line test for the practitioner in conducting the analysis since the standard form of New York law assignment and assumption agreement described above would transfer associated rights but not purport to create a new agreement. Likewise, the standard form of English law novation described above would create a new agreement but not purport to transfer associated rights.

<sup>43</sup> Goode (n 3) 48-50.

<sup>44</sup> *ibid* 371-372.

<sup>45</sup> *ibid* 40.

<sup>46</sup> See the discussion at n 42 above regarding a national law characterization that would take an agreement out of the enumerated categories in Article 2(4)(a) – (c).

<sup>47</sup> Goode (n 3) 40.

## VI. Cape Town Convention Implications for the Practitioner

So where does all of this leave the practitioner? If the *sui generis* approach is accepted and the test elucidated in the Official Commentary adopted, the standard US law agreement would likely be characterized as an assignment for purposes of the Cape Town Convention and the standard English law agreement would likely be characterized as a novation. However, what of agreements that do not fit neatly in either of those boxes? And what is one to make of the focus on obligations in the Official Commentary? And what of the risk of a differing judicial interpretation? Until such time as there is a clear judicial ruling on the subject or further clarification in a future version of the Official Commentary, it seems that a practitioner dealing with the transfer of an interest in an aircraft operating lease should both assign on the International Registry any existing international interests arising under the operating lease to the assignee and also register a new international interest on the International Registry in respect of the operating lease. This is the only approach that will protect the transferee regardless of how the transfer agreement is ultimately characterized in judicial proceedings.