

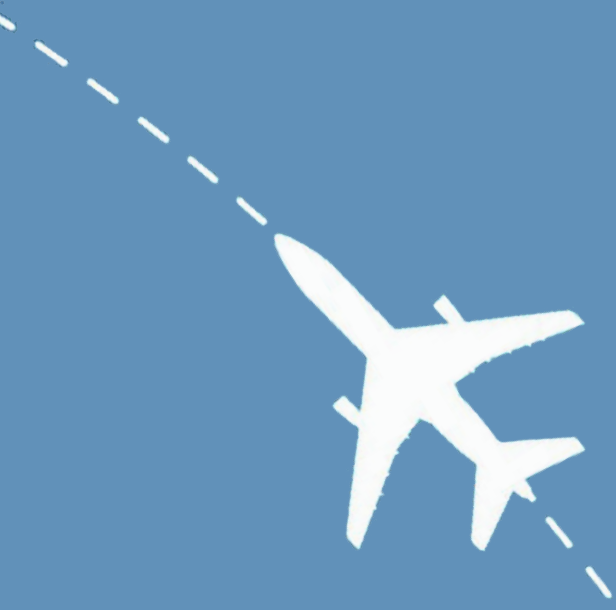


Cape Town Convention

Issues being addressed by the
Cape Town Convention (CTC)
for aircraft owners, financiers,
engine suppliers and others

LAYTONS

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Cape Town Convention

While for some mention of “Cape Town” may conjure up images of Table Mountain, the harbour, and surrounding vineyards, for those in the Aviation business Cape Town was the location for a diplomatic conference in 2001 to negotiate a treaty to standardise transactions involving moveable property including contracts of sale, security interests, leases and conditional sale agreements. It also sought to harmonise the effect of insolvency law on mobile assets such as aircraft and the various legal remedies, including repossession for default in mobile equipment financing agreements. In particular, the intention of the conference was to align the legal and administrative systems of, on the one hand, emerging economies, seeking access to aviation equipment and finance, with, on the other hand, more developed countries desirous of supplying aircraft.

The result of the diplomatic conference in Cape Town was a treaty, the CTC. The CTC then came into effect by being ratified by a number of governments. Finally, in order for the CTC to become operative, it needed to be implemented into the domestic law of the countries that had ratified it. The United Kingdom has now passed the necessary law to implement the CTC with effect from 1 November 2015. The main changes in the law will be:

- To require international aircraft transactions of sale, security interests, leases and conditional sale, to be registered in the new International Registry of Mobile Assets (see further below);
- To extend the potential remedies available to creditors in aircraft financing transactions that go wrong;
- To introduce a new insolvency regime for aircraft assets giving creditors 60 days to re-possess aircraft assets or for insolvent aircraft operators to cure the breach of their financing agreement; and
- To change the law on how and when interests in aircraft and engines can be created and their relative priorities.

What does the CTC apply to?

The CTC came into force in 2004. The part that relates to aircraft and aircraft engines came into international effect in 2006 and, as noted above, will be implemented into UK law in November 2015. It applies to aircraft which can carry at least eight people or 2750 kilograms of cargo, aircraft engines with thrust exceeding 1,750 pounds-force (7,800 N) or 550 horsepower (410 kW), and helicopters carrying 5 or more passengers, where the airframe or helicopter is at the time of conclusion of the applicable agreement registered, or agreed to be registered on the register of a contracting state of the CTC, and the debtor is also in a CTC contracting state.

The CTC has established the International Registry of Mobile Assets to register international property interests in aircraft and aircraft equipment, registered on the register of a CTC contracting state, comprising outright contracts of sale, charges, conditional sale agreements and interests in leases of aircraft and engines together with assignments of such interests, where the debtor under such transactions is also in a CTC contracting state, such registered interests are known as "international interests". The priority of rights registered at the Registry, is on a first to file basis. The exception to this priority rule is for what are known as "non-consensual" rights and interests such as statutory liens for landing charges, and common law liens for repairers which have priority over registered international interests under the CTC.

The coming into force of the CTC

The CTC Aircraft Protocol was first ratified so as to make changes in the laws of Ethiopia, Ireland, Malaysia, Nigeria, Oman, Panama, Pakistan and the USA, thereby providing access to cheaper funding for US-manufactured aircraft to be sold into Asia and Africa, supported by Exim bank funding. The rest of Europe, however, was slower to catch up and needed to overcome certain EU legal hurdles before

implementing the necessary national laws to put the CTC into effect. This was caused by the EU individual states having competence to change their substantive law of insolvency, whereas the EU has competence to make changes to conflict of law rules.

The CTC comes into effect in the UK on 1 November 2015

Changes in UK law are afoot in the law for aircraft owners, operators and financiers, as the UK Government has ratified the CTC on International Interests in Mobile Equipment and the associated protocol on matters specific to Aircraft Equipment. The CTC and Protocol will enter into force in the UK on 1 November 2015. The CTC implementation will not apply to interests that already exist and they will retain their priority without the need to make a registration with the International Registry. Interestingly, while it will now be possible to register international interests in aircraft engines as well as aircraft and helicopter airframes, known together as "aircraft objects", it will not be possible to register international interests in helicopter engines when installed on a helicopter. It will also be possible to register prospective interests in an aircraft object in the future on the occurrence of a stated event.

Change to the *Lex Situs* rule and registration of rights in aircraft and engines

Importantly, the CTC partially alters the *Lex Situs* rule of English law. This rule is used to determine the country in which a proprietary right e.g. ownership or a mortgage interest, in a tangible movable such as an aircraft, is validly created. The *Lex Situs* rule provides that the creation of the right will only validly occur if it happens in the country in which the asset is located at the time of creation.

By way of contrast, the CTC provides that an international interest in an aircraft object, including a sale or mortgage, can validly occur without reference to the physical location of the aircraft object. Accordingly, the implementation of the CTC into UK law provides that the creation of an international interest in an aircraft object takes effect wherever the conditions of the CTC are satisfied, without providing any determination of whether a proprietary right has been validly created or transferred under the *Lex Situs* rule. The practical effect of this is that for domestic law transactions, they will need to occur when the relevant aircraft is in the UK jurisdiction in order to be effective, but not for transactions involving international interests in aircraft and their engines. The registration of an international interest in aircraft and aircraft engines under the CTC is an autonomous interest that arises when the conditions of the CTC have been satisfied. The *Lex Situs* rule will continue to apply in relation to domestic law interests.

A registered interest in an aircraft object will have priority over any subsequent registered interests unregistered interests, except for certain non-consensual rights or interests that may have priority without registration (such as arise as liens for unpaid airport and navigation charges, and for common law repairers' liens). Assignments of registered interests need to be registered in order to have effective priority. Priorities in registered interests may be varied by agreement, but should be registered to be effective.

Remedies for holders of registered rights

The remedies given to the holder of an international interest in an aircraft object following a default include repossession, deregistration and export as well as extraction, if necessary, and sale or other realisation either with the consent of the debtor, or by order of the court, for the aircraft object to vest in the creditor in satisfaction of the secured obligations. The events of default can be agreed in writing between the parties, otherwise they comprise any action that substantially deprives the creditor of what it is entitled to expect under the agreement. Remedies must be exercised in accordance with the procedural law of the place of execution. In the case of the UK that means where the parties to a transaction have made a choice in writing that the courts of any part of the UK will have jurisdiction then, regardless of whether any of the parties have any connection with the UK, the High Court will exercise jurisdiction in England and Wales and the Court of Session in Scotland. Such Jurisdiction shall be exclusive unless otherwise agreed between the parties. Those courts shall have power to grant interim relief if the parties agree or if the aircraft object is in the UK so far as such interim relief is for preservation, custody, immobilisation of the aircraft object, or for the leasing, sale and application of the proceeds of sale where the court has been chosen by the parties, or the debtor is situated in the UK and the relief is granted on terms that it is enforceable only in the UK.

The CTC introduced a new remedy, being the remedy of irrevocable deregistration and export request authorization (IDERA). This is a new remedy that permits the creditor who registered its international interest in an aircraft object prior to the commencement of insolvency proceedings, to procure de-registration of the aircraft and export and physically transfer the aircraft object out of the territory where it is situated.

Change in insolvency law for aircraft in the UK

Probably the greatest change to the law in relation to aircraft in the UK is the special insolvency regime to govern creditors' rights in relation to aircraft objects. This provides that within a period of 60 days from the insolvency event arising, the creditor is entitled either to secure recovery to take possession of the aircraft object from the insolvency office holder, or the insolvency officer must cure the defaults, or agree to perform future obligations within such time limit.

The aircraft insolvency regime adopted by the UK is known as the Alternative "A" insolvency regime provided for under the CTC. Since this grants substantial rights to creditors, and reduces their risks, it is likely to reduce the costs of aircraft financing to UK operators. However, general creditors may be less willing to give credit, as the new insolvency regime reduces the size of the bankruptcy estate for the general pool of creditors of an aircraft operator, and thus it may reduce the willingness of general creditors to provide credit, or increase the cost of such unsecured credit.

The practical application of the CTC to:-

Airframe and engine manufacturers

For such manufacturers the entering into operation of the CTC creates greater certainty by the creation of international interests in aircraft and engines in relation to contracts of sale and conditional sale. The complexities arising under the Lex Situs rule are not overcome for UK domestic transactions, although the manufacturers will benefit in international transactions.

Manufacturers of helicopter engines are not able to benefit from the Convention as such engines are not treaty-protected aircraft objects, when they are removed from a helicopter and fitted into a different helicopter that has international interests registered over it by another provider or financier.

The only scope for CTC protection in such instances would be for the original supplier (who retains a property interest in any such engine) who wishes to perfect such interest either (impractically) to remove an installed engine from its helicopter frame at the time of filing an international interest or to register both a prospective international interest in the engine, in the event of it being removed from the helicopter, as well as an international interest in the helicopter.

Lessors of airframes and engines and aircraft financiers

The position here is similar to the position for manufacturers as the CTC will create greater certainty by the creation of international interests in aircraft and engines in relation to leasing of pooled engines and providers of "power by the hour". The complexities arising under the Lex Situs rule are not overcome for UK domestic transactions.

Lessors of helicopter engines are not able to benefit from the CTC as such engines are not treaty-protected aircraft objects, when removed from a helicopter and fitted into a different helicopter that has international interests registered over it by another lessor or financier. The only practical scope for CTC protection in such event is similar to the approach described above for the manufacturer, for the lessor of such an engine to register a prospective interest in the helicopter engine upon it being detached from the airframe, as well as an international interest against the helicopter itself.

Aircraft lessors and financiers have a greater set of remedies available to them than before, including interim remedies. They have the benefit of the “hard” insolvency regime of Alternative “A” of the CTC that allows repossession within 60 days of an insolvency event if the insolvent operator has not taken steps to cure the defect in that time; they also have the IDERA right of de-registration and export.

The adoption of the Alternative “A” insolvency regime may allow access for the financiers to funding, guarantees, or credit insurances from export credit agencies that may assist the scale of funding available and reduce the cost of credit under the “Cape Town Discount” where the “home countries rule” does not apply. Under the “home countries rule” the European and American Export Credit Agencies (ECA) agreed not to support financings of aircraft supplied to aircraft operators located in one of the home countries of the ECAs. The CTC has been adopted by the UK in a format that permits the UK to comply with the Aviation Sector Understanding (ASU) on export credits for civil aircraft being annexed to the rules of the OEED. These rules provide a framework for support of export credits in the aviation sector so the OECA States apply the same principles to create a level playing field and stop a “race to the bottom” in pricing export credits to benefit national interest. Under the ASU, a buyer or lessor of an aircraft in a contracting state that has ratified the CTC with the appropriate declaration is eligible for a discount of up to 10% of the premium rate of their export credit support, known as a “Cape Town discount”. The level of the actual discount given is at the discretion of the ECA.

Lessees of airframes and engines

Lessees of such equipment, including those who in turn sublease the equipment, will also want to protect their interests in the grant of such subleases etc. by way of an international interest registration.

Manufacturers of general aircraft equipment not being an aircraft

Such parties gain no benefit from the implementation of the CTC and indeed their rights as creditors supplying equipment to aircraft operators are postponed to the rights of secured creditors to a greater extent than under pre-existing rules.

Aircraft owners and operators

These parties will be likely to bear the financial burden of the greater administrative and legal costs of operating the CTC regime and may not necessarily see the benefit of cheaper funding of aircraft and engines, in obtaining a Cape Town discount, due to the operation of the home countries rule described above in relation to ECAs. If and when operators default, they will be subject to harsher remedies from their creditors, and they may also find that the cost of credit for equipment and services other than aircraft and engines will rise.

Export Credit Agencies (ECAs)

So far as operators in the UK are concerned, there may be opportunities for cheaper funding under the Cape Town Discount where aircraft are manufactured and financed by ECAs and manufacturers that are not party to the home countries rule.

General creditors of aircraft owners and operators

While prior to the CTC, English insolvency law did not give significant rights to unsecured creditors, the new strict insolvency regime arguably gives even fewer rights. This may mean that the cost of non-aircraft and aircraft engine credit may rise.

Airport and navigation rights lien holders

These parties will see their priority entitlements to liens over aircraft for non-payment of airport and air navigation charges, including fleet liens, maintained without the need to register them under the CTC scheme.

Insolvency practitioners

The insolvency of aircraft owners and operators may become more of a specialist subject for insolvency practitioners. It will be a different and separate regime from that which applies to other businesses, including from other seemingly similar businesses that are also characterized by heavy expenditure on capital equipment including other transport operations such as road, rail or shipping.

Recap

The UK will adopt a new more lender-friendly regime in connection with the international financing of aircraft with effect from 1 November 2015. The new regime will grant greater rights and remedies to creditors owning or financing aircraft and engines and will also change the insolvency regime for aircraft operators.

It will probably become more complex to operate aircraft. It is also presently uncertain the extent to which in practice any aircraft owner or operator will gain any benefit in its financing activities from the "Cape Town Discount". As in the oil and gas industry, more fortunes have been made from the supply and finance of equipment than have been made from oil exploration and production. It will lend even more truth to the old adage: "How do you make a small fortune out of running an airline: By starting with a large fortune!"

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Andrew acts for a wide range of asset financiers, owners and operators of aircraft and related assets.

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