



DCME Doc No. 8
17/10/01
English and Spanish only

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

(Cape Town, 29 October to 16 November 2001)

COMMENTS ON DRAFT CONVENTION AND DRAFT PROTOCOL

(Presented by the Latin American Association of Aeronautical and Space Law - ALADA)

1. BACKGROUND

1.1 Knowledge of the background on this matter is required to understand clearly the provisions of the draft UNIDROIT Agreement and Protocol on this issue.

1.2 In June 1988, the Canadian government asked UNIDROIT to extend the scope of application of the provisions of the Convention on International Financial Leasing adopted on May 28, 1988 to cover mobile equipment in general.

1.3 Particularly of interest was the principle that the security interests of creditors would not be invalidated and would continue to be effective in the event of insolvency of the debtor.

1.4 The UNIDROIT Council asked the Secretariat to commission a study of this issue, to be carried out by an expert with extensive financial expertise, Professor Ronald C.C. Cuming of the University of Saskatchewan (Canada). Professor Cuming prepared a report which was considered at the 68th Session of the UNIDROIT Council in 1989.

1.5 A small group of experts meeting in Rome in March 1992 considered the report, entitled "International regulation on issues of general interest relating to Interests in Mobile Equipment" and evaluated a questionnaire addressed to representatives of certain States. The group decided to prepare draft standard international regulations on security interests in high-value mobile equipment located beyond national borders.

1.6 In December 1997, a study group headed by Sit Roy M. Goode of Oxford University and other academic and legal experts drew up the first preliminary draft of the UNIDROIT Convention. The primary purpose of such document is to govern the creation and effects of the new international interest in mobile equipment and particularly to duly protect the rights of creditors under a lease agreement.

(10 pages)

1.7 The group considered that a registry, to be created by the same Convention, was required for such regulations to be effective. Such registry is the basis for each of the Protocols which specifically regulate each category of mobile equipment, as in the case of aircraft and aircraft equipment.

1.8 Before considering the participation of the International Civil Aviation Organization in the studies leading to the draft of an International Convention, which began in December 1997 with the approval of the ICAO Council, we will discuss some of the preliminaries within UNIDROIT.

1.9 A preliminary draft was completed on March 4, 1996 by the UNIDROIT Subcommittee, based on the work of the Study Group which met for the second time in Rome (April 12-16, 1996). It is worth noting that such second meeting considered a memorandum prepared jointly by Airbus Industrie and Boeing, as representatives of the Aviation Working Group (AWG) consisting of aircraft manufacturers, aircraft leasing companies and aircraft financing institutions. Such working group drafted the aeronautical text in response to the invitation made by the Subcommittee at its third meeting, also held in Rome (October 11-13, 1995).

1.10 The purpose of this text, which we shall refer to as the "aeronautical text", was to supply some key elements not included in the draft Convention.

1.11 The Study Group, supported by the Drafting Group, met twice to set down the conclusions reached at its meetings in Rome (April 13-15, 1996) and Oxford (October 23-24, 1996).

1.12 Considerable progress was made in the course of the review of the draft, during which a wide range of issues were addressed to balance both the international interest in having expeditious and reliable procedures and to temporarily allow for the registration of non-consensual national interests, previously identified by the States, to give them priority over international interests.

1.13 The result of the review of the articles was submitted to the third meeting of the Study Group, held in Rome (15-21 January, 1997).

1.14 Such meeting considered a proposal submitted jointly by the AWG and IATA, calling for the future international instrument to be developed on the basis of the general principles laid down in the Convention, applicable to the various categories of mobile equipment and one or more specific protocols with additional particular regulations to govern each category of equipment, such as aircraft and aircraft equipment.

1.15 This method was based on the need to provide a margin of flexibility to those sectors or equipment in respect of which progress towards the future convention was greater (aircraft equipment), and also taking account of the fact that further progress in developing regulations applicable to certain classes of equipment (railway rolling stock and space property) was impossible.

1.16 At its meeting in Wurzburg on July 24-26, 1997, the Drafting Group added several amendments agreed at the third meeting, to the text prepared by Professor Goode, Coordinator of the Study Group, particularly with a view to regulating the relationship between the future Convention and each Protocol.

1.17 It was only on December 1, 1997 that the ICAO Council, at its 10th Session in its 152nd Period of Sessions, included the subject matter of this paper in the general work program of the Legal Committee.

1.18 Two important issues led the International Civil Aviation Organization to participate: the creation of an international interest in mobile equipment, an entirely new legal concept, consisting of an international interest in addition and unrelated to the various types of interests recognized by the national legislation of the various States and, in addition, the creation of an international registry where titles relating to this type of international interest were to be recorded.

1.19 This constitutes a complete innovation over the previous regulations of the Convention on the International Recognition of Interests in Aircraft, adopted in Geneva in 1948 and currently in effect.

1.20 The 32nd ICAO Assembly (September 22-October 2, 1998) continued to encourage the joint work undertaken with the UNIDROIT Secretariat and assigned a higher priority to the study of this matter in the Schedule of Activities of the Legal Committee. However it should be noted that ICAO participated in the final stage of the work carried out by the international private law institution to which we owe the initiative on this project.

1.21 In October 1998, the ICAO Legal Committee decided to set up a Subcommittee to consider a draft instrument on international interests in mobile equipment, particularly aircraft equipment, and appointed the following States as members of the Subcommittee (three of which are LACAC Members): Germany, Saudi Arabia, Argentina, Australia, Brazil, Cameroon, Canada, China, Ivory Coast, Egypt, Spain, the United States, the Russian Federation, Finland, France, India, Indonesia, Ireland, Italy, Jamaica, Japan, Jordan, Mauritius, Nepal, the United Kingdom, Singapore and Venezuela.

1.22 The Subcommittee held three joint meetings with the UNIDROIT Committee of Experts in Rome (February 1-12, 1999), Montreal (August 24-September 3, 1999) and again in Rome (March 20-31, 2000).

1.23 As a result of this work and that of the 31st Period of Sessions of the ICAO Legal Committee in Montreal (August 28-September 8, 2000), several amendments were introduced to the draft Convention and Protocol and a text combining both instruments, based on the work of the Rapporteur, was approved. Mr. Gilles Lauzon (Canada) was appointed as Rapporteur at this 31st Period of Sessions of the ICAO Legal Committee.

1.24 In its 161st Period of Sessions and again in its 162nd Period of Sessions (March 2001), the ICAO Council once again assigned a high priority to consideration of this matter, and deeming that the requirements to call a diplomatic conference had been met, accepted the offer of the government of the Republic of South Africa for such meeting to be held in South Africa. The meeting is thus to be held in Capetown from October 29 to November 16 of this year, under the joint auspices of ICAO and UNIDROIT.

1.25 The Draft Convention, Draft Protocol and the Consolidated Text show that they are the result of arduous work originally undertaken many years ago by UNIDROIT, later joined by IATA and ICAO.

2. METHODOLOGY USED IN THE INTERNATIONAL DOCUMENTS.

2.1 There is a separation in regulatory structure between the UNIDROIT Draft Convention on international interests in mobile equipment and each specific protocol, such as the Draft Protocol on specific matters relating to aircraft and aircraft equipment.

2.2 It would seem that in the first stage of development of the above instruments, the intention was to include specific rules for each type of equipment, such as railway rolling stock, space property and aircraft equipment in the Convention, but that it was finally decided to adopt a two-fold structure because, among other reasons, it was believed that this would expedite the process of ratification, regardless of the degree of development in respect of categories of equipment other than aircraft equipment.

2.3 This treatment, which is certainly innovative - at least in international aeronautic law treaties - has more drawbacks than advantages, stemming from the difficulties both in its understanding and enforcement, not to mention the problems entailed in the ratification of both instruments. This two-fold situation raises the need for a continuous cross-reference between both documents which makes their application a very complex matter.

2.4 Furthermore, the very specific character of the air transport system calls for specific treatment, independent of that applied to other systems; we thus favor a consolidated text, as prepared by the President of the ICAO Legal Committee for its 31st Session.

2.5 Bearing in mind the unique features of international air transport and the current state of the industry, required to secure financial support, for practical reasons it would be better to adopt a single instrument, with provisions governing interests in aircraft and aircraft equipment. This issue of structure is extremely important in the expected life of the international instrument.

2.6 Having explained the position of ALADA regarding the economy of the instruments, we shall go on to consider the respective preambles setting forth the reason for adopting the system governing international interests.

2.7 The six -somewhat repetitive- recitals of the Preamble of the Draft Convention mention the need to facilitate financing for the acquisition and use of mobile equipment of high value or particular economic significance through asset based financing and leasing in two ways:

- a) by establishing a legal framework for international interests in this kind of equipment; and
- b) by creating an international registry to protect such interests.

2.8 In the Preamble of the Draft Protocol, which we shall refer to as the "Aeronautical Protocol", two recitals refer directly to the Convention, recognizing the need to adapt it to bring it into line with the very specific nature of aircraft financing.

2.9 The Preamble of the Combined Text merges the recitals of both documents into its six recitals, making it much clearer. As we believe this to be the best alternative, we shall now consider the Combined Text, progress in which would be highly desirable.

2.10 While admitting that it is a significant improvement over the independent versions, we believe it is excessively based in the tradition of "common law" which could give rise to certain inconsistencies with Roman-Germanic or continental law systems. A better balance between both systems would thus be required, such as the play of the interests at stake, of creditors on the one hand, and those of debtors, who need to have all proper defenses, on the other. This balance would be the key to success in securing adhesions and ratifications from the largest number of States.

2.11 The other issue to be settled is its relationship with the 1948 Geneva Convention. While it is true that the Geneva Convention would continue to govern all rights and interests not contemplated in the Combined Text, it is not good legislative practice to adopt this kind of treatment which hampers interpretation and thus, application of the text. The project under consideration refers to a special type of guarantee, security interests rather than personal guarantees.

2.12 The Combined Text basically consists of 75 articles, grouped into thirteen chapters, preceded, as already mentioned, by a Preamble citing the general and specific bases for the Convention and the Aeronautical Protocol.

2.13 Despite the fact that the Combined Text is much clearer than the draft Convention and the draft Protocol, its wording is highly analytical and unclear on many issues, showing the marked influence of “common law”; it is thus not easy to understand for those of us governed by Roman-Germanic or continental law systems.

3. ANALYSIS OF THE PRINCIPLES OF TRANSPARENCY, PROMPT EXECUTION AND APPLICATION OF INSOLVENCY LAW

3.1 The Combined Text sets forth three requirements, resulting from the need to protect the interests of creditors, debtors and any affected third parties with the creation of this kind of “international interest”.

3.2 It could be said that there is a clear desire to maintain the “principle of transparency”. That is the same purpose pursued with the creation of an international registry to record not only existing international interests but also any such interests which may be created in the future, as well as registrable non-consensual rights and interests, existing and prospective assignments of such interests, acquisitions by legal or contractual subrogation, subordination of interests and notices of international interests.

3.3 Thus, this type of registry, placed under a supervisory authority, covers a wide range of rights and interests; however, many of the real rights contemplated in the 1948 Geneva Convention which, pursuant to article 58, as amended, would fall under the scope of this Convention are not covered, thus excluding a broad range of material from application of this Convention, limiting the scope of this Convention to rights in personam and rights other than rights in rem. Special attention should be paid to the possible inconsistency in interpretation between financial leases and leases with a term in excess of 6 months contemplated in the 1948 Geneva Agreement, where the right of the lessee is defined as a right in the aircraft arising from its capacity as operator, without discussing whether the said right is a right in rem or a right in personam.

3.4 The Geneva Convention provides that: “Contracting States undertake to recognize: a) Title in and to aircraft; b) The right granted to the holder of an aircraft to acquire title thereto by purchase; c) The right to hold an aircraft under a lease agreement with a term of not less than six months; d) Mortgages and similar rights in and to an aircraft, created by contract to secure payment of a debt; ...” (Article 1).

3.5 The right granted to the holder of an aircraft to acquire title thereto by purchase is the right of the holder of a purchase option, which seems to have been incorporated into the new Convention (Combined Text) as a typical right in personam. It is the imperfect or revocable ownership of a purchaser who made the transaction subject to a condition subsequent. That is the case in paragraph c) of article 1 of the 1948 Geneva Convention.

3.6 Summing up, transparency is based on publicity, which is essential. It is an alternative available to the financier or lessor to ensure that his interest in the subject matter of a financial or leasing transaction is senior to any other possible claim over the same object. The purpose is to protect him vis-à-vis third parties and ensure that his claim will have priority over the claims of such third parties.

3.7 It should be noted that contractual categories are included in the Registry created by the convention, with the sole exception of the so-called national interests, that is, non-consensual categories such as those of tax creditors, already indicated by each State at any time as required under sections 51 and 52 of the Combined Text of the Convention. Indeed, any Contracting State may, at any time, in a declaration deposited with the depositary of the Protocol, declare those categories of non-consensual rights or interests which, under the laws of that State, would have priority over an interest in the object equivalent to that of the holder of the international interest and which shall have priority over a registered international interest, whether in or outside the insolvency of the debtor. Such a declaration may be modified from time to time.

3.8 While this kind of option would in principle seem to benefit developing States, allowing them to preserve their tax claims, if the list envisaged by the convention is long, the “risk” to be factored in financial transactions will grow to the same extent, thus making it a double-edged sword for those States which depend on external financing.

3.9 The Combined Text also lays down the rule that priority will be determined on the basis of “first in time”.

3.10 The purpose of this so-called “transparency” principle is to prevent any concealed maneuver conferring a higher priority to claims other than those registered as laid down in the Convention, thus, facilitating international financing transactions by eliminating such risk.

3.11 The document provides for the creation of an international registry which is to operate round the clock, where interests in and to aircraft or aircraft engines are to be registered, and determines the priorities set forth above.

3.12 The other principle adopted in the document is the principle of “prompt execution” which would apply if the debtor incurs in default or insolvency, enabling the creditor to promptly recover the aeronautical object and re-export it.

3.13 Thus, the alternatives for the recovery of the subject matter of the interest, both judicial and non judicial, as remedies available to the creditor in the event of default by the debtor, are directed at ensuring expeditious and economical execution.

3.14 It should be noted that a special insolvency regime is created, to apply only if the contracting State which is the main insolvency jurisdiction declared it when ratifying, accepting, approving or adhering to the international instrument. In the absence of such declaration, the insolvency regime of the respective State will apply.

3.15 Even in the new form of the Combined Text, the outright recovery of the subject matter of the security interest should not be admitted without the prior intervention of the court. Otherwise, such provisions might be inconsistent with the provisions of national insolvency law and jeopardize the continuation of transport services inherent in the operation of the aircraft. The debtor should continue to be in possession of the aircraft precisely to avoid that risk.

3.16 This principle should be distinguished from the principle of “prompt ratification” which, in respect of articles 62 and 63, could be construed as a mechanism intended to secure rapid effectiveness of the Convention.

3.17 The international instrument would go into effect according to a device which is unusual in this type of document. A brief three-month period as from the date of deposit, or from the third or fifth ratification, acceptance, approval or adhesion instrument is taken as a reference (included between square brackets as an option for the Diplomatic Conference), greatly facilitating the effect of the Convention involved. This is due to the need to create an international registry, requiring a significant number of adhering or ratifying States to make it viable and economical, since only a few States could not generate the high level of activity required to support the Registry.

3.18 The last principle of the Combined Text of the Convention to be discussed is that of “application of insolvency law”.

3.19 What is the scope of this principle? It assures financial creditors or lessors that the principles of transparency and prompt execution in the event of insolvency of the debtor will be fully respected in insolvency or bankruptcy proceedings. On this issue, particular care should be taken to avoid inconsistency with domestic insolvency legislation.

3.20 The registered international interest should be valid as against any other interest of the trustee or debtor in the insolvency or bankruptcy proceedings; however, as already noted, it should not affect special provisions laid down in insolvency legislation.

4. ECONOMIC IMPACT OF THE UNIDROIT-ICAO DRAFT CONVENTION

4.1 It should be noted that leases, the core of the international instrument, represent, under current economic circumstances, a system whereby airlines can finance the acquisition of aircraft, thus improving production technology, allowing for the replacement of equipment before it becomes obsolete, inefficient or less profitable, competing in more favorable terms as a result of lower costs.

4.2 Leases are actually financial transactions consisting of agreements between the leasing company, the aircraft manufacturer and the user, that is, the airline, which needs to finance the acquisition of the aircraft through a mechanism other than a normal loan.

4.3 The international document undoubtedly has a specific purpose, laid down in article 5 relating to Interpretation and Governing Law and which, in turn, refers to the recitals.

4.4 What would be the purpose of adopting the complex system of regulations represented by the UNIDROIT-ICAO Project? The need to acquire and use aircraft and aircraft equipment of high value or particular economic significance and to facilitate financing for the acquisition and efficient use of such equipment.

4.5 Such purpose is of interest both to air carriers and to the State, which wants to have a network of services using a fleet of modern aircraft for the service to users. This requires sizeable investments which, in developing countries, can only be made by resorting to external financing.

4.6 The decisive element, which would lead to the ratification of or adhesion to the Convention, lies in determining whether this is a genuinely attractive alternative for such purpose.

4.7 This leads us to consider possible sources of financing available to the air transport system, particularly for fleet renewal. One such source are internally generated funds, when such funds are available. Such funds could be generated by the same operations, which is a desirable but unlikely scenario due to the critical economic condition of airlines. The other possibility is resorting to external financing. This could be a Government subsidy, an internationally questionable practice, or bank financing, either through financial leases or equity interests, involving the whole or part of the corporate capital, with the participation of the public, private, domestic or international sector.

4.8 But actually, the main sources of financing in the air transport sector are long-term financial alternatives from the banking sector, or private-sector financing through mortgage loans, placements of bonds through agencies with the ensuing securitization (denoting the conversion of a rigid or illiquid loan into a liquid one) and operating or financial leases. We are thus recognizing the strong dependence on outside financing, particularly in Latin America.

4.9 Theoretically, if adopted, the Convention could give airlines of developing countries cheaper access to financing, which would not be as burdensome as in transactions in which the country-risk has a direct impact, resulting in higher interest rates. This results from comparing secured and unsecured loans and mutually-agreed securitizations.

4.10 These advantages stem, *inter alia*, from a potential cost reduction, particularly in legal and other professional fees, as well as lower interest rates. The cost will naturally vary depending on the market, efficiency in the use of legal resources, the complexity of negotiation structures and the lack of reliable information; the estimated savings can thus be speculative.

4.11 It is extremely important to bear in mind the seasonal character of the operation of air transport services, where there are times when a larger fleet than that normally available is required, diluting the risks of aircraft acquisition or leasing over time.

4.12 The same can apply to existing spare parts and aircraft engines and it can thus be held that adopting the Convention will result in favorable conditions for cost reduction and better access to re-equipment for a modern fleet, thus ultimately benefiting users of air transport services.

4.13 Concurrently with these potential advantages, there is the indirect impact on the economy of the country where the airline using this type of facility operates, with the natural result of an increased level of employment, trade, taxes and profits, among other elements. These advantages are not easy to assess "a priori", but the development of the air transport industry will undoubtedly act as a catalyzer on the national economy. These implications are both direct and indirect; the latter stem from the necessary interaction between air transport and other supplementary services such as service vendors, manufacturers of additional elements, etc.

4.14 Particularly important among such elements is fuel consumption, due to its impact on the operation of air transport services. International fuel consumption of air transport services stands at about 3.4 million of barrels of JP 1 a day.

4.15 Ramp services and the supply of on-board meals should be added to the above. Worldwide, the following figures are of interest: a) the four largest ramp service companies in 1996 employed 25,000 persons, with profits of 1 billion dollars in 1996; b) in 1996, catering companies employed 96,000 people and showed profits of 6 billion dollars. Such figure does not include those working for airlines with their own catering (ICAO, WW/IMP/WP dated March 19, 1998 submitted to the CNS/ATM World Conference held in Rio de Janeiro on the economic and financial elements of such services).

4.16 The tourist business in certain regions is growing exponentially. We must therefore contemplate the impact of travel agencies, even though their business has been suffering the negative effect of information technology tools such as the Internet.

4.17 The activities of leasing companies, dedicated to giving the air transport community access to equipment on competitive terms, should also be taken into account. Such companies employ some 3,000 persons worldwide, with profits of about 7 billion dollars in 1996.

4.18 ICAO has statistically identified this type in effect in studies conducted after the Montreal World Air Transport Conference (November 1994) had been convened. But it must be admitted that the beneficial effects of availability and lower costs in the operation of air transport services on the regional economy are difficult to quantify.

4.19 One of the parameters used in this case is Gross Domestic Product, measured by the increase in production value in the market, the level of salaries, interest and dividends, yields from the air transport industry and related activities. In markets where prices of financial services and production factors are determined by the free play of supply and demand, this is a sensible way of measuring economic contribution.

4.20 Unfortunately, models to measure the cost-benefit ratio are relatively undeveloped in Latin America, thus making it impossible to determine with any degree of certainty the impact that the adoption of the Convention would have on the air transport industry in the region.

4.21 The creation of jobs is extremely important in Latin American economies needing a strong revival and, given the repercussion of air transport and related activities worldwide, the catalyzing role of air transport on domestic economies should be borne in mind.

4.22 The other advantage to be measured is the generation of tax revenues as a critical element to maintain and enhance the social and economic infrastructure, which are indicative of the standard of life of a country.

4.23 Another point to be kept in mind is the desire of many developing countries to increase international financing so as to reduce their external debt. Such debt could be affected by Government financing guarantees or loans granted to national air carriers.

4.24 The contribution of air transport and of civil aviation activities generally to economic growth, employment and profits is worthy of note, particularly given its multiplier effect on other supplementary and related non-aeronautical activities.

4.25 If this type of international regulatory instrument, with the adjustments required to bring it into line with the basic and non-waivable principles of domestic legislation, is directed at facilitating access to upgrading of airline flight equipment, creating favorable conditions for the development of one of the mechanisms more widely used in the market, operating and financial leases, the efforts put forward by both international institutions for over a decade in the service of the international air transport community will have been useful.

COURSES OF ACTION SUGGESTED BY ALADA

The review of the key points of this project which are the subject matter of this Working Paper should lead ICAO Members participating in the Diplomatic Conference to be held in Capetown (South Africa) from October 29 to November, 2001, to analyze, in the light of their own domestic legislation and needs, and on the basis of the economic advantages to be shared by airlines, service providers, employees, users and the domestic economy, to decide on the advisability of adopting the Consolidated UNIDROIT-ICAO text, with such amendments or reservations as may be imposed by these two important elements.

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