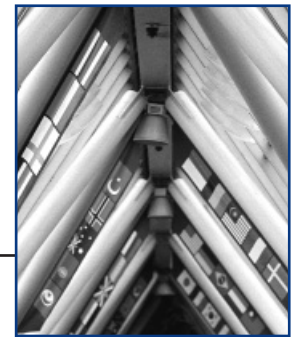




Cape Town and Aircraft Transactions in the United States

By Frank L. Polk



After a great deal of speculation and debate, the Cape Town Convention on International Interests in Mobile Equipment (Convention) and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Protocol) (collectively, Cape Town or the Treaty) have now been ratified by the requisite number of countries, including the United States, and will be in effect on March 1, 2006.¹

The Treaty in Brief

The Treaty is an ambitious and unique document that establishes comprehensive laws in each ratifying country (Contracting State) dealing with most significant aspects of buying, selling, leasing, and financing aircraft and engines, including issues relating to default, remedies, insolvency, priorities, title, aircraft deregistration, and the perfection and filing of liens against airframes and engines that meet certain minimum size requirements.

The Treaty is composed of two parts: (1) the Convention itself, which is drafted in general terms to deal with commercial transactions involving mobile equipment, and (2) the Protocol, which is specific to aircraft transactions. The Convention and Protocol should be read and interpreted as a single instrument. However, if there are any inconsistencies, the Protocol prevails.² A Consolidated Text has been created by combining the terms of the Convention and Protocol; it is a helpful tool that will be used in practice but does not have the legal effect of the Convention and Protocol. Additionally, regulations have been issued and procedures will be issued by the Supervisory Authority, discussed below, to provide guidance on using the system created under the Treaty.

On matters covered by the Treaty, the Treaty supersedes the Convention on the International Recognition of Rights in Aircraft (more commonly known as the Geneva Convention)³ and, under its terms as well as general principles of international law, will supersede conflicting state or national law.

Why the Treaty Is Important

The Treaty will have an immediate impact on aircraft transactions that occur on or after the effective date because it

(1) creates substantive laws pertaining to aircraft transactions, including default, remedies, assignments, and insolvency; and

(2) changes existing laws on the perfection of ownership and security interests in aircraft and engines.

The Treaty will apply to all transactions and most documents, entered into on or after the effective date, involving U.S.-registered aircraft that reach a certain minimum size, i.e., aircraft certificated for at least eight seats (including crew) and helicopters certificated for at least five seats (including crew). Additionally, if certain connecting factors are satisfied, the Treaty will apply to transactions involving engines rated at least 550 horsepower (or at least 1750 pounds of thrust).⁴ The Protocol defines this type of equipment, i.e., aircraft, helicopters, and engines, as “aircraft objects.”⁵

After March 1, 2006, it will no longer be enough to conduct searches and file documents at the Federal Aviation Administration (FAA) to perfect ownership and lien interests in qualifying aircraft objects, although that must still be accomplished. In addition to dealing with the FAA, it will be necessary to conduct searches and register interests in aircraft objects at the Cape Town International Registry (CTIR) created pursuant to the Treaty. Lenders, sellers, purchasers, lessors, or lessees of aircraft objects who fail to follow the simple but rather technical procedures for registering rights at the CTIR will find that their rights and interests in such collateral are unperfected and, thus, at risk of being subordinated to the rights and interests of a competing creditor or subsequent purchaser registering at the CTIR, even if that party had actual knowledge of the prior, but unregistered, interest.

When Cape Town Applies

The Treaty applies to a transaction involving an aircraft when three basic connecting factors are satisfied:

(1) the aircraft meets the minimum size requirements,⁶

(2) the transaction documents create an “international interest” in an aircraft, and

(3) the aircraft is registered in a Contracting State or the debtor is “situated in” a Contracting State at the time of the conclusion of the agreement.⁷

Engines have a slightly different rule because ownership or title to an engine is not registered at the FAA or any other national aviation registries. As a result, Cape Town applies to a transaction involving engines that have at least 550 rated take-off shaft horsepower (or 1750 pounds of thrust),⁸ the transaction documents create an “international interest” in an engine, and the debtor is “situated in” a Contracting State at the time of the “conclusion of the agreement.”⁹

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Because aircraft and engines are treated independently, a party may be faced with a situation where the Treaty applies to the engines but not the aircraft (or vice versa), as may be the case with some of the new microjets. Consequently, it will be necessary to research FAA Type Certificate Data Sheets to determine if specific aircraft and engines meet the minimum size requirements.¹⁰

The Treaty only applies to transactions that involve international interests in aircraft objects (and to documents that create or affect an international interest). The definition of *international interest* includes security interests, leasehold interests, and conditional sale agreements (referred to in the Treaty as "title reservation agreements").¹¹ The Treaty does not include ownership interests in the definition of an international interest; however, the Protocol extends the application of the Treaty to ownership interests that are evidenced by a "contract of sale" (i.e., a bill of sale), and ownership interests are generally treated as if they were international interests.¹² Other interests, rights, or documents covered by the Treaty are amendments, assignments, subordinations and subrogations related to international interests, and certain nonconsensual liens.

Additionally, the Treaty applies to transactions only if certain parties, or the aircraft objects, are associated with a Contracting State. Specifically, the Treaty is applicable if the relevant aircraft is registered in a Contracting State.¹³ Even if the aircraft is not registered in a Contracting State, the Treaty still applies if the debtor is situated in a Contracting State at the time of the conclusion of the agreement that creates the international interest in the aircraft or engine.¹⁴ For these purposes, *debtor* is defined as the chargor under a security agreement, a lessee under a lease, a conditional buyer under a title reservation agreement,¹⁵ or a seller under a traditional sale transaction.¹⁶ A debtor is situated in a Contracting State if it is formed, incorporated, or has its principal place of business in a Contracting State.¹⁷ *Conclusion of the agreement* is not defined, but the most likely interpretation is that this occurs when the relevant agreement is signed and delivered. The location of the creditor is irrelevant for purposes of determining if the Treaty applies to a transaction.

If the Treaty is applicable, parties must take the appropriate actions to register international interests in aircraft objects at the CTIR (under the Treaty, registration of an international interest in the aircraft object establishes the priority of that interest, which is the Cape Town equivalent of the "perfection" of that interest). Interested parties must also take care to promptly make a CTIR registration of any subsequent amendments, supplements, assignments, and subordinations to the original international interest.

Who's in Charge?

The Treaty places the primary power to manage and administer the Treaty with a Supervisory Authority, which is the International Civil Aviation Organization (ICAO). ICAO has the power to appoint a Registrar, which has the responsibility for establishing and operat-

ing the CTIR. Aviareto, a joint venture of SITA SC and the Irish government, has been appointed Registrar.

ICAO, in its capacity as the Supervisory Authority, is given a certain level of immunity from legal and administrative actions,¹⁸ but Aviareto can be sued under certain circumstances.¹⁹ Administrative or legal disputes with Aviareto will be handled in the Irish court system.²⁰ However, where parties to a transaction or competing creditors have a dispute among themselves and no relief is being sought against Aviareto, parties are free to litigate based on current principles of jurisdiction and venue.²¹

The Treaty in the United States

The United States ratified the Treaty²² and adopted amendments to the Transportation Code (49 U.S.C., subtit. VII, pt. A) and FAA Regulations (14 C.F.R. §§ 1 et seq.) to implement the Treaty.

At least seven different documents are the keys to understanding the Treaty itself and how it will be implemented in the United States: (1) Convention, (2) Protocol, (3) Cape Town Regulations, (4) Cape Town Procedures, (5) amendments to the Transportation Code, (6) amendments to FAA Regulations, and (7) declarations²³ adopted by the Senate when the United States ratified the Treaty.

The Treaty contains a major overhaul of the aircraft lien perfection and priority systems that have been in place in the United States for decades. Because Cape Town creates such widespread changes to the current system and because the concepts of priority and perfected interests are fundamental in any transaction, the rest of this article will focus on the blended FAA-Cape Town aviation lien perfection system, new priority rules, the Treaty's recognition of a prospective international interest, and preexisting liens.

But that is certainly not the limit of Cape Town's impact on the aviation industry. The Treaty will have a major impact on at least three other important aspects of aviation transactions: remedies,²⁴ assignments,²⁵ and aircraft deregistration.²⁶ Each of these topics requires a detailed discussion that is beyond the scope of this article.

Perfecting an International Interest

Cape Town and the CTIR will not eliminate the need for the FAA Civil Aviation Registry, which will continue to have an important role in the registration of aircraft and the perfection of liens in aircraft and engines. The new legislative and regulatory schemes contemplate a continuation of the traditional FAA system that has served the aviation community so well over the years while recognizing the need to implement the Cape Town system. As

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a result, Congress designated the FAA as an “exclusive entry point” to the CTIR and adopted legislation that blends the two systems.

The Treaty, in combination with the amendments to the Transportation Code and FAA Regulations, effective March 1, 2006, establishes a system that can be summarized as follows:

- Parties will continue to register aircraft in the name of the owner with the FAA Registry (for nationality, ownership, and operational purposes).
- As a condition to the CTIR registration of an international interest in an aircraft object, parties must (1) complete and file a new FAA Form (AC Form 8050-135), which will describe the parties, the collateral, and the international interest claimed in the collateral; and (2) file the relevant documents, such as bills of sale, security agreements, and leases, for recordation with the FAA Registry (mandatory for aircraft and helicopters but optional for engines).
- When the appropriate FAA filings are made, the FAA Registry will provide an FAA-Cape Town transaction code, which is required to register the international interest at the CTIR.
- To initiate the CTIR registration process, each party must first establish an account with CTIR.²⁷ Thereafter, one party logs on to the CTIR system, enters the relevant information (the parties to the transaction and a description of the aircraft objects by make, model, and serial number), and claims or consents to an international interest in the aircraft objects.
- The CTIR system automatically sends notice (via e-mail) to the second party to the transaction, giving it an opportunity to claim or consent to the registration of the international interest in the aircraft objects.
- The second party responds to the CTIR notice (via e-mail) and advises the CTIR that it does, or does not, consent to the registration of such international interest.
- If the second party consents to the registration, the registration of the international interest is substantially completed.

A registration is considered complete (and therefore perfected) when the registration is searchable on the CTIR system.²⁸ A registration is searchable when (1) the parties have entered all of the relevant information and submitted the appropriate consents through the CTIR system, and (2) the CTIR system has assigned a sequentially ordered file number to the registration and stored the information in its database.²⁹ All of the actions by the CTIR system should occur automatically in a matter of moments after parties have submitted the appropriate information, including their electronic consents to the registration.

The Cape Town Regulations, although somewhat convoluted, provide a road map for navigating the CTIR system, and practitioners must become familiar with this document.

Finally, do not be fooled by the fact that the FAA is classified as an exclusive entry point for the Cape Town system. Interested parties, not the FAA, will be responsi-

ble for making all of the relevant filings and registrations necessary to register and perfect their interests. In fact, the primary functions of the FAA vis-à-vis Cape Town are to accept and index the filing of AC Form 8050-135, provide parties with the FAA-Cape Town transaction code, and accept and maintain the filing of certain documents in connection with the deregistration of an aircraft.

Priority Rules

The Treaty creates new laws regarding the priority of liens or claims in an aircraft object. Currently, priority rules in the United States are governed by applicable state laws with one exception contained in the Transportation Code. The current U.S. priority rule is that the first to file a security interest at the FAA Registry has priority over all other liens against the aircraft or engine unless the filing party has “actual notice” of another claim or right in the aircraft or engine.³⁰ The concept of actual notice has led to various disputes, one of which was resolved in the only Supreme Court case dealing with liens and aviation laws, *Philkco v. Shacket*.³¹ The current U.S. rule will be changed and simplified because the Treaty establishes one priority rule: whoever is first to register a valid interest at the CTIR has priority over all other competing interests. The existence of actual notice is simply not relevant to the determination of the priority of competing liens or interests.³²

This clear and unambiguous priority rule makes perfection of one’s rights more important than ever. It places the responsibility entirely on the secured party, lessor, or purchaser/owner to register its interests or risk losing to a competing creditor, subsequent purchaser, or bankruptcy trustee, even if that competing party had actual notice of the prior but unregistered interests.

Prospective International Interests

Another change in current law is that the Treaty provides for the perfection of interests in aircraft objects through CTIR registration of a prospective international interest.³³ Thus, parties to a transaction may perfect their rights in an aircraft, helicopter, or engine before the transaction closes, which is not allowed under the current FAA system. The perfection of rights associated with a prospective international interest will be effective as of the time the prospective interest is registered, assuming the transaction actually closes³⁴ (if the transaction does not close, no rights have been created and no rights can be perfected).

Congress adopted specific procedures and requirements in connection with prospective international interests. Failure to satisfy these requirements can have dire consequences. Among other things, a party must first file a required form (AC Form 8050-135) with the FAA, at which time the party can register the prospective international interest with the CTIR. Federal law provides that parties have sixty days to file the actual documents pertaining to the prospective international interest (e.g., bills of sale, security agreements, or leases) for recordation with the FAA. If parties fail to make such a filing in that

time period, the Transportation Code provides that the interests are no longer valid (i.e., perfected).

Prospective international interests will be tricky because a current lender or owner will be reluctant (at best) to allow or consent to the registration of a prospective international interest in an aircraft object prior to receiving a loan payoff or the purchase price. Security agreements and loan agreements currently contain prohibitions against the placement of a competing lien on the relevant collateral, and it is likely that lenders will add similar language prohibiting any party from placing a prospective international interest on the collateral.

Furthermore, if transacting parties consent to registration of a prospective international interest and the transaction fails to close, a cloud is created on the title of the aircraft and engines.

On the other hand, the use of a prospective international interest registration can provide a certain level of efficiency and comfort in closing a transaction because it allows parties to take care of the Cape Town component of a transaction before closing.

The use of prospective international interest registrations will become common only if parties are able to develop a system of closing transactions in a way that protects the current lender or owner in case the transaction does not close as anticipated. One approach is for the parties to authorize a third-party agent to release the prospective international interest if the transaction goes awry. Such authorization would require both a written document and the appointment of that agent through the CTIR system.

Preexisting Liens

What impact, if any, will the Treaty have on liens or interests in aircraft and engines that are perfected before the effective date? That is, will a party whose interests are properly perfected be required to register its interests under the Treaty?

The answer is simple: nothing is required to be done. The United States adopted the Treaty in a way that all liens against aircraft and engines that are properly perfected on the effective date of the Treaty will be grandfathered and their perfection will continue in full force and effect.³⁵

However, there is a caveat: a lender will argue that it may derive some benefit (primarily, giving notice of the preexisting interest) from having a lien registered under the Treaty. As a result, there will be tension between a lender who wants to register a security interest under the Treaty (even though it is properly perfected at the FAA) and a borrower who does not want to spend the time or money necessary to accomplish that registration.

Because the Treaty only applies to interests created on or after its effective date, parties who want to take advantage of the Treaty must create a new international interest rather than simply register in connection with a preexisting interest. This means that parties should enter into new documents (after the effective date), probably in the form of a second priority lien or an amended and

restituted agreement, and register that interest at the CTIR (while taking caution not to have any adverse impact on the prior perfected interest).

Final Thoughts

Although the decision to register an international interest under the Treaty is optional, the failure to register such interests at the CTIR can be fatal to the interests of an owner, lender, lessor, or lessee. Such dire consequences are primarily driven by the priority provisions of Treaty, which are simple and clear: the first party to have a registered and searchable interest under the Treaty wins against competing interests, regardless of that party's knowledge of prior interests not registered with CTR. This is a critical matter that must be emphasized: an interest in an aircraft object that is covered by the Treaty should be perfected by following the procedures outlined above. Failure to do so could result in the loss of that interest, or at least the loss of priority, to competing creditors or a subsequent purchaser.

In light of the significant changes in both substantive and procedural laws relating to the perfection of ownership and security interests in aircraft and engines, the aviation industry must come to grips with the fact that the traditional and comfortable way of closing a transaction will come to an end and that the industry will go through an educational process in learning the best practices in dealing with the Treaty. Anyone who is active in the aviation field must give a great deal of thought as to how to conduct aircraft closings and whether old approaches to closings should be modified or scrapped. For example, the following questions should be considered:

- Should you confer with an attorney or consultant who is familiar with the Treaty?
- Should all parties be encouraged or required to appoint agents or attorneys to handle all aspects of the FAA filings and Cape Town registrations necessary to close a transaction in an effort to increase the efficiency of the closing process?
- Should you make a prospective international interest filing prior to closing?
- Should you use a more formalized closing process, including a written escrow agreement?
- Should you obtain an attorney's opinion that all of the procedural and substantive requirements of perfection and registration have been satisfied?
- Should you explore the advantages and costs of purchasing title insurance to provide assurances that all of the procedural and substantive requirements of perfection and registration have been satisfied?

Should old approaches to closings be modified or scrapped?

We have had the luxury of watching the Treaty develop from a distance and, over time, knowing that ratification and implementation were years away. Now that the Treaty will be in effect on March 1, 2006, the industry must commence an active and in-depth analysis of the Treaty and prepare for a new and different way of documenting and closing aircraft transactions.³⁶

Endnotes

1. The Treaty has been ratified or acceded to by the United States, Panama, Pakistan, Oman, Nigeria, Malaysia, Ireland, and Ethiopia. The critical eighth ratification was deposited by Malaysia on November 2, 2005. A copy of the Convention and Protocol can be found at www.unidroit.org/english/conventions/c-main.htm.

2. Convention, art. 6.

3. Protocol, art. XXIII.

4. The Transportation Code has been amended, effective when the Treaty becomes effective, to apply to engines rated at least 550 horsepower or the equivalent (the former standard was 750 horsepower). Just to keep things interesting at the FAA, the threshold for propellers will continue to be 750 horsepower because the Treaty does not apply to propellers.

5. Protocol, art. I, § 2(c).

6. Protocol, art. I, 2 (a) and (e). The Protocol provides that the Convention applies to aircraft that are type certified to transport at least eight persons or goods in excess of 2750 kilos (6050 pounds) and helicopters that are type certified to transport at least five persons or goods in excess of 450 kilos (990 pounds).

7. Convention, arts. 2, 3, 4; Protocol, arts. IV, V.

8. Protocol, art. I, 2 (b).

9. See *supra* note 7.

10. FAA Type Data Certificate Sheets can be accessed on the Internet at www.faa.gov/aircraft. The CTIR may also be set up to provide guidance on these matters.

11. Convention, arts. 2, 7.

12. Protocol, arts. III, V.

13. Protocol, art. IV.

14. Convention, arts. 3, 4.

15. Convention, art. 1(j).

16. Protocol, art. III. It is somewhat counterintuitive for the seller to be considered a debtor for Cape Town purposes; however, this classifi-

cation exists more for purposes of determining the applicability of the Treaty rather than for the rights and obligations of the seller and buyer. For example, the creditor is the party that is interested in, and has the right to, register its interest under Cape Town, so it makes sense that the buyer (who is characterized as the creditor for these purposes) is the party that has the right to register its ownership interest in an aircraft or engine.

17. Convention, art. 4.

18. Convention, art. 27; Protocol, art. XVII.

19. Convention, art. 28.

20. Convention, art. 44.

21. Convention, arts. 42, 43; Protocol, art. XXI.

22. The United States ratified and accepted the Convention and Protocol on October 28, 2004.

23. Each Contracting State must make certain declarations as part of the ratification process. The declarations are adopted by a Contracting State to include or exclude specific provisions of the Convention (primarily relating to default, remedies, deregistration, and insolvency) as they relate to the declaring Contracting State.

24. Convention, arts. 8-15; Protocol, arts. IX-XII, XVI.

25. Convention, arts. 31-36; Protocol, art. XV.

26. Protocol, arts. IX, XIII.

27. Establishing an account may take several days, so it must be accomplished prior to closing or delays will result.

28. Convention, art. 19.

29. *Id.*

30. 49 U.S.C. § 44108 (a).

31. 462 U.S. 464 (1983) (dispute between two competing purchasers of an aircraft).

32. At least that is the language contained in the Convention. The U.S. Transportation Code contains language indicating that actual knowledge is relevant. 49 U.S.C. § 44108. It will be interesting to see if case law holds that the Convention is controlling on this matter or if courts find a way for both concepts to survive.

33. Convention, arts. 1 (x),(y),(z), 18, 19, 20.

34. Convention, art. 19(4).

35. Convention, art. 60.

36. The best source for understanding Cape Town is Professor Sir Roy Goode's official commentary to the Convention: SIR ROY GOODE, OFFICIAL COMMENTARY (Unidroit 2002). Another excellent source is CONTRACT PRACTICES UNDER THE CAPE TOWN CONVENTION, CAPE TOWN PAPER SERIES VOL. I (Legal Advisory Panel of the Aviation Working Group 2004).



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