16 August 2010

Rachel Onikosi
Deputy Head, Legislative and International Policy Unit
Department for Business, Innovation & Skills
1 Victoria Street, London SW1H OET

Re: **BIS Call for Evidence – Convention on International Interests in Mobile Equipment and Protocol thereto on Matters Specific to Aircraft Equipment (July 2010)**

Dear Ms. Onikosi,

This is a response of the Aviation Working Group (the "**AWG**") to the above-identified Call for Evidence (the "**CE**") in connection with the government's assessment of whether to ratify the Convention on International Interests in Mobile Equipment (the "**Convention**" or "**C**") and the Protocol thereto on Matters Specific to Aircraft Equipment (the "**Protocol**" or "**P**"). The Convention and the Protocol will be referred to together as the "**Cape Town Treaty**" or "**Treaty**").

The AWG is comprised of major aviation manufacturers, financial institutions, and leasing company. Its members manufacturer most of the world's large aircraft and engines, and lease and finance a substantial majority of them. AWG works closely with the world's airlines, and, in particular, has taken joint positions on the Treaty with IATA, a representative of the world's airlines. AWG includes several UK-based members, and most AWG members do a substantial amount of business in the UK.

We have cut into this response the questions contained in Part III of the CE, and have set out our replies thereto below each such question.

To be clear at the outset, and as noted in reply to question 3.9, ***we strongly support ratification of the Cape Town Treaty and urge the government to do so as promptly as possible and with a high level of priority***.

The Cape Town Treaty reflects, enhances, and internationally promotes basic concepts found in English law. That should be expected given the central role played by the UK in negotiating and drafting the instruments. In fact, the drafting committee at every intergovernmental meeting that negotiated, and at the diplomatic conference that adopted, the Cape Town Treaty was chaired by a UK representative (either Sir Roy Goode (Oxford) or Bryan Welch (BIS)). The Treaty will reduce legal risk. It will produce economic benefit.

Importance of Protocol, art XI (Remedies on Insolvency) – Alternative A

The CE does not ask a question about the economically most important provision, P, art XI (remedies on insolvency). It is necessary to draw out the significance of applying Alternative A of this article ("**Alternative A**"). Most of the economic benefits and transaction risk reduction under the Treaty are predicated on the applicability of Alternative A (with a sixty (60) day waiting period). See *Economic Benefits of the Cape Town Treaty*, 2009, by Professor Vadim Linetsky, a leading authority on the financial modeling of secured transactions. Regarding the basis for this provision in emerging legal thinking, see "Cape Town Treaty in the European Context: the case for Alternative A, Article XI of the Aircraft Protocol", by Jeffrey Wool / Andrew Littlejohns. These materials can be downloaded at www.awg.aero . Thus, it is essential that Alternative A

apply in the UK though its inclusion in the UK's implementing legislation (that mode of application is required given agreements relating to EU competence). See Unidroit, "The European Union and the Cape Town Convention", DC9 / DEP, Doc. 8, June 2010 at Annex III.

We note the Department's willingness to meet to discuss these matters. We would like to do that.

QUESTIONS POSED AND REPLIES

3.1 Cross-border aircraft financing and leasing potentially attract the laws of different countries with differing rules on creditors' rights and the protection of security interests. To what extent do you consider that this affects:

a) the complexity of the transactions;
b) the predictability of legal outcomes;
c) the availability of finance or leasing facilities; or
d) the cost?

Reply: The internationality of aircraft financing and leasing, and the consequent applicability of several non-harmonised laws, undoubtedly produce complex transactions. Legal outcomes are less predictable than they could and should be. As mentioned in CE, para 1.11, there is a particular level of uncertainty in English law due to the application of the *lex situs* rule regarding property rights in aircraft. The recent Blue Sky case has brought that problem into sharp focus.

All else equal, greater complexity and less predictability result in higher transaction costs than would otherwise by the case. At some point on the continuum, these factors impact the availability of financing. The foregoing is axiomatic. It is a basic tenet of law and economic theory, which is now widely-accepted in policy-making relating to secured transactions.

A prime example of such conflict of laws issues relates to rights in aircraft engines. Laws differ significantly regarding the legal effect of installing or removing engines, which, given operational requirements, could happen in any jurisdiction. In some jurisdictions, these actions impact core property rights.

Beyond conflicts, the cost and availability of financing are significantly impacted by the underlying substantive law, more specifically, any impediments caused by it affect the timely access to collateral value. Timely access to valuable collateral is the basis of secured transactions and defines the leasing model. In financial terms, timely access to valuable collateral offsets loss (that is, reduces the risk of loss (to a creditor) notwithstanding the risk of default (by a debtor)), thus producing efficiencies.

A prime example of such substantive law issues – as noted in CE para 1.11 – is delay occasioned by insolvency law. Beyond that delay, such laws may qualify or restrict contractual (and non-insolvency law) enforcement rights or impact property rights. These prospects are directly inconsistent with the core principles underlying asset-based financing and leasing.

3.2 If any of the factors in question 3.1 apply, to what extent do you consider that the difficulties you have identified affect:

a) the rating of aircraft receivables,
b) the cost of export credit insurance, and/or
c) the cost of financing or leasing aircraft?

Reply: Sub-question 3.2(a) and (b) may be answered with reference to objective and publicly available information. Sub-question (c) raises methodological and confidentiality issues, and, thus, needs to be addressed based on general principles.

Re 3.2(a): "Aircraft receivables", in the context of the Treaty (which excludes general receivables financing), must refer to the rating of aircraft-backed securities. The only source of publicly available information regarding their cost is public, capital markets. In the aviation industry, these securities / transactions are known as "enhanced equipment trust certificates" ("**EETCs**"). There have been few EETCs in Europe and none in the UK, given uncertainties caused by applicable underlying insolvency law. In those transactions,

two major European airlines paid materially higher rates, and had materially more restrictive terms, than less creditworthy airlines (closing transactions in the same time frame) in the US. The sole reason for such preferential US financing terms was the existence and application of section 1110 of the US bankruptcy code, a functional equivalent to Alternative A. This follows from the policies of international rating agencies, which have, based on years of data, used a system of "enhanced" rating (rating upgrades) where timely recourse to valuable aircraft collateral can be safely assumed. Based on underlying law, including insolvency law, that has been the case in the US but not in Europe.

Thus, the ratification of the Cape Town Treaty will provide UK airlines with enhanced access to international capital markets, thus diversifying their sources of funding. In particular, it will open public debt markets, providing UK airlines with another important option (in addition to bank debt and leasing, their traditional options) to help fund their capital-intensive aircraft acquisition requirements. For discussion of other commercial transactions, please see below.

Re 3.2(b): The cost of export credit is governed by the OECD's aircraft sector understanding (the "**ASU**"). Under the ASU, all OECD countries (the UK included) plus Brazil have agreed that ratification of the Treaty – with a set of "qualifying declarations" (see reply to question 3.10) – justifies a material reduction in the fee charged.[1] That decision supports the proposition that transactions in legal systems that provide higher levels of predictability and reflect the principles underlying asset based financing should be priced lower than those systems that do not. As to quantification, the size of the "Cape Town Discount" depends on the credit standing of the borrower; the weaker the credit standing (the higher the risk of default), the larger the fee reduction. Under the current terms of the ASU, the range (for large aircraft) is 20 to 150 basis points on the upfront fee charged. To give an example, a 100 basis point reduction (a "B" rated airline would receive a 94 basis point reduction) on a USD 100m aircraft financing equals USD 1m. It is noteworthy that under the ASU the terms of export credit are not attractive for spare aircraft engines. That reflects concerns about the point noted above regarding the law applicable to rights in engines.

Re 3.2(c): This question raises the general topic of the relationship between harmonised and (see reply to 3.1 above, more importantly) commercially-oriented secured financing and leasing law, on the one hand, and the cost (and terms) of such transactions, on the other. It is not possible to provide definitive and precise information on this question, for two reasons. First, many factors go into transaction pricing (and the availability of financing). These include – in addition to credit and legal risk – more general and macro considerations, such as (i) general liquidity in the financial sector and the liquidity position of a particular financial institution, (ii) the impact of regulatory capital, (iii) comparative returns from other forms of lending, (iv) competitive issues that may lead a bank to consider longer-term and relationship issues in setting price, and (v) other sources of fees payable to a bank directly or indirectly linked to that transaction or related transactions. Secondly, confidentiality (and, possibly, competition law) considerations prevent the disclosure of terms in private financing transactions.

That said, and as noted above, the direct link between reduced transactional risk and improved pricing and other terms – all else equal – is a foundation of law and economics. It is now taken as an established fact. Elements of this thinking are seen (beyond the positions of the international rating agencies and the OECD countries, noted above) in the terms of BIS II (rules for regulatory capital) and daily decisions made by credit committees of financial institutions.

Finally, a specific word on the Treaty and "proof" of economic benefit. The extensive economic assessment and related academic work on the Cape Town Treaty has been without precedent in the field of commercial law reform. Two major studies were undertaken (see www.awg.aero), each of which took into account available information and research. The authors were of the highest possible caliber (in addition to Professor Linetsky, Northwestern University, they are Professors Anthony Saunders and Ingo Walters (INSEAD and

[1] The UK, France, Germany, Spain and the US currently follow the "home market rule", which prevents export credit into these countries. The ASU is currently under review. A number of home market airlines, including some in the UK, are seeking to have this restriction eased or removed. To the extent that is agreed, the points above will apply in respect of UK carriers.

NYU)). These academics are applied economists and finance specialists. If a higher standard than that undertaken in connection with the Treaty needs to be met, then question whether (i) any prior commercial treaty (or national law reform in this field) should ever have been adopted, or (ii) any future commercial law treaty (or national law reform in this field) will ever be adopted.

3.3 The Convention and Protocol embody an international legal regime for the creation, perfection and priority of international interests and outright sales. To what extent, if at all, do you consider such a regime would help to reduce any problems you have identified in your answer to question 3.1?

Reply: The terms of the Cape Town Treaty will significantly address all of the issues noted in 3.1 above. First, it will sweep away the problems associated with the *lex situs* rule. Secondly, with Alternative A, it will sweep away problems associated with insolvency delay and impairment. That, in turn, will provide UK airlines with enhanced access to international capital markets, thus diversifying and increasing their sources of funding. Thirdly, it will eliminate the above-noted legal issues associated with engine financing, though that depends on adoption by many countries. On that last point, while the Treaty is rapidly being adopted internationally, there is no doubt that UK ratification would provide a leading example to and justification for others to ratify. That would also serve the objective of the UK export community. See reply to question 3.9 below.

The Cape Town Treaty, unlike most other international legal instruments, was purposefully designed to facilitate a transaction type, thereby producing benefits to the industry sector. The core role that the aviation sector – IATA (airlines) and AWG (financiers and manufacturers) – played in the process ensures that result. The Treaty elegantly solves the current legal issues in this field, and does so in a manner consistent with leading legal thought. There are no losers: the problems solved equally benefit debtors, creditors, and manufacturers.

3.4 Do you:

a) consider that the International Registry system, which provides for registration of international interests in and sales of airframes, aircraft engines and helicopters, with priority over unregistered national interests, is an advantage or a disadvantage? Please explain your answer.

b) Do you find the ability to register an international interest against an aircraft engine separately from the airframe helpful or not helpful? Please explain your answer.

Reply: Re 3.4(a): The International Registry under the Treaty ("**IR**") is already recognised as both ground-breaking and well-established. Approximately half of the world's new aircraft transactions are registered in the IR. The system has run with virtually no problems since inception. There is strong supervision by ICAO. Users have direct input through an International Advisory Board.

The IR (and the above-noted priority rules) is a significant improvement over current law and practice. First, the system is electronic and low cost. It is simple and effective. Closings are made easier. Interests may be registered in advance ("prospective interests"), which takes pressure off of (expensive) closing logistics. In international (and national) law reform circles, the starting point for any discussion about registries systems is the IR. Secondly, the priority rules are clear and objective. In the context of aviation financing, clarity equals fairness. Parties can search the IR and determine exactly where they stand. Litigation relating to "knowledge" will be avoided. There will be no need for legal gymnastics (such as priority notices), which seek to address the issues handled directly by the Treaty. Thirdly, the IR (through the Treaty) establishes priorities on an international basis. Any other system would be limited to national priorities. That is inherently inefficient, and leaves risks in transactions which can be reduced only at significant expense. In short, the Treaty, through the IR and the priority rules, puts an efficient international system in place to deal with international transactions and fact patterns.

Re 3.4(b): The treatment of engines as separate property – and, correspondingly, the ability to separately register against them – is extremely useful. As noted in reply to question 3.1, the law applicable to rights in

engines varies widely, and, in some jurisdictions, is potentially prejudicial to the right of property holders. That is exacerbated by the *lex situs* problem in the engine context.

Engines are highly valuable equipment. They consistently maintain their value. They should therefore serve as excellent collateral, if the underlying law so permits. In addition, they are often separately financed (spare engines) and pooled and interchanged. From a commercial perspective, they are often hired out on a short-term basis, where strong property rights are particularly important. For all these reasons, the treatment of engines under the Cape Town Treaty – as separate property to which the Treaty's clear rules apply – is a vast improvement to current law around the world. It will support advanced engine financing and use.

3.5 The Cape Town Convention sets no time limit for the completion and registration of transactions, and completion gives priority to the registered international interest as from the time of registration of the prospective international interest without the need for any additional registration. Do you consider this to be advantageous?

Reply: As mentioned above, this is a significant advantage without any corresponding disadvantage. The absence of a required time period, and the ability to make a prospective registration, takes pressure off of closing logistics. While the priority "relates back", there is no unfairness to any party – since the registration only has priority from the time it is searchable. There are no secret interests. Any searching party can easily self-protect: all it needs to do is search the IR. It is then on notice that an interest, actual or prospective, might have a higher priority. That searching party would not close its financing transaction until the IR is cleared of any registration that could prevail over its interest.

The priority notice concept under English law aims at the same objective, but achieves it using a heavier two-step, paper-based process. The Treaty simplifies and improves the process.

3.6 Do you know of difficulties experienced in (a) repossessing UK registered aircraft or engines situated in a foreign country or (b), exercising other default remedies over such assets in a foreign country? If so, please give details.

Reply: We do not understand the relevance of this question – unless it is driving at providing an example and justification for other countries to ratify. See response to question 3.9. This question – what is the position (of a UK-registered aircraft) under foreign (substantive and procedural) law would not be addressed by UK ratification. It would only be addressed by ratification by foreign countries (where the aircraft is located). And, if that is the optic, why limit the question to UK-registered aircraft. What about the position of a UK financier with a non-UK registered aircraft located elsewhere. Or a UK manufacturer who has problems financing sales given foreign law. These are all analytically the same: what is the position under foreign law. (N.B.: In many jurisdictions, there are significant repossession and enforcement problems.) UK ratification will not address these problems, save to the extent others are thereby encouraged to ratify. That encouragement, however, is important, given the wide range of material UK interests in international aviation.

3.7 The Cape Town Convention confers on the creditor the right, on adducing evidence of default, to obtain early judicial relief pending final determination of the case. Do you consider this useful? Please explain your answer.

Reply: This provision C, art 13 ("**Relief Pending**"), on which an opt-out is permitted (see C, art 55), and which is strengthened by an opt-in permitted under P, art X (see P, art XXX(2), was designed to provided countries opposed to non-judicial remedies with a court-based function equivalent thereof.

The UK is not such a country. English law on non-judicial remedies is well-established and effective. The international financing community is comfortable with it.

Thus, since the UK, reflecting its law, would be expected to permit non-judicial remedies through the mandatory declaration required by C, art 54(2)(permitting action "without leave of the court"), the Relief Pending provision is not necessary to reduce transactional risk or increase economic benefit in the context of

the UK. The aviation community should be largely indifferent as to whether the UK, when ratifying, makes these particular declarations.

3.8 The Aircraft Protocol confers on the creditor the additional default remedies of de-registration (removal of an aircraft from a nationality register), and export. How useful do you consider these additional remedies to be?

Reply: These remedies are essential. In light of the terms of the Chicago Convention of 1944, to effectively exercise remedies against an aircraft, a creditor must be able to de-register that aircraft. The Treaty not only provides these remedies, but adds the extremely useful IDERA clause ("irrevocable deregistration and export authorization"), P, art XIII. Most countries have opted into the IDERA clause (see P, art XXX(1)). An international standard is rapidly developing in favor of the use of IDERAs. (Even countries with very efficient de-registration systems (like the US) have made the IDERA election.) Underscoring its importance, the IDERA clause is an ASU qualifying declaration. Importantly, the use of an IDERA is expressly without prejudice to safety laws and regulations.

3.9 In light of your answers to the above questions:

a) do you favour ratification of the Convention and Protocol; if so

b) what impact do you consider these instruments will have on your sector of the aviation industry?

c) if the answer to question 3.9(a) is yes, within what time scale should the UK proceed to ratification? Please give reasons for your answer.

Reply:

Re 3.9(a): ***We strongly support ratification of the Cape Town Treaty.***

In connection with that ratification, it is essential that the UK implement the economically must important provision, P, art XI (remedies on insolvency) – **Alternative A** (with a sixty (60) day waiting period). Most of the economic benefits and transaction risk reduction effected by the Cape Town Treaty is predicated on the applicability that provision. See materials by Linetsky and Wool / Littlejohns referred to above. See also reply to question 3.10 re ASU qualifying declarations.

Re 3.9(b): Ratification of the Cape Town Treaty (with P, art XI, Alternative A implemented through legislation) will reduce legal and transactional risk. It will produce economic benefit to airlines (by reducing cost and providing additional sources of financing), manufacturers (including through its impact on ratification by others, by promoting exports), and financial institutions (by reducing risk). Such direct benefits have important indirect benefits, including (from export enhancement) job creation and (from airline benefits) pass-through benefits to passengers.

UK ratification will ensure that English law remains a preferred governing law of choice in aviation finance and leasing, and that London remains central in the aviation financing and leasing industry.

Re 3.9(c): ***We urge the government to do so as promptly as possible and with a high level of priority***. The ratification by the UK has been delayed for a long time, given two matters unrelated to the core objectives of the Cape Town Treaty: EU competence issue and the Gibraltar-hold. These two items have finally been addressed. UK companies should start to benefit from the Treaty as promptly as possible. In addition, the recent strains on the financing sector coupled with demand for modern, environmentally friendly aircraft argue for swift action to help in these areas. Finally, while the UK has not yet ratified, many UK companies still need to comply with the Cape Town Treaty (e.g., register with the IR if they (i) buy aircraft equipment from a party located in a contracting state, or (ii) lease an aircraft from a financed lessor located in a Contracting State). In other words, aspects of compliance are already required; ratification will permit the corresponding benefit.

3.10 Do you have any other comments you would like to make?

Reply: We make following additional comments:

(i) The UK should make a set of "qualifying declarations" under the ASU. That would be as follows: (1) non-judicial remedies, C, art 54(2), (2) IDERA, P, art XIII, and (3) Alternative A (60 calendar day waiting period, implemented through legislation).

(ii) With respect to non-consensual rights and interests, the UK should align such rights with those customary in the international community. The UK "fleet lien" is seen as out-of-line with international norms, over-reaching, and potentially harmful to airlines (restricting credit) and financiers (increasing risk). The recent GKL litigation has drawn greater attention to the problem of the UK fleet lien. Thus, a tailored declaration under C, art 39 should be agreed after a policy assessment on this matter.

(iii) We note the Department's current intent to have a second consultation on the declarations to be made and the content of the implementing legislation. We think that such is not necessary, given the clarity on what is needed to ensure the benefits of the Treaty, and the consistency thereof with leading legal thought. If it is necessary, we encourage the government to undertake and complete that second step as promptly as possible.

———

Thank you for considering these comments.

Finally, as noted above, representatives of AWG would welcome the opportunity to meet with the Department to discuss these matters.

Sincerely yours,

Jeffrey Wool

Secretary General
Aviation Working Group

CC: Claude BRANDES, Co-Chairman, AWG

CC: Scott SCHERER, Co-Chairman, AWG