

Cape Town Treaty in the European context: The case for Alternative A, Article XI of the Aircraft Protocol

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Introduction. This article is a précis of a draft position paper of the Aviation Working Group ('AWG'), currently being developed. That paper will figure prominently in AWG's consultations with European governments in connection with their processes to ratify the Cape Town Convention ('Convention') modified by the Aircraft Protocol ('Protocol', with the Convention, the 'Cape Town Treaty'). As the paper is in draft form, AWG reserves its position on its form and context.

The paper supports the proposition that, in connection with their ratifications, *it is imperative the countries make a declaration selecting Alternative A of Article XI of the Protocol, remedies on insolvency, with a 'waiting period' of 60 calendar days.*¹ Without that declaration, the Cape Town Treaty will not produce the desired economic benefits.

The selection of Alternative A is justified on economic grounds. It is also in line with emerging legal thought in Europe on insolvency.

The Convention is an international instrument purpose-designed to achieve a commercial objective – to facilitate efficient forms of asset-based financing, thereby producing economic benefit, reducing financing costs to the airlines. This is achieved by reflecting the salient characteristics of asset-based financing in the Cape Town Treaty, to give providers of finance greater confidence in the decision to grant credit, enhance the credit rating of aircraft receivables and reduce borrowing costs, to the advantage of all interested parties.

The most fundamental characteristic is the ability to predictably rely, in the insolvency context, on contract and property rights relating to the aircraft equipment. The Cape Town Treaty's other key provisions include providing the creditor with effective and prompt remedies in case of default or insolvency of the debtor, and speedy interim relief pending final determination of a claim.

The insolvency options. The Cape Town Treaty offers Contracting States three options on insolvency, namely:

- To adopt, by declaration, Alternative A of Article XI of the Protocol ('Alternative A'), or
- To adopt, by declaration, Alternative B of that Article ('Alternative B'), or
- To retain national insolvency law, by making no declaration ('Existing Insolvency Law Retention').

However, only Alternative A (together with certain other declarations) will produce the desired economic benefits.

If a Contracting State adopts Alternative A or B, the cho-

sen alternative will then override otherwise applicable insolvency law.

Alternative A. Alternative A requires the insolvency administrator or debtor, by the end of the "waiting period" specified in the Contracting State's declaration, or any earlier date on which the creditor would otherwise be entitled to possession under the applicable law, either:

- (a) to give possession of the aircraft to the creditor, or
- (b) to cure all defaults (other than a default constituted by the opening of insolvency proceedings) and to agree to perform all future obligations under the agreement (the lease, loan/mortgage or conditional sale agreement).

Thus Alternative A provides both the creditor and the airline (or its insolvency administrator) with a clear timetable during which they can negotiate the return or retention of the aircraft.

As of July 15, 2007, of the 16 countries which have ratified the Convention, 14 have adopted Alternative A. One that has not, the United States, has the functional equivalent Alternative A in its insolvency law (Section 1110 of the Bankruptcy Code). Ireland made no insolvency declaration; it is hoped that they will assess the matter further.

Alternative B. Alternative B requires the insolvency administrator or debtor, as the case may be, upon the request of the creditor, to notify the creditor, within the time specified in the Contracting State's declaration, whether it will: (a) cure all defaults and perform all future obligations under the agreement and related transaction documents; or (b) give the creditor the opportunity to take possession of the aircraft, in the latter case subject to any additional step or the provision of any additional guarantee that the court may require as permitted by the applicable law.

Under Alternative B, the enforcement of remedies may depend upon a discretion exercised by the national court in accordance with applicable domestic law (which may impose a moratorium on enforcement of security upon insolvency). Alternative B is unsatisfactory to creditors because it does not impose a time limit for actual assumption of the agreement or return of the aircraft – the only time limit imposed on the airline or its insolvency administrator is to notify its initial decision.

As of July 15, 2007, no ratifying country has adopted Alternative B.

Existing insolvency law retention. In theory, a Contracting State could elect, by not making any declaration concerning insolvency, to preserve its existing national law and not pro-

vide any timetable for return or retention of the aircraft.

However, in that case the Contracting State's airlines would not reap the economic benefits of the Cape Town Treaty, since financiers would not consider the Treaty to have brought the necessary level of certainty in insolvency – which is precisely the time when a secured creditor needs to be confident of its ability to enforce its security.

Trends in insolvency law. The approach to “options” on insolvency sought to reflect legal rules and trends during the development of the Cape Town Treaty (1994-2001), as well as the diplomatic objectives of reflecting generalised conceptions of legal traditions and as an aid in reaching political agreement. AWG, together with IATA, was the major proponent of Alternative A.

Recent legal developments in Europe and elsewhere, coupled with economic considerations, convincingly support the proposition that European States should elect Alternative A, through formal declaration and/or via incorporation into national law.

Over recent years, leading legal thought on insolvency has, following a swing from ensuring pre-insolvency entitlements (*‘Entitlements Theory’*) to maximising post-insolvency benefits/flexibility for the debtor (*‘Rescue Theory’*), settled on the more nuanced approach of assessing these respective objectives in the specific context subject to insolvency rules (*‘Context Theory’*). (These are our own descriptions of the relevant theories/thinking, and other authors may use different terminology).

The Context Theory, as applied, has produced rules respecting the primacy of pre-insolvency entitlements where competing policies so justify. The clearest case to date is the Financial Collateral Directive (2002/47EC), which permits the enforcement and realisation of financial collateral notwithstanding otherwise applicable insolvency rules. The Financial Collateral Directive, like the Cape Town Treaty, deals with secured transactions.

Context Theory analysis requires an assessment of economic considerations, in light of the practical realities of aircraft financing and airline insolvency proceedings, and balanced against other interests, assessed in concrete terms. Such considerations include the following:

- 1) reducing financing costs on the basis of more accurate transaction risk pricing;
- 2) developing European capital markets and increasing the range of financing options for European airlines;
- 3) levelling the financing playing field between competing airlines, at all times in the business and liquidity cycles;
- 4) providing sensible incentives to debtors and creditors regarding their pre-insolvency and post-insolvency behaviour;
- 5) ensuring orderly and effective insolvency proceedings, producing efficient utilisation of valuable assets; and
- 6) realising a range of consequential economic benefits.

These economic considerations, collectively, argue in favour of Alternative A, particularly given (a) the procedural safeguards embodied in Article A (including the setting of a ‘waiting period’ by a Contract State to ensure a clear framework for consensual negotiations among the parties), and (b) absence of compelling counter-arguments or reasons for selecting Alternative B or Existing Insolvency Law Retention.

European examples of Context Theory: The Financial Collateral Directive. There is a trend in European law supporting the Context Theory. Application of the Context Theory would unambiguously result in the selection of Alternative A.

Although there is no EU insolvency law as such, a number of EU Directives mandate national legislatures to disapply domestic insolvency law in pursuit of EU-wide policy, often based on clearly articulated economic rationale.

The key example is Directive 2002/47/EC of June 6, 2002 on financial collateral arrangements (the *Financial Collateral Directive*). This directive is intended to contribute to the integration and cost-efficiency of the financial market, as well as to the stability of the financial system in the Community. It applies to “*financial collateral arrangements*”, which are the provision of collateral (by either title transfer or security) over cash or financial instruments, provided one of the parties is a financial institution, public authority, central bank or clearing house.

The Financial Collateral Directive requires Member States to ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider or collateral taker.

So, for example, the implementing legislation in the United Kingdom specifically disapplies, for financial collateral arrangements, those provisions of the UK Insolvency Act 1986 which restrict the enforcement of security or repossession of goods in the event of a company going into administration or moratorium. Consequently a collateral taker is free to enforce its security without obtaining the consent of the administrator or the permission of the court.

Alternative A and capital markets (EETCs). In the case of US financings that qualify for protection under Section 1110 of the US Bankruptcy Code,² rating agencies are likely to enhance the ratings awarded to capital markets securities backed by a pool of single-airline aircraft (known as *Enhanced Equipment Trust Certificates* or “EETCs”). This is on the basis that there is an enhanced prospect for full recovery following a default.

Standard and Poor's note “*Aircraft Securitization Criteria*”³ states that US financings are likely to benefit from a one- or two-notch credit rating enhancement by virtue of the protection afforded to creditors under Section 1110. Outside the US, a one notch rating upgrade is possible, but only in circumstances where access to the collateral is likely to be reasonably timely and where the prevailing legal system recognises the rights of secured creditors and lessors. These are precisely the issues that the Cape Town Treaty, anchored by Alternative A, will address. We expect future rating methodology to be refined to take these legal protections into account, thus producing a convergence between European and US ratings.

In awarding a rating to such a securitisation, the rating agency will further look to:

- (a) how well the prevailing legal system recognises the rights of creditors and lessors to repossess collateral;
- (b) how quickly can the creditors/lessors enforce those rights; and
- (c) if creditors/lessor must await resolution of insolvency proceedings, how long is that likely to take?

If any of these factors is uncertain, it may be necessary to secure backstop guarantees from a highly-rated party, which would repay the certificate-holders if the aircraft is not recovered within the defined period. It may also be necessary to secure an additional dedicated or extended liquidity facility.

In the US, where airline creditors have the benefit of Section 1110, the rating agencies have typically sized the liq-

liquidity facility for EETCs to cover **18 months** of debt service on the rated bonds, in case of airline default. This is based on the assumption that, in relatively depressed market conditions, 12 to 15 months is the minimum time necessary for the trustee to find purchasers after the trustee has taken physical possession of the aircraft (being generally three to six months after a default).

In Europe, the rating agencies have adopted a far more conservative approach when determining the size of liquidity support, largely based on the perception that insolvency regimes in certain European jurisdictions are less creditor-friendly than in the US. There have been two major European capital market aircraft-backed transactions. In one, the liquidity facility was sized to accommodate **42 months** of debt service for the rated notes. This period of time allowed for the possibility of a protracted repossession and resale period through the national courts. In the other, there were similar concerns, resulting in a liquidity facility sized to accommodate **36 months** of debt service in the case of the senior notes. The foregoing is based on publicly available information.

While we have highlighted the benefits of Alternative A in capital market transactions, the correlation between risk and cost reduction applies to all forms of asset-based financing and leasing to varying degrees and with differing characteristics. That would extend to **export credit transactions** where under the recently finalised new Aircraft Sector Understanding, all ECAs will (after the grandfathering period contained therein) offer a **uniform ‘Cape Town Discount’**.

Practicalities of insolvency proceedings. We contend that Alternative A will provide the following efficiencies:

- (a) it will provide a sound framework for consensual negotiations between the airline/insolvency officer and the secured creditors, with discipline being imposed on rationalisation of the airline’s fleet, and orderly decisions on retention or handback of given aircraft;
- (b) it will ensure an efficient administration process; and
- (c) it will ensure cost/benefit calculations by debtor/insolvency officer, which enhances the likelihood of a successful rescue.

The United States provides a very good example of airline reorganisations in an “Alternative A” legal system. Section 1110 of the US Bankruptcy Code is in similar terms to Alternative A.

The practical experience of Section 1110 in the United States has been very encouraging. Key points include the following:

- Because aircraft lessors have the comfort of an orderly timetable for retention or handback of their aircraft, there is very little tendency to take enforcement/repossession action prior to inception of a Chapter 11 procedure.
- A number of US airlines have successfully completed restructurings under Chapter 11, and they have not found Section 1110 to be an impediment to restructuring. Examples of such restructurings include Continental, Delta, Northwest, US Airways and United.

Conclusion. The full version of the AWG position paper will spell out these points out in greater detail, and contain additional considerations. Yet even a sketch of basic economic and emerging legal thought in Europe (Context Theory), together with an account of airline bankruptcies in practice, shows the overwhelming case for the selection of Alternative A.

Notes:

- 1 It is understood that, based on issues of the respective competence of the EU and its Member States, it may be necessary, desirable, or otherwise agreed that countries should effect the decision to adopt Alternative A via amendments to national law. This article will not address that topic, as its purpose is to focus on substantive considerations.
- 2 Section 1110 excludes certain types of leases from the automatic stay on proceedings under the Code and allows creditors to repossess aircraft if the debtor does not cure all defaults and resume lease rentals/debt payment within 60 days of filing for bankruptcy.
- 3 Standard & Poor’s paper titled “Structured Finance: Aircraft Securitization Criteria”, published in 1999. See page 7 “Criteria for Airline Equipment Debt”.

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