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The Cape Town Convention aircraft protocol's substantive insolvency regime: a case study of Alternative A

Donald G. Gray, Dean N. Gerber and Jeffrey Wool*

Following a brief history of insolvency law, including a summary of a provision (Section 1110) of the US Bankruptcy Code that inspired Alternative A of Article XI of the Aircraft Protocol to the Cape Town Convention, the authors outline the content, development, and intended impact of Alternative A. Section 1110 and Alternative A are then compared, as an aid to interpretation of the latter. Finally, the authors provide a case study applying Alternative A, designed to set out the intended application, interpretation, and effect of Alternative A. That case study – and such intended outcomes – underscores that the economic value of Alternative A is linked to the commercial predictability it provides, which is the main reason why courts have no discretion to modify its terms.

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1. Introduction

While addressing *lex situs* issues was a goal of the Convention on International Interests in Mobile Equipment¹ (the 'Convention' or the 'Cape Town Convention'), it was not fundamental to the treaty from an aviation perspective.² The main driver was to reduce the cost and increase the availability of financing for high value mobile equipment.³ In no area does the Cape Town Convention have a greater impact on such cost and availability of financing capital than in the context of bankruptcy, insolvency or other payment moratoria or 'stays' impacting a debtor

¹ Convention on International Interests in Mobile Equipment adopted in Cape Town, South Africa, 16 November 2001.

² Mainly as the Geneva Convention of 1948 addressed many *lex situs*-related issues in the aviation context.

³ C. Mooney, 'Insolvency Law as Credit Enhancement: Insolvency-related Provisions of the Cape Town Convention and the Aircraft Equipment Protocol' (2004) 13 Int Insol Rev 27, 28, and UNIDROIT Secretariat, 'Analysis of the Replies to the Questionnaire on an International Regulation of Aspects of Security Interests in Mobile Equipment', UNIDROIT Study LXXII, Doc. 3, Rome, April 1991, Part I, [11].

and its creditors. The insolvency provisions of the Cape Town Convention and the related protocol dealing with specific aircraft objects⁴ (the 'Aircraft Protocol' or 'Protocol') are integral to lowering the cost and increasing the availability of financing for aircraft equipment (and, indeed, with the recent capital market transactions involving, for example, Air Canada and Turkish Airlines, there is empirical evidence to such effect⁵). Leading commentators have described Article XI of the Aircraft

⁴ Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, adopted in Cape Town, South Africa, 16 November 2001.

⁵ In 2013, Fitch issued a press release in connection with Air Canada's groundbreaking enhanced equipment trust certificate ("EETC") financing which stated, as part of the rationale for the favorable transaction rating the following:

Fitch views the creditor protection provided by Convention Alternative A in Canada to be the same as the legal protection provided by Section 1110 in the US... The general insolvency regime in Canada is strong, with case law precedent from AC's 2003 CCAA filing in favor of the aircraft lessor. The Convention fortifies the existing legal framework by expanding the scope of eligible financing instruments to include leases as well as mortgages, and CSAs. Fitch views the creditor protection provided by Convention Alternative A in Canada to be the same as the legal protection provided by Section 1110 in the US... Canada has also adopted the Convention in its best possible form. As implemented, Convention Alternative A takes priority over any other inconsistent law in the country (with some limited exceptions). Furthermore, Canada has a solid standing in the international arena with a long history of honoring statutory law and treaties. Accordingly, Fitch believes that the enforceability of the Convention Alternative A will be similar to Section 1110 in the US with incrementally stronger provisions due to the requirement to maintain the aircraft and preserve its value during the initial 60-day stay period, a broader scope and a quicker deregistration process. Fitch's rating process for AC 2013-1 treated the Convention in Canada as having parity with Section 1110.

See, <http://www.businesswire.com/news/home/20150311005754/en/Fitch-Rates-Air-Canada-s-2015-1-Class-Certificates>. S&P issued the following as part of its press release for its rating of the Air Canada EETC:

Protocol as the 'single most significant provision economically' of the entire UNIDROIT project.⁶

Article XI of the Convention, which applies only if the applicable contracting state has made a declaration to that effect (and will be discussed further below), provides that, upon the occurrence of an insolvency-related event (effectively the commencement of any insolvency proceedings), the applicable insolvency administrator is given a prescribed 'waiting period' during which it must either (i) cure all defaults (and agree to perform all future obligations under the agreement giving rise to the

The pass-through certificates benefit from legal protections afforded by Article XI, Alternative A, of the Protocol to the Cape Town Convention on International Interests in Mobile Equipment, as adopted in Canada. Alternative A is similar to Section 1110 of the US Bankruptcy Code ...

See, <http://commodities-report.com/commodities-sp-assigns-air-canada-2015-2-pass-through-certs-final-rtgs.html>. Moody's issued the following as part of a press release for Turkish Airlines 2015 EETC financing:

The A2 rating of the Certificates considers the credit quality of Turkish Airlines, the importance of the Boeing B777-300ER aircraft to Turkish Airlines' network strategy, the initial equity cushion of about 35% (before priority claims) and the support of an 18-month liquidity facility. The rating also reflects the expectation that secured parties would be able to repossess the aircraft pursuant to the provisions of the Cape Town Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (together 'Cape Town') following a payment default. This is because of the way in which The Government of Turkey has implemented Cape Town in its legal system. Turkey's Cape Town declarations include Alternative A with a 60 day waiting period and the use of IDERAs (Irrevocable De-Registration and Export Request Authorizations).

See, https://www.moody's.com/research/Moodys-assigns-A2-rating-to-Turkish-Airlines-Series-2015-1-PR_320245.

⁶ Professor Sir Roy Goode, Official Commentary to the Cape Town Convention (3rd edn UNIDROIT 2013) (hereinafter 'Goode') 5.56.

Convention interest) or (ii) give possession of the aircraft object to the applicable creditor.⁷ This provision (referred to in the Convention as 'Alternative A') is central to the insolvency protections afforded by the Convention. Because the underpinnings of Alternative A (as will be shown) were inspired principally from, are very similar to (and, in some ways, were drafted to be superior to), the US Bankruptcy Code and specifically, Title 11, Section 1110 of the US Code (hereafter, 'Section 1110'), this paper will briefly summarize these provisions and the history of Section 1110. –

While driven by the above-mentioned economical objective, Alternative A raises educational and practical issues given that its concepts and approaches are significantly different from, and conflict with, prior insolvency law in most jurisdictions.⁸ Using a case study approach, this paper will consider the impact

of the Convention's insolvency provisions in a chosen civil law jurisdiction – the Province of Québec in Canada – the underlying national law insolvency regime of which is at odds with certain of the specific terms and aims of Alternative A. Using the lessons and approaches adopted in progressing a Section 1110 proceeding as guideposts, we suggest in the case study how an insolvency event involving a debtor subject to an Alternative A scenario should progress in a Cape Town Convention environment.

2. The impact of insolvency law on asset financing

To best assess how Cape Town's Alternative A insolvency regime should work in practice, one should be informed of the history and development of insolvency law over the years. The first section of this Part 2 sets forth an historical overview of insolvency laws and explains how they developed over time to achieve particular aims. The next section narrows the scope of the insolvency discussion to aircraft finance, outlining the development of Section 1110 of the US Bankruptcy Code.

2.1. Brief history of insolvency laws

Insolvency or bankruptcy, economically, occurs when an organization or an individual cannot meet its financial obligations with its creditors as its debts become due. Insolvency or bankruptcy proceedings are collective judicial or administration proceedings involving such a person or entity for purposes of reorganization or liquidation. Therefore, even though insolvency and bankruptcy both deal with the situation when liabilities exceed assets, distinctions can be made between insolvency (a *financial state*), on the one hand, and bankruptcy (*legal proceedings*), on the other. For purposes of this paper, however, the terms 'insolvency' and 'bankruptcy' are used interchangeably. When formal bankruptcy or insolvency proceedings are commenced, the objective can be (a) an orderly liquidation of the debtor and distribution of its assets to creditors (generally

⁷ Protocol, Article XI Alternative A. Although this paper will focus on the provisions of Article XI Alternative A (often referred to as the 'hard rule'), there is another option for contracting states to consider under Article XI. This other option, Alternative B, is referred to as the 'soft' or 'discretion-based' version. Unlike Alternative A, Alternative B may condition the exercise of a creditor's rights upon the availability of such rights under applicable law. In particular, the applicable law may 'permit the court to require the taking of any additional step or provision or any additional guarantee' (Protocol, Article XI, Alternative B(3)). Because of the way Alternative B is drafted, while, in many respects it seems almost identical to Alternative A, by retaining the concept of judicial discretion, which is expressly eliminated in Alternative A, it is, in fact, similar in effect to the existing law in many countries. The uncertainty created by such a discretion-based rule has made it an extreme outlier as, to date, only one contracting state (Mexico) has made the declaration to apply its terms (and Mexico is in the process of considering a change to Alternative A). All of the contracting states who are looking to achieve the main aims of the Cape Town Convention have adopted Alternative A. The text of Article XI of the Protocol is attached as Annex A hereto.

⁸ Such concepts and approaches do not raise archetypal common versus civil law type issues, as insolvency law development has, broadly speaking, been driven by other factors, such as the extent to which reorganization should be facilitated, impacts on vested, pre-insolvency rights, and lending, and business incentives.

referred to as a liquidation) or (b) an orderly restructuring of the debtor's affairs so that it may continue in business (generally referred to as a restructuring or reorganization). While the laws relating to a restructuring vary from the laws of a liquidation, the remedies under the Convention are available for both types of proceedings. As liquidation proceedings generally only have minimal effect on the ability of secured creditors to repossess assets, this paper will focus on restructuring proceedings in which the debtor wishes to maintain possession and operation of its financed assets while it seeks to successfully complete its restructuring.

Historically, insolvency laws were a repressive regime that inflicted severe punishment on debtors who failed to satisfy their outstanding debts. The failure to satisfy a debt was akin to criminal behavior, and often resulted in a loss of civil rights (in certain jurisdictions, insolvency could have resulted in similar penalties being inflicted on the debtor's family as well).⁹

As trade expanded during medieval times, however, creditors needed a better procedure to collect debts.¹⁰ With the increase in commerce, and improved transportation, many new issues arose for creditors. The pro-creditor regime in place at the time, for example, did not adequately address certain problem such as debtors fleeing to avoid collection, or a variety of intercreditor issues.

In 1570, Queen Elizabeth I of England passed the most comprehensive insolvency law up to that time.¹¹ The overarching goal of the law was to aid creditors in their collection of debts.¹² In brief, the system parallels today's liquidation process: bankruptcy commissioners seized the debtor's assets, appraised them, sold them, and then distributed the proceeds pro rata to the creditors.¹³ Even though this law

gave debtors some additional latitude compared to the previous regime, it was still very much pro-creditor in the sense of being an enforcement mechanism. Over the next two centuries, the English government occasionally amended its insolvency laws, but did not alter the fundamental approach, and the system remained an involuntary remedy that only creditors could utilize.¹⁴

In 1705, the English parliament passed the Statute of Anne,¹⁵ which 'established the roots of a more humanitarian legislative treatment of honest but unfortunate debtors.'¹⁶ Notably, the Statute of Anne allowed for the discharge of debts for a debtor who cooperated in the bankruptcy proceeding, while also granting that debtor an allowance from the bankruptcy estate.¹⁷ Nevertheless, because creditors were still the only parties that could file a bankruptcy petition, commentators agree that the focus of the Statute of Anne was still to assist creditors.¹⁸

However, by the mid-1700s, the Industrial Revolution changed society's attitudes about credit and commerce, and 'a more enlightened attitude toward bankruptcy' took hold.¹⁹ The impetus of this effect on bankruptcy law was the creation of the company and the introduction of limited liability.²⁰ There was a recognition that bankruptcy was an inevitable part of business, and that the preservation of companies in this context enhanced economic growth and investment, which culminated in the decriminalization of insolvency.²¹

What resulted was a view that bankruptcy proceedings need not always be a final measure, but rather that, in certain

⁹ Charles Jordan Tabb, 'The History of Bankruptcy Laws in the United States', 3 *Am Bankr. Inst L Rev* 5, 7 (1995) 2.

¹⁰ *ibid.*

¹¹ *ibid* 8.

¹² *ibid.*

¹³ *ibid.*

¹⁴ *ibid* 9–10.

¹⁵ 4 Anne, ch. 17 (1705).

¹⁶ Tabb 10.

¹⁷ *ibid.*

¹⁸ *ibid* 11.

¹⁹ *ibid* 11.

²⁰ Paul Omar, 'The Foundations of International Insolvency', *European Insolvency Law*, 1 (Ashgate 2004) 10.

²¹ *ibid* 11.

circumstances, the preservation of a company was a desirable end in its own right.²² By the twentieth century, numerous governments had implemented 'rescue' procedures – i.e. controlled reorganizations or restructurings which attempted to balance the interests of the company, and its employees and suppliers, with those of its creditors as a whole.²³ Key to any rescue of an insolvent company is the concept of a judicial 'stay.' A stay is a mechanism used to give a debtor reasonable time to try to restructure its affairs. Creditors are effectively stayed (prevented) from enforcing their security, to permit the debtor to retain its assets and continue operating while it works to restructure. The theory being that if, for example, an airline loses its aircraft, it loses its ability to generate revenue and continue in business. The difficulty with this process is that it can impose substantial costs on creditors (which, in turn, makes credit more costly and reduces its availability) and deprives them of vested and expected property rights. Stays may, in effect, result in aircraft collateral becoming expensive, non-financially performing, assets. The challenge for bankruptcy courts has been balancing the legitimate enforcement of a creditor's rights to repossess defaulted and non-performing assets with the 'public' interest in having a successfully restructured debtor, which would be in a position to continue to generate economic activity (and jobs) and pay its debts in the future.²⁴ In

many jurisdictions (including the US as discussed below), there is no limit on how long a stay may continue. For example, under the Companies' Creditors Arrangement Act (Canada) (the 'CCAA'), the court has the authority to stay all proceedings for any period of time that it considers necessary and appropriate in the circumstances.²⁵ While the initial automatic stay under the CCAA is for a period not exceeding 30 days, there is no limit on how long this stay may be extended or ultimately last.²⁶

As a result of this progression, insolvency laws ceased to be viewed solely as a means to *discourage* defaulting on a debt, but, rather as a means to *encourage* business investment. Taken a step further, targeting enhancements to specific provisions of insolvency law could be used to achieve societal aims. This approach is no better exemplified than in the area of aircraft finance. The capital expenditures required of airlines (and, more recently, aircraft leasing companies) to build and maintain their fleets makes them susceptible to economic downturns. Some of today's modern commercial wide-body aircraft can cost in excess of \$US200 million. Aircraft engines can cost in excess of \$US30 million dollars each. Airlines, leasing companies, and other users of aircraft, even well-established ones, cannot afford to own all of their aircraft outright (unleveraged). Given the large amount of money involved, and an industry susceptibility to bankruptcy, financiers have long demanded special protection for their investment. Without this protection, financial institutions or aircraft manufacturers would be unwilling to provide financing for aircraft to new or troubled airlines, leasing companies, or other users, or would do so only under terms far less favorable

²² *ibid* 13.

²³ *ibid* 12.

²⁴ For a take on the trend, over time, in insolvency law development, see Jeffrey Wool and Andrew Littlejohns 'Cape Town Treaty in the European Context: The Case for Alternative A, Article XI of the Aircraft Protocol' [Airfinance Journal]. Wool and Littlejohns suggest that insolvency laws, while initially focusing on ensuring pre-insolvency entitlements, thereafter swung to maximizing post-insolvency benefits/flexibility and have since settled on what the authors refer to as the 'Context Theory' which constitutes a nuanced approach of balancing these respective objectives in a specific context thereby requiring an assessment of economic considerations, in light of practical realities, as balanced against other interests. Indeed,

they suggest that such considerations, collectively, argue in favor of Alternative A as the proper declaration to be made by contracting states under the Convention.

²⁵ Companies' Creditors Arrangement Act (RSC, 1985, c. C-36) ss. 11 and 11.02(2).

²⁶ For example, the stay during Air Canada's CCAA proceedings commenced in 2003, was extended several times, and lasted for approximately 18 months.

to the borrower. It is in this context that we will now explore the terms and background of Section 1110 of the US Bankruptcy Code and, later, Alternative A of the Cape Town Convention.

2.2. Section 1110 of the US Bankruptcy Code

Consistent with the discussion above, when a debtor files a petition for relief under chapter 11 of the US Bankruptcy Code²⁷ (reorganization), an automatic stay takes effect that prevents a creditor from exercising remedies against the property of the debtor without the consent of the applicable bankruptcy court.²⁸ The automatic stay (i) precludes a creditor from exercising any remedies to recover any cash flows – such as principal, interest, or rent – due under a financing document, and (ii) prohibits the creditor from repossessing the collateral. The stay allows the debtor to keep its assets while it reorganizes and was designed to carry out the US Bankruptcy Code's policy of avoiding the disorderly, piece-meal removal of the debtor's estate by its creditors. For airline debtors, however, chapter 11 creates a special rule (which counters, somewhat, the 'rescue' theory) whereby the automatic stay is limited. Section 1110 is the primary statutory provision distinguishing airline reorganizations from other types of general chapter 11 reorganizations within the US.²⁹

²⁷ 11 USC Section 101, *et seq.*

²⁸ For a good discussion on the application of the United States Bankruptcy Code to airline bankruptcies, see Michael J. Edelman and Douglas J. Lipke, 'Chapter 11 Cases Involving Airlines' Collier Guide to Chapter 11 at 24–27 (LexisNexis 2010).

²⁹ *ibid* 24–26. It is important to note that Section 1110 is not limited to Chapter 11 proceedings involving airline debtors. By its terms, Section 1110 would also apply in the context of a vessel documented under Chapter 121 of Title 46 of the United States Code in connection with a financing by a water carrier that, at the time such transaction is entered into, holds a certificate of public convenience and necessity or permit issued by the United States Department of Transportation (11 USC, §1110). However, the drafting of Section 1110 includes a prerequisite to its application that the debtor be a water carrier who holds 'a certificate

The nineteenth-century railroad industry laid the foundation for the development of Section 1110. Railroads share two important characteristics with airlines: (i) railroads require expensive equipment to operate, which usually must be financed, and (ii) railroads are susceptible to bankruptcies. In 1935, in response to a variety of railroad bankruptcies, the US Congress added Section 77(j) to the Bankruptcy Act of 1898.³⁰ By allowing the owner of conditionally sold or leased rolling stock equipment to take possession of the collateral despite the commencement of a reorganization case, Section 77(j) limited the ability of a bankruptcy court to exercise its equitable powers.³¹ Identical protections were later added to the Bankruptcy Act for owners of aircraft equipment in 1957,³² and owners of marine equipment in 1968.³³ In 1978, the US Congress adopted a new federal Bankruptcy Code³⁴, which included Section 1110, which generally preserved the special

of public convenience and necessity or permit issued by the Department of Transportation.' This is problematic in that certificates of public convenience and necessity have never been issued to water carriers and in any event those certificates are currently issued by the Surface Transportation Board and not the Department of Transportation. As such, there are no examples of actual utilization of Section 1110 in the context of a vessel financing. There is, however, another provision of the Bankruptcy Code which provides 1110-like protections in the context of bankruptcy proceedings involving US railroads. (11 USC, §1168). Section 1168 is very similar to Section 1110 and covers rolling stock equipment which is leased or conditional sold to, or subject to a security interest granted by, a US railroad (the requirement for a US railroad debtor is not specifically set out in Section 1168 but is inferred by virtue of the fact that Section 1168 is housed in the US Bankruptcy Code subchapter IV which deals exclusively with US railroad reorganizations).

³⁰ Act of 27 Aug 1935, 49 Stat. 911 (repealed 1978).

³¹ Bankruptcy Act §77(j), 11 USC 205(j) (1934) (repealed 1978).

³² Act of 4 Sept 1957, Pub L No 85-295, 71 Stat 617 (repealed 1978).

³³ Act of 17 Oct 1968, Pub L No 90-586, 82 Stat 1149 (repealed 1978).

³⁴ 11 USC Section 101, *et seq.* (referred to herein as the 'US Bankruptcy Code').

protections previously afforded to aircraft financiers under the Bankruptcy Act.

The prevailing view is that Section 1110 was created, and continues to survive, for a variety of reasons including: (i) the perceived macro-economic significance of the aviation industry, (ii) the high cost of aircraft (which suggests the need for external financing), (iii) the particular susceptibility of airlines to bankruptcy, (iv) the mobility of aircraft, and (v) the quickly depreciating nature of aircraft (particularly when left unused or not maintained to specific maintenance standards for any extended period of time). In its simplest terms, Section 1110 creates an exemption from the automatic stay generally afforded to chapter 11 debtors. Instead, an airline debtor is forced, within 60 days of filing its bankruptcy petition, to either cure all defaults under its financing documents or risk repossession of the aircraft by the creditor.³⁵ In addition to

curing its defaults, however, the airline debtor must also 'agree to perform all obligations of the debtor' under the financing agreement.³⁶ Absent such an agreement by a debtor to perform all its obligations and a cure of

³⁵ 11 USC Section 1110 provides as follows:

- (a) (1) Except as provided in paragraph (2) and subject to subsection (b), the right of a secured party with a security interest in equipment described in paragraph (3), or of a lessor or conditional vendor of such equipment, to take possession of such equipment in compliance with a security agreement, lease, or conditional sale contract, and to enforce any of its other rights or remedies, under such security agreement, lease, or conditional sale contract, to sell, lease, or otherwise retain or dispose of such equipment, is not limited or otherwise affected by any other provision of this title or by any power of the court.
- (2) The right to take possession and to enforce the other rights and remedies described in paragraph (1) shall be subject to section 362 if—
 - (A) before the date that is 60 days after the date of the order for relief under this chapter, the trustee, subject to the approval of the court, agrees to perform all obligations of the debtor under such security
 - (B) any default, other than a default of a kind specified in section 365(b)(2), under such security agreement, lease, or conditional sale contract—

- (i) that occurs before the date of the order is cured before the expiration of such 60-day period;
- (ii) that occurs after the date of the order and before the expiration of such 60-day period is cured before the later of—
 - (I) the date that is 30 days after the date of the default; or
 - (II) the expiration of such 60-day period; and
- (iii) that occurs on or after the expiration of such 60-day period is cured in compliance with the terms of such security agreement, lease, or conditional sale contract, if a cure is permitted under that agreement, lease or contract.

- (3) The equipment described in this paragraph:
 - (A) is (i) an aircraft, aircraft engine, propeller, appliance, or spare part (as defined in section 40102 of title 49) that is subject to a security interest granted by, leased to, or conditionally sold to a debtor that, at the time such transaction is entered into, holds an air carrier operating certificate issued pursuant to chapter 447 of title 49 for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo; or (ii) a vessel documented under chapter 121 of title 46 that is subject to a security interest granted by, leased to, or conditionally sold to a debtor that is a water carrier that, at the time such transaction is entered into, holds a certificate of public convenience and necessity or permit issued by the Department of Transportation; and
 - (B) includes all records and documents relating to such equipment that are required, under the terms of the security agreement, lease, or conditional sale contract, to be surrendered or returned by the debtor in connection with the surrender or return of such equipment.

outstanding defaults, Section 1110 provides that a creditor's right 'to take possession ... and to enforce any of its other rights and remedies ... is not limited or otherwise affected by any other provision of [the Bankruptcy Code] or by any power of the court,'³⁷ including

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- (4) Paragraph (1) applies to a secured party, lessor, or conditional vendor acting in its own behalf or acting as trustee or otherwise in behalf of another party.
 - (b) The trustee and the secured party, lessor, or conditional vendor whose right to take possession is protected under subsection (a) may agree, subject to the approval of the court, to extend the 60-day period specified in subsection (a)(1).
 - (c)
 - (1) In any case under this chapter, the trustee shall immediately surrender and return to a secured party, lessor, or conditional vendor, described in subsection (a)(1), equipment described in subsection (a)(3), if at any time after the date of the order for relief under this chapter such secured party, lessor, or conditional vendor is entitled pursuant to subsection (a)(1) to take possession of such equipment and makes a written demand for such possession to the trustee.
 - (2) At such time as the trustee is required under paragraph (1) to surrender and return equipment described in subsection (a)(3) any lease of such equipment, and any security agreement or conditional sale contract relating to such equipment, if such security agreement or conditional sale contract is an executory contract, shall be deemed rejected.
 - (d) With respect to equipment first placed in service on or before October 22, 1994, for purposes of this section—
 - (1) the term 'lease' includes any written agreement with respect to which the lessor and the debtor, as lessee, have expressed in the agreement or in a substantially contemporaneous writing that the agreement is to be treated as a lease for Federal income tax purposes; and
 - (2) the term 'security interest' means a purchase-money equipment security interest.

11 USC section 1110.

³⁶ 11 USC §1110(a)(2)(A).

³⁷ 11 USC §1110(a)(1).

the automatic stay provisions which typically preclude a secured creditor or lessor from repossessing its equipment in the absence of judicial relief. As such, an eligible creditor can require immediate return of an aircraft under the applicable financing documentation – notwithstanding any other provision of the Bankruptcy Code – upon written demand.³⁸ Section 1110 also supersedes the airline debtor's right to use, sell or lease the equipment under any of the other applicable provisions of the Bankruptcy Code, such as Section 363.³⁹ Section 1110 further provides that, following any cure and agreement to perform,⁴⁰ the airline debtor must cure any subsequent default that occurs within the first 60 days of the bankruptcy proceeding by the later of such 60th day or 30 days after the default. Thereafter, the debtor must cure all defaults in accordance with the parties' agreement (assuming the parties' agreement permits cure).⁴¹

Whether an airline creditor qualifies for Section 1110 protection depends upon four key factors: (i) the type of

³⁸ *ibid* section 1110(c)(1).

³⁹ Eidelman and Lipke 24–27. Section 363 of the US Bankruptcy Code allows for unwinding complicated financial structures. Under that section, the bankruptcy court can sell assets free and clear of any interest, including secured lien creditors. A section 363 sale is not only effective for the debtor, providing the quick sale of the property without resolving competing interests in the property as a condition of the sale, but also advantageous for the buyer providing protection from successor liability. While secured creditors have certain rights with respect to any such sale, absent the protections afforded by Section 1110, Section 363 sales would allow a debtor greater flexibility to deal with Section 1110-eligible assets.

⁴⁰ While the legislative history clearly indicates that an airline debtor, in order to satisfy the requirement of Section 1110, is not required to assume the applicable executory contract or unexpired lease under Section 1110, it is equally clear that an agreement by the debtor to perform all of its obligations by virtue of having made the election in Section 1110(a) amounts to a post-petition agreement under which the debtor agrees to meet the obligations coming due under such existing executory contract or unexpired lease. See *In re Airlift Int'l*, 761 F.2d 1503 (1985).

⁴¹ 11 USC §1110(a)(2)(B).

equipment⁴², (ii) the type of financier, (iii) the remedies provided under the transaction documents, and (iv) the type of debtor. Each of these factors is discussed further below as part of the comparison with the insolvency provisions of the Convention.

The benefits of Section 1110 are available to (i) a secured party with a security interest in the qualifying equipment described above, or (ii) a lessor or conditional vendor of such equipment.⁴³ For all intents and purposes, Section 1110 would cover those financing arrangements customarily utilized by US airlines in connection with their fleets.

Where each of the foregoing requirements for coverage under Section 1110 is met, Section 1110 creditors are provided with strong legal rights. In these circumstances, neither the bankruptcy court nor any other provision of the Bankruptcy Code enables an airline-debtor to limit or affect a Section 1110 creditor's ability to exercise remedies over the aircraft equipment. Section 1110 has played a pivotal role in the expansion of available financing resources for US airlines in order to allow them to grow their fleets. Moreover, due to the large number of US airline bankruptcies occurring since the adoption of Section 1110⁴⁴, the financial markets, rating agencies, airlines and

other interested parties have become aligned in their approach and expectations in associated bankruptcy proceedings.

3. The content, development and impact of Cape Town's Alternative A

3.1. The development of Alternative A

Early in the developmental stages of the Cape Town Convention, the nascent Aviation Working Group ('AWG')⁴⁵, which played a pivotal role in developing and finalizing the Convention, by virtue of the composition of the AWG and their vast experience in the aviation finance markets, recognized that addressing international security/leasing issues in a positive way would result in an increase in the availability of credit, and/or a reduction in the cost of such credit, to owners/operators of aircraft equipment. They assessed that tightly framed legal rules could facilitate the extension of asset-based credit, particularly by ensuring that the basic commercially oriented, and contractually agreed, rights of asset-based financiers and lessors are respected. At a minimum, they argued, this required providing financiers/lessors with prompt access to assets on default, and the ability to convert such assets to proceeds to satisfy contractual obligations. Since existing national legal systems varied widely on the degree to which they could achieve these objectives, the Convention provided a vehicle to establish a more uniform set of rules in order to maximize the facilitation of such credit. Core to the AWG's analysis was the inclusion in the Convention of a provision (which ultimately became 'Alternative A') designed to address rights in an asset in the context of bankruptcy and insolvency (and this provision was generally considered critical to the success of the Convention).

⁴² For equipment granted as collateral under the security agreement and first placed in service prior to 22 October 1994 (the 'Effective Date'), a slightly different set of rules of apply (effectively, the security interest arising thereunder must qualify as a 'purchase money equipment security interest') (11 USC §1110(d)(2)). For purposes of this article and the discussion regarding Section 1110, the authors assume that the equipment is first placed in service after the Effective Date.

⁴³ 11 USC §1110(a)(1). In general, the characterization of whether a transaction, as discussed below, would fall into one of the specific categories of transactions will be determined by the substance of such transaction and not the form.

⁴⁴ According to Airlines for America (an advocacy group representing US airlines), there have been well over 100 airline bankruptcies in the US since 1978, and, while many involved chapter 7 liquidations, the majority of these cases were restructured under chapter 11. See <http://airlines.org/data/u-s-bankruptcies-and-services-cessations/>.

⁴⁵ The AWG, organized at UNIDROIT's request by Airbus and Boeing, has grown considerably over time. It now includes most of the world's leading aircraft and engine manufacturers, financiers, and lessors (see www.awg.aero).

The insolvency rules were initially intended to be mandatory parts of the treaty. The AWG⁴⁶ concluded, however, that optionality would be required in order to obtain widespread acceptance of the treaty in various legal systems. Hence the ability of contracting states to select Alternative A, Alternative B or the status quo in those states.

Alternative A was specifically drafted with view to preserving all of the best parts of Section 1110, while simplifying it and amending the problematic provisions, particularly Section 1110's debtor restriction (i.e., limited to air carriers). The intent was to develop an efficient and enhanced version of Section 1110.

While the AWG did not make specific reference to Section 1110 when recommending its international insolvency provisions for inclusion in the Convention, the fundamental underpinnings of such proposed provisions were inspired by the terms and conditions of Section 1110.⁴⁷ And for good reason. US airlines had long benefited from having Section 1110 apply to their transactions, and its availability constituted a critical element of the more favorable pricing they achieved on their financings. Since the enactment of Section 1110, empirical evidence of the impact of its terms, including the rating of bonds secured by aircraft, further bolstered the case for its retention. The AWG drew on this evidence to make the case for the inclusion of its robust insolvency provisions in the draft Convention.

⁴⁶ Two of the authors of this article (Messrs Wool and Gray) were heavily involved in the drafting, negotiation and finalization of the Convention's insolvency provisions, the former as representative of AWG, and the latter as a member of the Canadian delegation.

⁴⁷ See Anthony Saunders et al, 'The Economic Implications of International Secured Transactions Law Reform: A Case Study', 20 U Pa J Int'l Econ L 309, 327 (1999); Jeffery Wool, *The Case for a Commercial Orientation to the Proposed UNIDROIT Convention as Applied to Aircraft Equipment*, 31 Law & Pol'y Int'l Bus. 79, 92 (1999) (noting that international credit rating agencies grant a rating enhancement of two notches to secured debt of airlines which is protected by Section 1110).

3.2. *Economic impact of Alternative A*

To further support the underlying premises of the Convention (and, in particular, the international insolvency provisions), a study was commissioned to determine what cost-savings benefits, and external debt-level reduction benefits, would be achieved by countries ratifying the Cape Town Convention.⁴⁸ The study stated that the treatment of a financier or lessor in the context of bankruptcy or insolvency proceedings (or their functional equivalent) is the 'litmus test of an asset-based financing.'⁴⁹ The assessment went on to suggest that the optional convention rule being promoted (namely, Alternative A) will assist in 'internationalizing the types of financing benefits and alternatives available to US airlines under Section 1110.'⁵⁰ The assessment's conclusions were not surprising – the Convention would achieve significant economic gains (estimated at several billion US dollars on an annual basis), principally by reducing risk associated with these transaction types, thereby increasing the availability and reducing the cost of aviation credit.

3.3. *Alternative A provisions and their effect*

Alternative A, which applies only where contracting state, which is the 'primary insolvency jurisdiction' of the debtor (as discussed below), has made the applicable declaration, requires the debtor (or the insolvency administrator⁵¹),

⁴⁸ Anthony Saunders and Ingo Walter 'Economic Impact Assessment: A Study Prepared Under the Auspices of INSEAD and the New York University Salomon Center', September, 1998 (a copy of this paper can be found on the Cape Town Academic Project Website at www.ctcap.org).

⁴⁹ *ibid* 12.

⁵⁰ *ibid* 13.

⁵¹ There must be one party responsible for complying with Alternative A. Part II to Annotation 4 to the Official Commentary ('Annotation 4'), attached as Annex B hereto, gives guidance on that topic: It reads as follows –

In the case that the insolvency-related event has arisen under Article I(2)(m)(i) of the Protocol (insolvency proceedings), the responsible party is (i) the

by the end of the waiting period specified in the applicable declaration (typically 30 to 60 days) either (a) to give possession of the aircraft object to the creditor, or (b) to cure all defaults (other than a default constituted by the commencement of the insolvency proceedings). Until the creditor is given the opportunity to take possession of an aircraft object, the debtor must preserve its value, and maintain it in accordance with the terms of the agreement constituting the underlying international interest.⁵² The creditor is also entitled to apply for any other forms of interim relief available under applicable law. This provision restricts the operation of the relevant insolvency law by precluding any order or action that prevents or delays the exercise of remedies after expiry of the waiting period, or would modify the obligations of the debtor without the creditor's consent.

4. The key differences between Alternative A and Section 1110

Alternative A and Section 1110 are similar in their most important respects in that they each ensure that, in the event of insolvency type proceedings by or against an airline, to which, pursuant to applicable law, its terms apply, the debtor/lessee would be required either to cure all defaults within a specified limited time (and continue to perform its contractual obligations), or to return the aircraft equipment to the financier/lessor, and that the material rights of the financier/lessor would not otherwise be prejudiced in such insolvency proceedings. There are, however, certain key differences between them.⁵³

“insolvency administrator”, as defined in Article 1(k) of the Convention, which may be the “debtor in possession”, applying the debtor in possession criteria below, where an insolvency administrator exists, and (ii) the debtor as such, where no such insolvency administrator exists. Thus, if an insolvency administrator exists, it is the responsible party, and if an insolvency administrator does not exist, the debtor is the responsible party.

⁵² Protocol, Article XI(5).

4.1. Type of equipment

The initial step in any analysis of the applicability of either Section 1110 or Alternative A is to determine whether the specific equipment (which is the subject of the interest running to the benefit of a creditor) qualifies for coverage. In this regard, Section 1110 and Alternative A cover roughly the same ground. The coverage for Alternative A (as one would expect) is limited to aircraft objects themselves (namely, airframes, engines, and helicopters meeting the minimum standards set out in the Protocol – more or less the minimum size for most commonly used commercial aircraft⁵⁴). Section 1110 has a slightly wider coverage, and provides that the benefits afforded thereunder are available in respect of certain qualifying ‘equipment,’ which includes airframes, engines, propellers, appliances, and spare parts (each as defined in the Federal Aviation Act).⁵⁵

More important is the coverage under the applicable provisions for maintenance records. Retrieving maintenance records in the context of the exercise of remedies is critically important to the successful remarketing of aircraft equipment. Section 1110 adopts the approach that the covered ‘equipment’ includes all records and documents relating to such equipment which are required pursuant to the applicable financing documentation to be surrendered or returned by the debtor in connection with the surrender or return of such equipment.⁵⁶ As such, if the equipment is covered under Section 1110, the applicable creditor would be entitled to return of maintenance records (in connection with the required return of the equipment) to the extent that underlying documentation would so mandate the return of such records at such time. Alternative A adopts a slightly different approach. The Convention defines each of the various aircraft objects (airframes, engines,

⁵³ A chart comparing Alternative A to Section 1110 is set out as Annex C to this article.

⁵⁴ Protocol, Article I, Section 2.

⁵⁵ 11 USC §1110(a)(3)(A)(i).

⁵⁶ 11 USC §1110(a)(3)(B).

and helicopters) to include 'all data, manuals and records relating thereto.'⁵⁷ It does not delineate those records which are and are not required to be returned in the context of the exercise of remedies pursuant to the underlying financing documents, but rather simply requires that all data, manuals, and records be returned. This is a significant distinction, since manuals and records play such a vital role in the remarketing process. The ability to obtain a fulsome set of records following repossession of any aircraft equipment (without having to negotiate which records may or may not be covered by the underlying documentation) materially enhances a creditor's ability to recover the value of its collateral.

4.2. *Type of debtor*

In order for Section 1110 benefits to be made available to a financier, the debtor must, at the time the transaction was entered into, possess an air carrier operating certificate issued pursuant to Chapter 447 of title 49 of the US Code for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo.⁵⁸ Because such operating certificates may only be issued to citizens of the US, Section 1110 applies only in the context of Chapter 11 proceedings involving US certificated air carriers (effectively US airlines and

US freight operators). Foreign air carriers given authority to operate in the US would not qualify for Section 1110 protection as air carrier operating certificates issued under Chapter 447 of title 49 can only be issued to citizens of the US.⁵⁹ Accordingly, Section 1110 does not apply to non-US certificated carriers. Nor does Section 1110 apply to aircraft equipment leasing companies or holding companies that are not US certificated air carriers. This limitation is significant in that Section 1110 benefits effectively are only provided in the case where a US airline is a direct debtor under a lease or secured loan. In the case of structured financings, whereby multiple layers/parties could possibly play a role (including, potentially, leasing companies and/or special purpose vehicles), Section 1110 would only apply in such structures with respect to a bankruptcy proceeding where a certificated airline is the debtor (and in such case only creditors holding rights in contracts constituting a lease or secured loan to such airline would have the benefits afforded by the statute).

Alternative A adopts a much more inclusive approach. Alternative A could apply in respect of an international interest involving any debtor (and not just certificated airlines) which may be the subject of an insolvency-related event. Further, Alternative A would apply in any insolvency proceeding occurring in any Cape Town Convention contracting state where the debtor's 'primary insolvency jurisdiction' has made the applicable declaration adopting the provision. This approach not only broadens the scope of Alternative A to any debtor, but also gives the application of the protections afforded by Alternative A extra-territorial effect. The phrase 'primary insolvency jurisdiction' is defined in the Protocol to mean:

[T]he Contracting State in which the centre of the debtor's main interests is situated, which for this purpose shall be deemed to be the place of the debtor's statutory seat or, if there is none, the

⁵⁷ Protocol, Sections 2(b), 2(e), and 2(l).

⁵⁸ 11 USC §1110(a)(3)(A)(i). 49 USC §44701(b) and §44705 set out the general requirements for air carrier certification in the US, ensuring that the entities deserving of the certificate are 'properly and adequately' equipped and are 'able to operate' passenger and/or cargo aircraft. Beyond these vague minimum statutory standards, the Administrator of the FAA may further specify the qualifications for the air carrier operating certificate as he sees fit to further the many policy objectives outlined in the statute and, as such, the FAA established specific standards that would allow the issuance of an air carrier operating certificate, which signifies an entity's ability to operate aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo. The applicable equipment at issue in a Section 1110 proceeding need not meet the above threshold in order to benefit from coverage under the statute so long as the applicable air carrier is so qualified to operate equipment meeting such threshold.

⁵⁹ 49 USC §40102(a).

place where the debtor is incorporated or formed, unless proved otherwise.⁶⁰

4.3. Type of proceeding

Section 1110 is applicable only for air-carrier debtors that are the subject of cases under Chapter 11 of the US Bankruptcy Code⁶¹, which involve a reorganization of a debtor's business affairs and assets. Accordingly, in cases involving Chapter 7 (liquidation) of the US Bankruptcy Code,⁶² there are no special protections afforded to Section 1110 creditors (presumably because in liquidation proceedings

the effective stays affecting secured creditors terminate relatively quickly). For cases at risk of conversion to a Chapter 7 liquidation or dismissal, a creditor seeking to enforce its rights under Section 1110 should take action expeditiously. Courts have specifically denied Section 1110 protections where a party so protected failed to assert its Section 1110 rights prior to the conversion of a case to a Chapter 7 liquidation.⁶³

Alternative A, on the other hand, applies (assuming the contracting state that is the primary insolvency jurisdiction has made the applicable declaration) upon the occurrence of an insolvency-related event. For purposes of the Convention, the Protocol defines 'insolvency-related event' as follows:

- i the commencement of the insolvency proceedings; or
- ii the declared intention to suspend or actual suspension of payments by the debtor where the creditor's right to institute insolvency proceedings against the debtor or to exercise remedies under the Convention is prevented or suspended by law or State action.⁶⁴

Clause (i) of the definition is the more traditional formulation, which ties the insolvency-related event to the commencement of insolvency or bankruptcy proceedings. The Convention defines 'insolvency proceeding' broadly to include 'bankruptcy, liquidation or other collective judicial or administrative proceedings ... in which the assets and affairs of the debtor are subject to control or supervision by a court for the purposes of reorganization or liquidation.'⁶⁵ Unlike a Section 1110 scenario, which is specifically confined to the Chapter 11 setting in the US, Alternative A is designed to apply in any insolvency-related event occurring in any contracting state involving a debtor

⁶⁰ Protocol, Section 2(n). A detailed discussion of the concept of a primary insolvency jurisdiction is outside the scope of this paper. It should be noted, however, that the concept was inspired from the 'COMI' (or 'centre of main interest') notion in European law. While European jurisprudence relating to the COMI will likely be taken into account by courts in Convention contracting states, the concept of primary insolvency jurisdiction is *sui generis*. The issue of the proper location for insolvency proceedings for an aviation debtor was recently considered in the CHC Group bankruptcy proceedings in the US and Canada. The CHC Group started as a Canadian company (Canadian Helicopters), and its headquarters recently moved to Texas, but many operations continued to be based in Canada. The CHC Group has more than 200 aircraft, based all around the world. While the CHC Group filed for relief under Chapter 11 of the Bankruptcy Code in the US, some creditors argued that the proper jurisdiction for such proceedings was in Canada. The issue was litigated before a court in British Columbia when Canadian recognition proceedings were brought by CHC. In that case, it was determined that the COMI was located in the US. As it related to the CHC Group's Canadian fleet, it appeared that the Convention was not applicable, as the relevant aircraft in Canada were financed before the Convention came into force in Canada. As such, a Convention 'primary insolvency jurisdiction' ('PIJ') review was not conducted. In general, the analysis under COMI should produce a similar result to an analysis conducted to determine the PIJ under the Convention. A conflict between the COMI test and the PIJ test could arise, however, where the corporate seat is located in a different jurisdiction to where administrative decisions are made which, at least to a limited extent, is the case with the CHC Group.

⁶¹ 11 USC §§1101 *et seq.*

⁶² 11 USC §§701 *et seq.*

⁶³ See *Ozark Air Lines, Inc. v. Public Bldg. Comm'n of St Clair County*, 2007 WL 43742 (Bankr. N.D. Okla. 4 Jan. 2007).

⁶⁴ Protocol, Article 1(n).

⁶⁵ Convention, 1(d).

(assuming the debtor's primary insolvency jurisdiction has made the requisite declaration). But the Convention goes further. Clause (ii) of the definition of 'insolvency-related event' above has a two-fold purpose.⁶⁶ The first is to provide a trigger in those instances where a debtor may not be eligible for insolvency proceedings.⁶⁷ This situation may arise in connection with state-controlled airlines that might not be subject to ordinary insolvency proceedings. The second relates to a scenario whereby a debtor is facing serious financial hardship and the applicable state (either through affirmative action or law) prevents applicability of the remedies under the Convention. The broad scope of insolvency-related events provides creditors in those instances greater assurances that their interests will be properly protected and subject to the beneficial regime provided by Alternative A.

4.4. *Type of interest*

With regard to the types of interests covered under Section 1110 and Alternative A, respectively, there is, again, a fair amount of overlap. As discussed above, Section 1110 covers a secured party with a security interest in, or a lessor or conditional vendor of, qualifying equipment.⁶⁸ While Section 1110 does provide a safe-harbour in respect of certain

⁶⁶ Part I to Annotation 4 provides more detail on this concept. It reads as follows:

An insolvency-related event occurs under Article I (2)(m)(ii) of the Protocol on the date when two conditions have been met: (1) the debtor has suspended payments to a creditor or declared its intention to do so, and (2) a law has been enacted or state action occurs that prevents or suspends the rights of such creditor to initiate insolvency proceedings against the debtor or exercise remedies under the Convention and Protocol. A declaration of intention to suspend payments is implicit in a statement by a debtor that it is unable to make payments to its creditors or that it intends to pay its creditors less than it is contractually obligated to pay.⁷

⁶⁷ Goode 5.14.

⁶⁸ For equipment first placed in service prior to 11 October 1994, in order for a security interest to qualify for Section 1110 coverage, it must constitute a

leases,⁶⁹ for the most part it does not seek to provide any specific guidance as to what agreement would qualify for coverage. Any issues regarding characterization of an agreement for the purposes of Section 1110 have, by virtue of certain amendments made to Section 1110 over the years, been removed, and therefore any controversy over whether a particular agreement is a lease, conditional sale agreement or security agreement is irrelevant as all three types of agreements are covered under the statute.⁷⁰ So a security agreement would likely be considered a security agreement for purposes of Section 1110 regardless of the form of the document, so long as it had the same substantive effect under applicable national law.⁷¹ Alternative A is predicated on the assumption that the applicable creditor has the benefit of an 'international interest.' As such, and in order to obtain the benefit of Alternative A, a creditor must be a secured party under a security agreement, a conditional seller under a title reservation agreement or a lessor under a leasing agreement otherwise meeting the requirements of the Convention. Article 7 requires that the agreement

- (a) is in writing, (b) relates to an object of which the chargor, conditional seller or lessor has power to dispose; (c) enables the object to be identified in conformity with the Protocol; and (d) in the case of a security agreement, enables the secured obligations to be determined, but without the need to state a sum or maximum sum secured.⁷²

Unlike Section 1110, the Convention provides specific guidance as to what agreements are

'purchase-money equipment security interest.' See note 47 *infra*.

⁶⁹ 11 USC Section 1110(d)(1).

⁷⁰ Glenn S. Gerstell and Kathryn Hoff-Patrinis, *Aviation Financing Problems Under Section 1110 of the Bankruptcy Code*, 61 Am Bankr LJ 1, 171 (1987).

⁷¹ Since Section 1110 issues are practically confined to the US, it would be unusual to find financing documentation utilized in an aircraft financing which take a form different from a traditional security agreement or lease; Convention, Articles 2(2) and 7.

⁷² Convention, Articles 2(2) and 7.

covered as international interests – and has specific definitions of each. This is intentional, given that many legal systems do not fully recognize such interests, and so it was felt that the creation of a *sui generis* interest, based solely upon the requirements set out the Convention itself and without regard to national law, was important and would be better-suited to achieve the goals of the Convention. As such, the question as to whether an interest falls within the Convention is to be determined by the Convention itself.⁷³

4.5. Registration/recording requirements

One other area where Section 1110 and Alternative A differ is in respect of the requirement to protect the applicable interest (which is the subject of the exercise of rights) via compliance with filing and/or recordation requirements. In respect of Section 1110, the case law of the statute makes clear that a secured party/lessor has a right to take possession of the applicable equipment pursuant to its agreement with the debtor, and that this right was not limited or affected by any other provision of the US Bankruptcy Code (including any section of the Code which would limit or restrict the exercise of remedies by virtue of the failure of the secured party or lessor to properly record its interest with the FAA or otherwise perfect its right) or by any power of the court.⁷⁴ So long as the applicable conditions set out in Section 1110 are satisfied, a creditor would be entitled to avail itself of the protections provided therein, even if it neglected to take proper steps to protect and perfect its interest.

Alternative A adopts a different approach. Under the Convention, an international interest is effective (i.e., it would be recognized as proprietary in nature and rank ahead of the claims of unsecured creditors) in the insolvency

proceedings of a debtor if it was registered in the International Registry prior to the commencement of those proceedings⁷⁵ or if it was otherwise effective under applicable law.⁷⁶ As Alternative A presupposes that the applicable creditor holds an international interest, it would be incumbent on the creditor then to demonstrate that it satisfied either of the two foregoing tests (which practically would be that the proper registration of the applicable international interest had been made with the International Registry).

4.6. Rights/remedies during and after waiting/stay period

As mentioned above, during a Chapter 11 proceeding, the automatic stay provided under Section 362 of the US Bankruptcy Code⁷⁷ prevents a creditor from exercising virtually any action that might have any direct or indirect effect on property within the debtor's estate. Notwithstanding this statutory injunction, Section 1110 expressly empowers financiers possessing the benefit of its protections to remove the covered equipment from the debtor's estate in accordance with the applicable lease, security agreement, or conditional sale agreement (unless, as discussed above, within the specified 60-day period the debtor cures⁷⁸ all defaults thereunder and agrees to perform all obligations going forward). Section 1110 does not mandate what steps a debtor need take in the event that it fails to

⁷⁵ Convention, Article 30(1).

⁷⁶ Convention, Article 30(2).

⁷⁷ 11 USC §362.

⁷⁸ The obligation under Section 1110 to cure a default excludes the so-called '*ipso facto* defaults' under Section 365(b)(2) of the US Bankruptcy Code, which are defaults triggered by, *inter alia*, (i) the bankruptcy filing, (ii) the financial condition of the debtor, or (iii) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations. See 11 USC §365(b)(2). It should be noted that these *ipso facto* defaults are a broader category of defaults that need not be cured than the defaults which need not be cured in an Alternative A context (which is limited to the opening of insolvency proceedings).

⁷³ Goode 2.51.

⁷⁴ *Vanguard Airlines, Inc. v. Int'l Aero Components, Inc.*, 295 B.R. 908 (Bankr. W.D. Mo. 2003); *United Airlines, Inc. v. U.S. Bank N.A.*, 406 F.3d 918 (7th Cir. 2005).

cure and does not agree to perform. Rather, non-compliance with such requirements of Section 1110 merely releases the creditor from the shackles of the automatic stay and allows it to exercise whatever remedies it is entitled to under the applicable financing documentation, which includes any action to exercise control over the property of the debtor's estate, including repossessing property leased to the debtor.

Alternative A adopts a more assertive approach. Should the applicable debtor fail to cure all defaults and agree to perform all future obligations under the applicable covered agreement, the debtor then becomes affirmatively obligated to give possession of the applicable aircraft object to the creditor by no later than the end of the waiting period.⁷⁹ Further, until the creditor is given the opportunity to take possession of the subject aircraft object, the insolvency administrator is affirmatively obligated to preserve such aircraft object and 'maintain it and its value in accordance with the agreement.'⁸⁰ It is permissible, however, for either the insolvency administrator or debtor, as applicable, to utilize such aircraft object pursuant to 'arrangements designed to preserve and maintain it and its value,' which 'would seem to include earning income from continued operation of the aircraft object.'⁸¹ While certain interim measures could be granted by a bankruptcy court in the US, Section 1110 does not create affirmative obligations on the part of the debtor, it only sets out conditions under which a creditor is

entitled to proceed against the equipment to preserve and protect the collateral.⁸²

4.7. Deregistration/export

As described above, Section 1110 is designed to give relief from the automatic stay arising in connection with the bankruptcy of an airline. It neither mandates the debtor to take any affirmative steps nor does it instruct the FAA and other authorities in the US to assist in the implementation of any such remedies. Alternative A, on the other hand, has specific mandates which instruct the registry authority and other administrative authorities in a contracting state, as applicable, to procure the remedies of de-registration of the aircraft and physical and legal export of the applicable aircraft object no later than five working days after the date on which the creditor notifies such authorities that it is entitled to procure such remedies in accordance with the Convention.⁸³ The applicable authorities are further charged to expeditiously cooperate with and assist such creditor in connection with the exercise of such remedies.⁸⁴ As such, it is a treaty obligation of the contracting state, and all applicable government authorities therein, to assist such creditor in connection with the exercise of such remedies. The creditor, therefore, has the benefit of looking to the contracting state, and all applicable authorities therein, and not only the debtor itself, when enforcing its remedies.

5. Case study

5.1. Background: Canadian law primer

5.1.1. Canadian common law/Québec civil law

⁸² Nothing in Section 1110 prevents a creditor from seeking relief from the automatic stay if cause exists, or from seeking to assert a right to adequate protection, even during the first 60 days of the applicable bankruptcy case. See 7 Collier on Bankruptcy 1110.04 [1][d] (Alan N Resnick & Henry J Sommer eds 16th edn).

⁸³ Protocol, Article XI(8)(a).

⁸⁴ Protocol, Article XI(8)(b).

⁷⁹ Protocol, Article XI Alternative A (2). This provision does not mandate or imply non-judicial remedies if the relevant contracting state requires, through its declaration under Article 54(2), leave of the court for all remedies. In such a case, the creditor should bring action in the insolvency court requesting cure or return by no later than the end of the waiting period. This is a practical point only, as the contracting state has an international obligation to ensure that the debtor or insolvency administrator, as applicable, complies with this timeframe and the other provisions of Alternative A.

⁸⁰ Protocol, Article XI Alternative A (5)(a).

⁸¹ Goode 3.110.

In Canada, federal (national) law and the law of 12 of its provinces and territories is derived from English common law. Provincial law in the Province of Québec, however, comes from the civil law system of France. Canada's federal Bankruptcy and Insolvency Act ('BIA') draws its inspiration directly from English common law.⁸⁵ However, in 2001 and 2004, the Parliament of Canada enacted statutes aimed at harmonizing federal law with Québec civil law.⁸⁶ This resulted in amendments to the BIA designed to achieve such harmonization.⁸⁷ Therefore, Canada's current bankruptcy and insolvency legal regime draws on both common and civil law concepts and mechanisms.

5.1.2. Implementation of the Cape Town Convention in Canada

Each country has internal rules on the implementation and effect of treaties, and when and the extent to which treaties have the force of law that prevails over conflicting national law. Canada is a dualist jurisdiction, where domestic law and treaty law operate on distinct planes. A treaty has no direct effect domestically until it is implemented by domestic legislation.

Additionally, Canada is a federalist state, with the distribution of powers weighted toward the provinces. The highest-level courts of appeal in Canada have consistently upheld an expansive view of provincial powers and a narrow view of federal power under the Canadian Constitution.⁸⁸ In Canada, the broad reading of the

provincial property and civil rights power clause in the Canadian Constitution has given provinces the power to regulate contracts, which encompasses extensive regulation of property rights and the debtor-creditor relationship, although bankruptcy and insolvency and aeronautics remain federal powers.⁸⁹ This means that Canada was required to pass federal legislation as well as provincial legislation in each province and territory in order to fully and properly adopt the Convention and Protocol into its laws.

Canada's federal implementing legislation, the International Interests in Mobile Equipment (Aircraft Equipment) Act (Canada) (the 'Federal CTC Act'),⁹⁰ directly mirrors the provisions contained in the Convention and Protocol as a set of codified laws. Its implementation is clear and straightforward as it lays out the requirements for creating and registering an international interest, the rights available to creditors and debtors, the procedural requirements for exercising a remedy, and the establishment of priority rules through the International Registry. As the statutory scheme contemplated in the Convention and Protocol is directly implemented at the national level, no further federal legislation is required.⁹¹

The Federal CTC Act became law on 24 February 2005, however significant portions of the Convention and Protocol were not proclaimed in force. Most notably, and with the purpose of putting Canadian airlines on equal footing with their U.S. counter parts as it relates to Section 1110/Alternative A remedies, the federal legislation did proclaim the bankruptcy and insolvency amendments, including

⁸⁵ 'Research in Bijuralism: Bankruptcy and Insolvency Act' in *The Harmonization of Federal Legislation with the Civil Law of the Province of Québec and Canadian Bijuralism. Collection of Studies* (Ottawa (On), Department of Justice Canada 1999), 841-886.

⁸⁶ 'Harmonization of the Canada Business Corporations Act: Laying the Bijural Foundations of Federal Corporate Law', in *The Harmonization of the Bankruptcy and Insolvency Act with Québec Civil Law – Revision Proposal*, *Revue juridique Thémis*, Vol 42, Nos 1 and 2, 2008, Les Éditions Thémis, Faculty of Law, Université de Montréal (QC), 5-11.

⁸⁷ *ibid.*

⁸⁸ Peter W Hogg, *Constitutional Law of Canada* 5th edn (Carswell 2007) (loose-leaf updated 2013, release 1), ch 5 5-18.

⁸⁹ *Supra* at 5-4.

⁹⁰ SC 2005, c 3; Some provisions of this Act were not proclaimed into force until the enactment of the Jobs and Growth Act 2012, SC 2012, c 31, s 411 (the 'Jobs and Growth Act').

⁹¹ The level of detail and specificity in the Convention makes it a fully implementable legal regime.

provisions similar to Alternative A, but not Alternative A itself, into federal law in 2005.

Pursuant to this Act, a provision of the Convention or Protocol given force of law that is inconsistent with any other law, except certain federal statutes that mainly relate to matters of criminal law, prevails to the extent of the inconsistency. All remaining parts of the Convention and Protocol were proclaimed into Canadian federal law on 1 April 2013.

Canada's provincial and territorial implementing legislation, including Québec's statute, An Act to Implement the Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment and the regulations thereunder (collectively, the 'Québec CTC Act'),⁹² are also codified laws as opposed to sets of general principles. Such legislation sets forth the same clauses as the Federal CTC Act. The Convention and Protocol were proclaimed into provincial and territorial law starting with certain provinces (including Québec) on 1 April 2013, and were finally proclaimed by the last of the remaining Canadian provinces and territories on 1 July 2016.⁹³

5.1.3. *Insolvency proceedings in Canada*

Insolvency law in Canada is principally governed by two federal statutes: the BIA and the CCAA. Airlines which intend to restructure their affairs and to continue their operations typically commence insolvency proceedings in accordance with the CCAA.⁹⁴

⁹² CQLR c M-35.1.2.1, 2007.

⁹³ Canada's initial Declarations in 2012, included Alberta, British Columbia, Manitoba, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Ontario, Quebec, and Saskatchewan. In 2014, Declarations in respect of Prince Edward Island and the Yukon Territory were deposited and, in 2015, Declarations in respect of New Brunswick, the remaining Canadian jurisdiction, were deposited.

⁹⁴ Virtually all airline insolvency proceedings in Canada that have involved an expressed intent to restructure have been commenced under the CCAA.

In 2009, the CCAA was amended to provide that a court may declare a vendor, which provides goods or services that are considered critical to the ongoing operation of the debtor, a 'critical supplier,' and order such vendor to continue to provide such goods or services on terms to be set by the court that are consistent with the existing supply relationship, or that are otherwise considered appropriate by the court. In return, the 'critical supplier' can be granted a super-priority charge over all or any part of the debtor's property to secure the value of such goods or services required to be supplied under the order.⁹⁵

Rather than trying to complete complicated amendments to the BIA and the CCAA, to give effect to Alternative A, a process that was not done successfully with the 2005 amendments, and to ensure that Canada properly made all 'Qualifying Declarations' (the 'Qualifying Declarations') required by the OECD Aircraft Sector Understanding 2011, in order to receive the maximum benefits provided hereunder,⁹⁶ the Government of Canada decided to simply declare Alternative A, as is, on a standalone basis, when it proclaimed into force the remaining provisions (i.e., those provisions not proclaimed under the 2005 Federal CTC Act) of the Convention and Protocol in 2013. At that time, it also repealed the bankruptcy and insolvency amendments contained in the 2005 Federal CTC Act.⁹⁷ Accordingly, as noted above, as of 1 April 2013, the Convention and Protocol, and all Qualifying Declarations, including Alternative A, became federal law in Canada, and provincial law in most

⁹⁵ Bankruptcy and Insolvency Act (RSC, 1985, c B-3) s 81.1.

⁹⁶ 2011 Sector Understanding on Export Credits for Civil Aircraft, [TAD/ASU(2011)1].

⁹⁷ The government of Canada implemented those provisions of the 2005 Federal CTC Act that were not proclaimed in 2005, and Alternative A itself, by adopting an omnibus statute, the Jobs and Growth Act, which had the effect of giving force of law to Article XI of the Protocol (by removing this article from the list of excluded provisions in section 4(2) of the 2005 Federal CTC Act.

provinces, including Ontario and Québec. In accordance with Article XXX of the Protocol, the Government of Canada declared 'that it will apply Article XI, Alternative A of the Protocol in its entirety to all types of insolvency proceedings ... and that the waiting period ... shall be sixty (60) calendar days.'⁹⁸

As now modified following ratification of the Convention and Protocol, Canadian federal law specifically overrides the authority of a Canadian court to issue a stay of proceedings in the context of a CCAA restructuring for aircraft objects beyond the 60-day waiting period. This covers all stays applicable to aircraft objects, including the special stay rights applicable to critical suppliers.

Further, Canadian federal law mirrors the provisions in the Convention and Protocol by providing that the continuation of the 60 day waiting period is subject to a debtor's obligation during such waiting period to preserve the aircraft object's value and maintain it in accordance with the underlying agreement.⁹⁹

5.2. Case study: the facts

For the purposes of this article, we apply and analyze the following hypothetical fact pattern, which presents realistic elements in airline default and insolvency scenarios:

- Clare Aircraft Leasing Limited (the 'Lessor') leased a Boeing 767 ('Aircraft 1'), an Airbus 320 ('Aircraft 2') and one spare GE CF6 engine (the 'Engine' and, together with Aircraft 1 and Aircraft 2, the 'Equipment') to Air Montreal (the 'Airline'), a Québec-based airline situated, for the purposes of the Convention, in (and the primary insolvency jurisdiction of which is located in) Canada.
- The lease agreement for the two aircraft (the 'Aircraft Lease') was signed following Canada's ratification of the Convention and Protocol. The aggregate rent under

the Aircraft Lease was US\$1,000,000 per month.

- The lease agreement for the engine (the 'Engine Lease' and, together with the Aircraft Lease, the 'Leases') was also signed following Canada's ratification of the Convention and Protocol.
- The Leases were made subject to the laws of the Province of Ontario and contained customary default and termination provisions for agreements of that type.
- The Leases were duly registered with the International Registry as international interests, subject to no prior interests of record at the International Registry.
- On 1 May 2016, the Airline failed to make a rent payment under each Lease when due, which constituted an event of default under each Lease.
- On 1 June 2016, the Lessor served a notice of default on the Airline under each Lease.
- On 2 June 2016, the Lessor determined that Aircraft 1 and the Engine were located in Hangar 3 at Montreal Mirabel International Airport ('YMX') and that Aircraft 2 was located in Hangar 4 at YMX, where it was undergoing a C check performed by MRO Services Inc. ('MRO'), an unrelated third party.
- On 6 June 2016, the Airline filed for bankruptcy protection (the 'Insolvency Proceeding') under the CCAA, with the intention of restructuring/reorganizing its affairs and continuing its operations. The order issued by the Superior Court, Commercial Division (the 'Bankruptcy Court') in Montreal effectively stayed all enforcement actions against the Airline to give it time to complete its restructuring.
- That same day, after unsuccessful negotiations with the Airline, the Lessor notified the Airline's insolvency administrator (the 'Administrator') that it would not, under any circumstances, renegotiate the terms of the Lease for the Aircraft,¹⁰⁰ and that it expected to repossess the Aircraft not more than 60 days after commencement of the Insolvency

⁹⁸ Canada's Declarations.

⁹⁹ Protocol, Article XI 5(a).

Proceeding if the Airline did not cure all defaults under the Lease for the Aircraft and undertake to perform that Lease going forward. The Lessor made no demand to the Administrator that the Engine be returned.

- The Administrator advised the Lessor that it considered the Lessor to be a 'critical supplier' under Canadian bankruptcy law, and that it required that the Equipment remain in the fleet as it would be required to successfully complete a restructuring of the Airline. The Administrator further advised the Lessor that it needed to operate the Equipment in order to generate ongoing revenues, but that it only had funds to perform the minimum required maintenance on the Equipment to keep it flying (which was below the standard specified in the applicable Leases).
- On 16 June 2016, the Administrator requested an order from the Bankruptcy Court that:

(1) the Lessor was a critical supplier in respect of the Leases, and each item of Equipment was necessary for the operation and successful restructuring of the Airline, and, therefore, should continue to be subject to the general stay, or special stay applicable to critical suppliers, and should not, therefore, be subject to Alternative A;

(2) the Airline should be permitted to perform only the basic minimum maintenance on the Equipment which, although keeping it

airworthy in the short term, would require significant future expenditures to return it to the conditions required by the Leases;

- (3) given that the current market rent for the Equipment, in the aggregate, had dropped to US\$500,000 per month, the court should order that the Leases be continued for each item of Equipment and amended by reducing the rent accordingly; and
- (4) the Airline should be permitted to sell off major engine components from each Aircraft and the Engine to third parties to generate revenue, replacing them with airworthy, but much lower value, components.

While the requests in paragraphs (1) and (3) are common in airline restructuring proceedings, the requests in paragraphs (2) and (4), while not usual as formal requests in airline insolvency proceedings, reflect issues which are not uncommon as airlines try to operate while in financial distress.

- On 17 June 2016, MRO requested an order from the Bankruptcy Court that:

(1) it was entitled to a 'right of preference' (possessory mechanics' lien) under the Civil Code of Québec ('CCQ')¹⁰¹ in respect of Aircraft 2;

(2) it was entitled to maintain possession of and/or sell Aircraft 2 if not paid in full; and

(3) MRO's right to receive such payment takes priority over any rights and remedies that the Lessor may have under the Lease in respect of Aircraft 2, including under Alternative A.

¹⁰⁰ The practical reality under Alternative A will be that creditors and airlines will often need to agree on extensions to the waiting/stay period. Accordingly, as with Section 1110, Alternative A permits a *voluntary* delay or conditioning of remedies. Part III of Annotation 4 gives guidance on this point: It reads as follows – 'The holder of an international interest with rights under Alternative A and the insolvency administrator or the debtor, as applicable, may agree (i) to delay the giving of possession of the object to the creditor, and (ii) to the conditions applicable to such delay.'

¹⁰¹ Article 2728 CCQ.

- On 17 June 2016, the Lessor requested an order from the Bankruptcy Court that:
 - (1) the Equipment should be returned to it immediately upon the expiry of the 60 days from commencement of the Insolvency Proceeding;
 - (2) the Equipment, including the records related thereto, must be maintained strictly pursuant to the terms of the Leases, or the stay should be terminated so it could be immediately returned to the Lessor;
 - (3) (a) during the stay period the value of the Equipment must be preserved such that, in addition to the relief requested in (2) above, the Equipment must be:
 - i fully insured pursuant to the terms of the Leases;
 - ii fully protected from disgruntled employees and third parties through adequate security arrangements; and
 - iii operated and protected in accordance with the terms of the Leases; and
 - (b) no parts or component removals or sales should be permitted.

5.3. Main issues in the case study

5.3.1. Topic I – non-judicial remedies; applicable law

5.3.1.1. *Non judicial remedies.* As noted above, while Alternative A is a cut-off of the otherwise applicable local law bankruptcy stay at the end of the declared waiting period (60 days in the case of Canada), Alternative A does not imply an override a national law requirement for court supervised remedies, unless a contracting state has so declared under Article 54.2 of the Convention that leave of the court is not required for Cape Town Convention remedies (a declaration that Canada did make).¹⁰² So, in

¹⁰² Canada's Declarations.

accordance with local procedural law, pursuant to Article 14 of the Convention – if it so permits – the creditor should (as a practical matter) bring a motion in court to require return or cure no later than the end of the waiting period. If local procedural law does not so provide, then the Convention specifically overrides the conflict (assuming treaty primacy, as is the case in Canada) and creates that procedural law. In all events, and notwithstanding these practical points, the contracting state has an international treaty obligation to proceed in a manner that adheres to the deadlines and otherwise complies with Alternative A, which requires mandatory return of aircraft objects prior to the end of the waiting period, whether or not proceedings are formally brought in court.

5.3.1.2. *Choice of law.* Québec conflict of laws rules recognize choice of law clauses, and Canada declared 'in accordance with Article XXX [(Declarations relating to certain provisions)] of the Protocol, that it will apply Article VIII [(Choice of law)] of the Protocol with regard to choice of law and such shall be applicable in Canada.'¹⁰³ Québec courts will therefore apply Ontario law to the interpretation of the Leases (Art 3111 Para 1 CCQ).¹⁰⁴

5.3.1.3. *Applicable law.* While under Canada's constitution, Québec provincial civil law applies to rights in personal property, such as aircraft, for Québec-based debtors, bankruptcy, and insolvency (and aeronautics) are subject to federal jurisdiction, so Québec courts will apply federal law to those aspects of this case. As noted above, Canadian bankruptcy law is largely derived from English/US common law but will be applied in a manner consistent with civil law concepts. In Canada, the 'civil

¹⁰³ Canada's Declarations.

¹⁰⁴ The analysis in this article does not extend to conflict of laws rules beyond those arising from a contractual choice of law clause.

law has an impact on the application of federal insolvency law in Québec, although in practice, there is considerable convergence between how [such law] is interpreted and applied in Québec and the rest of Canada.¹⁰⁵ It should be noted however, that (i) Québec courts will apply Québec law, and not Ontario law, to procedural issues, as opposed to substantive ones (Art 3132 CCQ); and (ii) if Ontario law is not pleaded or its content is not established (usually by way of an expert report), Québec courts will apply Québec law. As noted above, however, the Convention creates an overriding international obligation regardless of what is plead in the courts. The courts must, therefore, as a matter of treaty law, ensure compliance with Alternative A.

5.3.2. *Topic II – return of the equipment: Canadian insolvency proceedings, Alternative A and third-party rights*

Absent the curing of all defaults under the Leases by the Airline (other than defaults constituted by the Insolvency Proceedings themselves) and its agreement to perform all future obligations thereunder, the Lessor's ultimate goal is the expeditious return of the Equipment. The following analysis addresses the application of Alternative A for both scenarios, where the Equipment is in the possession of the Airline and/or MRO.

5.3.2.1. *Application of Alternative A, and interaction with local law.* As set out above, the Alternative A remedies of the Convention expressly provide that 'the insolvency administrator or the debtor, as applicable, shall, subject to paragraph 7, give possession of the aircraft object to the creditor no later than: (a) the end of the waiting period' (60 days in the case of Canada). However, the insolvency administrator or the debtor, as applicable, may retain possession of the aircraft object where,

¹⁰⁵ Janis P Sarra, *Rescue! The Companies' Creditors Arrangement Act* (2nd edn, Carswell 2013) 46.

by the time specified by the contracting state's declarations, it has cured all defaults other than a default constituted by the opening of insolvency proceedings and has agreed to perform all future obligations under the agreement. A second waiting period shall not apply in respect of a default in the performance of such future obligations. This is in stark contrast to the CCAA which allows Canadian courts to issue a broad, and indefinite,¹⁰⁶ stay of proceedings during the restructuring process. Such a stay will include terms preventing the termination of a contract, such as a lease, provided that rent is paid during the restructuring process. Rent is not necessarily required to be paid for financed aircraft during the stay period in Canada.

However, given that Alternative A takes priority over these provisions of the CCAA, the Administrator and the Airline have no discretion to continue to retain the Aircraft after the waiting period, unless specifically agreed by the Lessor.

5.3.2.2. *Right of preference/mechanics' liens.* The Québec civil law equivalent to a mechanics' lien is found at Article 1592 of the CCQ, which provides:

A party who, with the consent of the other party, has detention of property belonging to the latter has a right to retain it pending full payment of his claim against him, if the claim is exigible and is closely related to the property of which he has detention.

This right to retain property pending payment of a claim is broadly similar to the common law concept of mechanics' liens and constitutes a prior claim (Art 2651(3) CCQ), which allows the retaining party's claim to be preferred over all other creditors.

¹⁰⁶ While the initial stay under a CCAA order is normally for 30 days, extensions to the initial stay can be, and are, routinely granted as long as the supervising court, in its discretion, considers that there is a reasonable prospect of a successful restructuring.

As mentioned above, the Québec CTC Act provides, in effect, that the Convention does not increase the rank of an interest in relation to prior claims or legal hypothecs that exist under Québec law. Relating more specifically to the case study in this article, Section 1 Para 3(1) of the Québec CTC Act provides: 'a prior claim will rank before an international interest registered in the International Registry established under the Convention and the Protocol, whether in or outside insolvency proceedings.' As a result, the claim of a party who retains property under Article 1592 of the CCQ will be preferred to international interests existing under the Convention.

Québec courts have strictly interpreted the terms 'belonging to the latter' at Article 1592 CCQ.¹⁰⁷ As such, the owner of the property must be a party to the contract pursuant to which the right to retain is being exercised. In other words, if the legal owner/lessor did not consent to the contract by which a lessee remitted the property to another party, this other party will not have a right to retain it as against the owner. When ratifying the Convention and Protocol, the Government of Canada did make declarations under Article 39 of the Convention, that non-consensual rights under Canadian law (such as a right of detention arising from a mechanics lien) that have priority over an interest in an object equivalent to that of a holder of a registered international interest, would take priority over the holder of a registered international interest.¹⁰⁸

6. Resolving the case study

In light of the foregoing analysis, and notwithstanding that Alternative A has not yet been reviewed by the courts in Québec, the facts outlined in the case study should be resolved by the Bankruptcy Court as follows:

- (1) Alternative A would apply to the Equipment in the context of the Airline's Insolvency Proceedings given that:
 - i the Equipment constitutes aircraft objects;
 - ii the Leases create international interests; and
 - iii the international interests have been validly registered on the International Registry and are not subject to any competing registrations.
- (2) Notwithstanding that the Lessor in respect of the Equipment may well be a 'critical supplier' under the CCAA, the specific provisions of the Federal CTC Act, and Québec CTC Act, override that national law categorization, and the rules of Alternative A would be held to be applicable.
- (3) The Administrator would fail on its primary request for continuation of the Leases with a reduced rent. At best, the Administrator could succeed with a request that the Airline retain possession of the Equipment, provided that it (i) cures all defaults under the Lease within 60 days, (ii) has agreed to perform all future obligations under the Lease, and (iii) preserves the Aircraft and Engines, and maintains them and their value in accordance with the Lease, all as required by Alternative A during the waiting period.
- (4) The fact that the Lessor made no formal demand upon the Administrator or Airline in respect of its Alternative A rights in respect of the Engine, including in respect of the 60 day rule, is irrelevant. Such rights arise automatically under Alternative A, and require no action by a creditor. Had Canada not made a declaration under Article 54.2 of the Protocol, then a formal request to the court would have been required. Such a requirement for court intervention should in no way impair the obligation of the Administrator to fully comply

¹⁰⁷ See *Air Charters Inc c. TSA Aviation Inc* 2005 QCCA 355.

¹⁰⁸ Canada's Declarations.

with Alternative A and return the Equipment within the waiting period. If, however, the Airline wished to exercise its rights to retain the Equipment under Paragraph 7 of Alternative A, it must, among other things:

- i comply with its obligations under Paragraph 5(a) of Alternative A to preserve the aircraft objects and maintain them and their value in accordance with the Leases;
 - ii have cured all payment and performance defaults under the Leases by, among other things, paying to the Lessor all rent arrears and performing all maintenance obligations to the standards required by the Leases; and
 - iii have agreed to perform all future obligations under the Leases. While there is not yet precedent as what form such 'agreement' should take, as a practical matter the agreement could (x) be reflected in a court order (as is often the case during US Section 1110 proceedings); or (y) be reflected in a commercial amendment to the Leases to be entered into between Lessor and Airline. In most jurisdictions, including Canada, an agreement made during insolvency proceedings must be approved by the court, which would occur in this case. It should also be noted that, if the Leases are cross-defaulted to each other, the Airline will need to cure all relevant defaults under all Leases. This would also result in them having to accept or reject all of the Equipment (unless otherwise agreed by the Lessor).
- (5) MRO would be entitled to a right to retain Aircraft 2, until paid for its services, provided that, under Québec law, the Lessor was a party to the agreement pursuant to which MRO was performing the C check.¹⁰⁹

- (6) If MRO does have a right to retain Aircraft 2, this right would constitute a prior claim under Québec law, pursuant to Canada's declaration under Article 39 of The Convention, and would take priority over Lessor's rights and remedies under Alternative A. The MRO is not subject to the 60-day return requirement or the other provisions of Alternative A. In order to procure repossession of Aircraft 2 from the MRO, the Lessor will, therefore, as a practical matter, need to deal with the MRO's claim.

7. Conclusion

Accordingly, under Canadian federal law, and the civil law of the Province of Québec, Alternative A should be applied by the applicable courts in Canada, and complied with by the Administrator, precisely as intended by the drafters of the Convention and Protocol.

The US experience under Section 1110, while not directly relevant, may provide significant guidance to practitioners and courts interpreting Alternative A. What is apparent from the 1110 experience in the US is the immense value that this provision provides for the benefit of airlines and their creditors, alike. This was the driving principle in the development of Alternative A. The value of Alternative A, similar to that of Section 1110, is that it creates a commercially predictable transaction which enables a creditor to maximize its earning potential in respect of an aircraft object, even during a default. As demonstrated in the case study analysis, there is no discretion for a court in a contracting state which has properly implemented the Convention and Protocol to vary the Alternative A remedy. As such, practitioners and courts should interpret Alternative A with an

¹⁰⁹ As noted in Topic II, paragraph (b) above, it is a requirement for the establishment of a prior claim (mechanic's lien) under Québec provincial law that the owner (the Lessor in this case) has agreed to the performance of the work for which the claim is made.

aim to providing the predictability to aircraft financing transactions intended by the contracting states to the Convention and Protocol.

ANNEX A

Article XI – Remedies on insolvency

This Article applies only where a Contracting State that is the primary insolvency jurisdiction has made a declaration pursuant to Article XXX(3).

Alternative A

- (1) Upon the occurrence of an insolvency-related event, the insolvency administrator or the debtor, as applicable, shall, subject to paragraph 7, give possession of the aircraft object to the creditor no later than the earlier of:
 - (a) the end of the waiting period; and
 - (b) the date on which the creditor would be entitled to possession of the aircraft object if this Article did not apply.
- (2) For the purposes of this Article, the 'waiting period' shall be the period specified in a declaration of the Contracting State which is the primary insolvency jurisdiction.
- (3) References in this Article to the 'insolvency administrator' shall be to that person in its official, not in its personal, capacity.
- (4) Unless and until the creditor is given the opportunity to take possession under paragraph 2:
 - (a) the insolvency administrator or the debtor, as applicable, shall preserve the aircraft object and maintain it and its value in accordance with the agreement; and
 - (b) the creditor shall be entitled to apply for any other forms of interim relief available under the applicable law.
- (5) Sub-paragraph (a) of the preceding paragraph shall not preclude the use of the aircraft object under arrangements designed to preserve the aircraft object and maintain it and its value.
- (6) The insolvency administrator or the debtor, as applicable, may retain possession of the

aircraft object where, by the time specified in paragraph 2, it has cured all defaults other than a default constituted by the opening of insolvency proceedings and has agreed to perform all future obligations under the agreement. A second waiting period shall not apply in respect of a default in the performance of such future obligations.

- (7) With regard to the remedies in Article IX (1):
 - (a) they shall be made available by the registry authority and the administrative authorities in a Contracting State, as applicable, no later than five working days after the date on which the creditor notifies such authorities that it is entitled to procure those remedies in accordance with the Convention; and
 - (b) the applicable authorities shall expeditiously co-operate with and assist the creditor in the exercise of such remedies in conformity with the applicable aviation safety laws and regulations.
- (8) No exercise of remedies permitted by the Convention or this Protocol may be prevented or delayed after the date specified in paragraph 2.
- (9) No obligations of the debtor under the agreement may be modified without the consent of the creditor.
- (10) Nothing in the preceding paragraph shall be construed to affect the authority, if any, of the insolvency administrator under the applicable law to terminate the agreement.
- (11) No rights or interests, except for non-consensual rights or interests of a category covered by a declaration pursuant to Article 39(1), shall have priority in insolvency proceedings over registered interests.
- (12) The Convention as modified by Article IX of this Protocol shall apply to the exercise of any remedies under this Article.

Alternative B

- (1) Upon the occurrence of an insolvency-related event, the insolvency administrator or the debtor, as applicable, upon the request of the creditor, shall give notice to the creditor within the time specified in a

declaration of a Contracting State pursuant to Article XXX(3) whether it will:

- (a) cure all defaults other than a default constituted by the opening of insolvency proceedings and agree to perform all future obligations, under the agreement and related transaction documents; or
 - (b) give the creditor the opportunity to take possession of the aircraft object, in accordance with the applicable law.
- (2) The applicable law referred to in sub-paragraph (b) of the preceding paragraph may permit the court to require the taking of any additional step or the provision of any additional guarantee.
 - (3) The creditor shall provide evidence of its claims and proof that its international interest has been registered.
 - (4) If the insolvency administrator or the debtor, as applicable, does not give notice in conformity with paragraph 2, or when the insolvency administrator or the debtor has declared that it will give the creditor the opportunity to take possession of the aircraft object but fails to do so, the court may permit the creditor to take possession of the aircraft object upon such terms as the court may order and may require the taking of any additional step or the provision of any additional guarantee.
 - (5) The aircraft object shall not be sold pending a decision by a court regarding the claim and the international interest.

ANNEX B

ANNOTATION TO PROFESSOR SIR ROY GOODE'S OFFICIAL COMMENTARY, THIRD EDITION (UNIDROIT, 2013)

CONVENTION ON INTERNATIONAL INTEREST IN MOBILE EQUIPMENT AND PROTOCOL THERETO ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT

Release No.4

Date: 22 March 2016

This document sets out an annotation (“**Annotation**”) to Professor Sir Roy Goode’s Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Object, Third Edition (the “**Official Commentary**”). There is a separate document that sets out all Annotations on a cumulative basis, organised with reference to the order of the Official Commentary.

This document is issued by the Cape Town Convention Academic Project, a joint undertaking of the University of Oxford Faculty of Law and the University of Washington School of Law, pursuant to procedures established by these two institutions.

The facility for the Cape Town Convention Academic Project to issue Annotations has been endorsed by Professor Sir Roy Goode in a personal, and not in any official, capacity. The Annotations have no official standing and do not constitute part of the Official Commentary, which is the only publication authorised by the 2001 Diplomatic Conference. It deals with questions not addressed or not fully addressed in the Official Commentary. It seeks to provide a neutral and informed analysis for the benefit of those involved with the above-noted convention (“**Convention**”) and protocol (“**Protocol**”).

The format followed in this document is to set out (i) the referenced paragraph(s) and/or illustration(s) in the Official Commentary, (ii) the background and/or issue(s), (iii) the Annotation related to such paragraph(s) and/or illustrations, and (iv) the rationale for such Annotation.

Annotation 4. Official Commentary Reference (s): 2.183, 2.236, 3.102-3.114, 4.10, 4.17-4.18, 4.211-4.215, 5.14, 5.15, 5.18, 5.56-5.68, 5.118

General Background/ Issues: The availability of remedies on insolvency, where a Contracting State has made a declaration under Article XXX(3) of the Protocol in respect of Article XI of the Protocol (**remedies on insolvency**), is designed to strengthen the creditor’s position vis-à-vis the insolvency administrator or the debtor on the occurrence of an “insolvency-related event”. See paragraph 3.102 of the Official Commentary. The underlying purpose is to reflect the realities of modern structured finance by ensuring as far as possible that, within a specified and binding time-limit, the creditor either (a) secures recovery of the object or (b) obtains the curing of all past defaults and a commitment to

perform future obligations. See paragraph 5.57 of the Official Commentary.

This annotation addresses select points relating to the treatment of remedies on insolvency in the Convention and Protocol. It will be divided into four parts, supplementing the Official Commentary on these points. First, what are the parameters for determining when an insolvency-related event has occurred under Article I(2)(m)(ii) of the Protocol. Secondly, which party must comply with remedies on insolvency. Thirdly, may the parties delay or condition the timing of the remedies on insolvency by agreement following an insolvency-related event. Fourth, whether the remedies on insolvency are applicable to a debtor outside of its primary insolvency jurisdiction.

Part I: Parameters of Insolvency-Related Event under Article I(2)(m)(ii) of the Protocol

Specific Background/Issue: Remedies on insolvency are triggered if either (i) “insolvency proceedings” are commenced, or (ii) there is a “declared intention to suspend or actual suspension of payments by the debtor” where a right of a creditor to “institute insolvency proceedings against the debtor or to exercise remedies under the Convention is prevented or suspended by law or State action”. This first limb, conventional insolvency proceedings, is given a wide and functional meaning under Article 1(l) of the Convention, and includes all collective proceedings, including interim proceedings, subject to control or supervision by a court (as defined in the Convention) for purposes of reorganisation or liquidation. The second limb, covering legislative, executive, or administrative action, is meant to make the definition of insolvency-related event more comprehensive and inclusive, triggering remedies on insolvency whenever (i) the debtor declares its intention to suspend payments or actually suspends payments, and (ii) the creditor’s right to institute insolvency proceedings or exercise remedies under the Convention and Protocol is prevented or suspended by law or State action.

Annotation: A Contracting State that has declared the availability of remedies on insolvency may not, consistent with the Protocol, prevent or condition such or other Convention or Protocol remedies by law or state action outside the scope, or which seeks to avoid the effects, of an “insolvency-related event”. Whether “insolvency proceedings” (Article I(2)(i)) have been commenced is a matter of national law. An insolvency-related event occurs under

Article I(2)(m)(ii) of the Protocol on the date when two conditions have been met: (1) the debtor has suspended payments to a creditor or declared its intention to do so, and (2) a law has been enacted or state action occurs that prevents or suspends the rights of such creditor to initiate insolvency proceedings against the debtor or exercise remedies under the Convention and Protocol. A declaration of intention to suspend payments is implicit in a statement by a debtor that it is unable to make payments to its creditors or that it intends to pay its creditors less than it is contractually obligated to pay.

Rationale: The annotation deals with actions contemplated by, and those inconsistent with, remedies on insolvency, and expands upon, and carries forward the logic of, paragraph 5.14 of (‘the basic intent ... is to trigger the starting point of the time period in Article XI of the Protocol ... where there are financial problems and State action or law (whether made or taken before or after a declared intent to suspend payment) prevents application of the remedies under the Convention’) and 5.18 (illustration 57, which addresses the core case) of the Official Commentary. It more clearly defines a law or state action which violates the basic principles of the provision on remedies on insolvency.

Illustration A

Airline 1, owned and controlled by the government of State Y, has encountered financial difficulty. State Y is a Contracting State that has made a declaration under Article XXX(3) to adopt Alternative A with a waiting period of 60 days. State Y passed a law preventing creditors of Airline 1 from commencing insolvency proceedings, or exercising remedies under the Convention and Protocol, against Airline 1. That legislation permits the debtor or a third party appointed by the debtor or the minister of transportation (manager) to take all action needed to restructure Airline 1, including modification of contracts and asset sales, without creditor consent. The legislation states that the action by the manager is not subject to judicial review, as authority therefor arises under the legislation. That legislation is non-compliant with the Protocol, unless its application is conditioned on the occurrence of an insolvency-related event as defined in the Protocol and, in such application, is subject to the terms of Protocol. If Airline 1 issues a communication to one or more of its creditors advising that it intends to modify the payment terms of its leases, or actually suspends its payments, an insolvency-related event

shall have occurred on the date of the communication or suspension. In that case, at the end of the 60 day waiting period following that insolvency-related event, the creditors of Airline 1 are permitted to exercise all remedies permitted by the Convention and the Protocol, notwithstanding the conflicting provisions of the State Y's national legislation.

Part II: Party Obligated to Comply with Remedies on Insolvency

Specific Background/Issue: Adoption of the Convention and Protocol obligates a Contracting State to give positive effect, within the timetable declared by the Contracting State that is the primary insolvency jurisdiction, to the remedies on insolvency. See paragraph 2.236 of the Official Commentary. The central requirements for meeting this obligation are that (i) a creditor is given possession of the object unless all transactional defaults (except one constituted by the opening of insolvency proceedings) are cured, and future obligations are committed to, by the end of the declared waiting period or earlier date on which a creditor is entitled to possession under applicable law, (ii) during the period described in (i), the object and its value is preserved and maintained in accordance with the agreement, and (iii) no obligations under the agreement may be modified without the consent of the creditor. See paragraphs 3.109–3.110 of the Official Commentary. This annotation focuses on which party is obligated to take or ensure these actions as part of Contracting State compliance with the Convention and Protocol.

Annotation:

In all cases where an “insolvency-related event” has occurred, there must be one party (the **responsible party**) obliged and empowered to take the action required to effect the remedies on insolvency.

Insolvency-related event under Article I(2)(m)(i) of the Protocol

In the case that the insolvency-related event has arisen under Article I(2)(m)(i) of the Protocol (insolvency proceedings), the responsible party is (i) the “insolvency administrator”, as defined in Article 1(k) of the Convention, which may be the “debtor in possession”, applying the debtor in possession criteria below, where an insolvency administrator exists, and (ii) the debtor as such, where no such insolvency administrator exists. Thus, if an insolvency administrator exists, it is the responsible party, and if an insolvency administrator does not exist, the debtor is the responsible party.

The Official Commentary, at paragraph 3.107, states that a debtor is its own insolvency administrator “where the estate is being administered in insolvency proceedings by a debtor in possession if permitted under applicable insolvency law”. The foregoing standard is met, and thus the debtor in possession is its own administrator, where the debtor has the authority to administer the estate, meaning that that it has the authority to enter into transactions and deal with assets, even if under the supervision of a court-appointed third party.

Illustration B

A court in State X issued an order commencing insolvency proceedings against Airline 1, which is necessary and sufficient to commence such proceedings under domestic insolvency law. The court appoints an interim manager, whose responsibilities under domestic insolvency law are to collect financial information about Airline 1, supervise Airline 1's activities to preserve the value of the estate, and to interact with the supervising court in respect of matters that could adversely affect creditors generally. Airline 1, which has the power to remain operational, may enter into ordinary course transactions, but not make any substantial disposition of assets without the approval of the interim manager. Domestic insolvency law contemplates a later stage (following the end of the Alternative A waiting period) when a plan of reorganisation or restructuring, which may be proposed by any creditor, the debtor, or the interim manager, would be approved by the court. In this case, the debtor, and not interim manager, is the insolvency administrator with responsibilities to take action under Alternative A within the timetable declared by State X in its ratification of or accession to the Protocol.

Insolvency-related event under Article I(2)(m)(ii) of the Protocol

In the case that the insolvency-related event has arisen under Article I(2)(m)(ii) of the Protocol (law or state action described in the annotation above), the responsible party is the debtor as such, unless the law or state action expressly authorises a third party to administer the reorganization or liquidation, in which case it is such third party.

Rationale: The reference in Article XI (Alternative A and B) to action by “the insolvency administrator or the debtor, as applicable” is ambiguous in that it does not make clear how to determine which of those two parties is the responsible party. That lack of

clarity leaves open the possibility that a debtor may claim that the actions required under Article XI are the responsibility of a purported insolvency administrator, while such purported insolvency administrator asserts that the responsibility remains with debtor. The annotation provides guidance by noting that in the absence of law or state action that expressly authorizes a third party to administer the reorganization or liquidation, the debtor remains the responsible party, and where an insolvency administrator exists, it is the responsible party.

Part III: Delay or Conditioning of Remedies on Insolvency following an Insolvency-Related Event

Background/Issue: Article XI(2) and (7) (**Alternative A**) of the Protocol, with the related declaration under Article XXX(2) and (3) of the Protocol, sets out explicit timetables for the giving or retaining possession of an object. The relevant parties, namely the creditor with rights under Alternative A and the insolvency administrator (as defined in Convention and discussed in the annotation above), may wish to agree to delay, or otherwise condition, the availability of such rights.

Annotation: The holder of an international interest with rights under Alternative A and the insolvency administrator or the debtor, as applicable, may agree (i) to delay the giving of possession of the object to the creditor, and (ii) to the conditions applicable to such delay.

Rationale: While Official Commentary in paragraphs 3.109, 5.60-5.63, and 5.66 address the time-based rules which are critical to Alternative A, the overriding principle of party autonomy remains. In addition to excluding the application of Article XI of the Protocol, the parties may derogate from or vary its terms, provided that such is consistent with mandatory rules. See Article IV(3) of the Protocol, and, more generally, paragraphs 2.17 and 2.19 of the Official Commentary. A voluntary delay or conditioning of rights under Alternative A falls squarely with this party autonomy principle and does not violate mandatory rules in the instruments.

Part IV: Applicability of Remedies on Insolvency for a Proceeding Outside of the Primary Insolvency Jurisdiction.

Background/Issue: Upon the occurrence of an insolvency-related event, Article XI(1) of the Protocol conditions the applicability of the Article XI remedies on insolvency upon a declaration pursuant to

Article XXX(3) of the Protocol having been made by the primary insolvency jurisdiction. There is no other condition. Article I(2)(n) of the Protocol defines the “primary insolvency jurisdiction” as the Contracting State where the centre of debtor’s main interests is situated. However, some jurisdictions provide for insolvency proceedings in respect of a debtor connected to the jurisdiction by having a domicile, place of business or property there, and purport to bind the creditors and property of the debtor wherever located. Aviation and aviation finance are global industries and participants may have a domicile, place of business or property in many different jurisdictions. Accordingly, insolvency proceeding in respect to a debtor may occur in a Contracting State that differs from the primary insolvency jurisdiction for that debtor.

Annotation: Article XI of the Protocol applies to a debtor in a Contracting State if the primary insolvency jurisdiction for that debtor has made a declaration pursuant to Article XXX(3) of the Protocol. The application of Article XI of the Protocol does not depend upon the insolvency proceeding taking place within the debtor’s primary insolvency jurisdiction. Whether the courts of another State have jurisdiction over matters governed by Article XI depends entirely on that State’s own insolvency jurisdiction rules. If Article XI of the Protocol applies to a debtor, then, in accordance with Article XXX(4) of the Protocol, the courts of any Contracting State in which an insolvency proceeding with respect to such debtor takes place are obligated to apply Article XI of the Protocol in conformity with the declaration made by the primary insolvency jurisdiction. Article XI of the Protocol overrides Article 30(3)(b) of the Convention, and therefore any rules of law of the forum that conflict with Article XI are superseded by the rules of Article XI. The content of this annotation is to be distinguished from, but is compatible with, the terms of Article XII of the Protocol, which applies where a Contracting State has made a declaration under Article XXX(1) of the Protocol in respect thereof. Article XII of the Protocol addresses the cooperation with foreign courts and insolvency administrators, and thus presupposes the existence of foreign main proceedings, when an aircraft object is situated in the Contracting State making that declaration.

This annotation does not imply that insolvency proceedings outside of the primary insolvency jurisdiction should be treated as primary or main-type proceedings by-passing the latter as and where they

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occur, as contemplated inter alia by the UN Model Law on Cross-Border Insolvency or the EU Regulation (EU) 2015/848 on insolvency proceedings.

Rationale: The annotation confirms the plain meaning of Articles I(2)(n), XI(1), and XXX(4) of the Protocol, none of which state that insolvency proceedings must occur in the primary insolvency jurisdiction, and expands upon paragraph 5.118 of the Official Commentary. In its discussion of the availability of the remedies on insolvency provided by Article XI of the Protocol, the Official Commentary addresses secondary insolvency proceedings occurring outside of the primary insolvency jurisdiction, the main insolvency proceedings occurring

within the primary insolvency jurisdiction, and the relationship between the two. It does not directly address the availability of the remedies on insolvency provided by Article XI of the Protocol where the insolvency proceeding takes place outside of the primary insolvency jurisdiction. Clarity on this item, the applicability of Article XI as declared by the primary insolvency jurisdiction (whether or not insolvency proceedings are taking place therein) in all Contracting States, is essential to avoid insolvency forum shopping and produce the intended economic benefits of the Convention and Protocol (see paragraph 5.56 of the Official Commentary), which are directly related in this context.

ANNEX C

Alternative A	Section 1110
<u>Applies to ANY debtor</u>	<u>Debtor – air carriers</u>
Limited to aircraft objects and includes all data, manuals, and records relating to the object	Covers airframes, engines, propellers, appliances, spare parts, and includes only those records which are required to be returned
<u>Mandatory return of equipment following termination of waiting period</u>	<u>Provides relief from automatic stay following termination of waiting period</u>
Applies to any international interest	Applies to a lease, security or conditional sale agreement, subject to PMESI for security interests pre 22 October 1994
International interest must be registered	No perfection required
If no cure (or extension), insolvency administrator must give possession to creditor	If no cure (or extension), relief from automatic stay
Waiting period – for most jurisdictions, 60 days	60 days
<u>Automatic obligation to preserve aircraft and maintain it and its value in accordance with the agreement</u>	<u>Must seek adequate protection outside of Section 1110</u>
Cure obligation - all defaults (excluding opening of insolvency proceeding)	Cure obligation - all defaults other than 365(b)(2) defaults (which includes defaults relating to financial condition)
Aviation authority – obligated to deregister in 5 days	No comparable provision