Insolvency Law as Credit Enhancement: Insolvency-related Provisions of the Cape Town Convention and the Aircraft Equipment Protocol

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I. Introduction

Responding to an increasingly global economy, in recent years several projects and studies have explored the means of coordinating the multiple laws and judicial proceedings that affect distressed firms having assets in more than one state and which are parties to cross-border, multi-jurisdictional transactions. A variety of institutions and organizations have recognized the importance of reforming the laws, structures, and systems that bear on transnational insolvencies, including the United Nations Commission on International Trade Law (UNCITRAL),[1] the European Union,[2] the International Monetary Fund,[3] the World Bank,[4] INSOL International,[5] and The American Law Institute,[6] among others. In general these projects have focused primarily on the procedural and coordination aspects of

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1. *See* U.N. Comm'n on Int'l Trade Law, Model Law on Cross-Border Insolvency with Guide to Enactment, U.N. Doc. A/CN.9/442 (1997).
2. *See* Council Regulation 1346/2000 on Insolvency Proceedings, 2000 OJ (L 160).
3. *See* International Monetary Fund, Report on Insolvency Arrangements and Contract Enforceability (December 2002) <http://www.imf.org/external/np/g10/2002/insolv.htm> (29 February 2004); International Monetary Fund, Report on Orderly & Effective Insolvency Procedures (1999) <http://www.imf.org/external/pubs/ft/orderly/index.htm> (29 February 2004).
4. *See* Stijn Classens & Leora F. Klapper, Bankruptcy Around the World (The World Bank Policy Research Working Paper No. 2865) (July 2002) <http://www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000094946_02080204172482> (29 February 2004).
5. INSOL International has collaborated with UNCITRAL on international insolvency issues over several years. *See* <http://www.insol.org/>.
6. *See* The American Law Institute, Principles of Cooperation Among NAFTA Countries (2003).

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multi-jurisdictional insolvencies.[7] Bankruptcy scholars also have devoted considerable attention to issues relating to transnational insolvency.[8] And, for the most part, these projects as well as the relevant scholarship tend to focus on reforms that could render insolvency proceedings more efficient and effective and that would increase coordination among jurisdictions. Stated otherwise, the efforts have focused primarily on how actual transnational insolvencies should best be administered so as to provide optimal results for a distressed debtor and its creditors and shareholders (or other owners).

In this brief essay I consider insolvency law reform from a very different perspective. I focus on the instrumental effects of insolvency law on the primary behaviour of participants in a market economy. My hypothesis is straightforward: there are significant economic effects of insolvency law the primary impact of which do not fall on insolvent debtors and those with relationships with those debtors, such as creditors and shareholders. Instead, some aspects of insolvency law affect primarily debtors that are *not* financially distressed (and that never will be) as well as other market participants having or wishing to have relationships with those debtors. In particular, insolvency law influences directly the availability and cost of credit and other investments in firms.

The availability and cost of secured credit, sometimes referred to as "asset-based" credit, is especially sensitive to the regime for insolvency law that would apply when a debtor becomes subject to insolvency proceedings. This phenomenon played a central role in the development of the regime for secured credit in the Convention on International Interests in Mobile Equipment ("Convention") and the Protocol thereto on Matters specific to Aircraft Equipment ("Protocol").[9] The Convention and Protocol create a modern system for secured credit (including equipment leasing) in the realm of aircraft financing. But, as discussed below, they reach even further. They contain provisions intended to override the insolvency laws that otherwise would be applicable under the laws of a state that becomes a party to the Convention and the Protocol. And these provisions were crafted precisely for the purpose of increasing the availability and reducing the cost of credit.

Part II of this paper provides a brief summary of the background that ultimately led to the development and completion of the Convention and the Protocol. Part III offers an overview of the principal features of the regime that would exist

7. *See* Charles W. Mooney, Jr., *Extraterritorial Impact of Choice-of-law Rules for Non-United States Debtors under Revised U.C.C. Article 9 and a New Proposal for International Harmonization*, Ch. 10, in CROSS-BORDER SECURITY AND INSOLVENCY (M. Bridge & R. Stevens eds., 2001), at 189 ("Understandably, the focus of these projects has been on procedural aspects of insolvency proceedings, to the end that cooperation, maximization of recoveries, and equitable distributions would be promoted.").

8. *See*, e.g., CROSS-BORDER SECURITY AND INSOLVENCY, *supra* note 7.

9. The Convention may be found at <http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf> (29 February 2004) and the Protocol at <http://www.unidroit.org/english/conventions/mobile-equipment/aircraftprotocol.pdf> (29 February 2004). An indispensable guide for anyone dealing with the Convention and Protocol is the OFFICIAL COMMENTARY (hereinafter, "COMMENTARY"), prepared by Professor Sir Roy Goode and approved by the Governing Council of the International Institute for the Unification of Private Law (UNIDROIT). The Commentary is available from UNIDROIT, Via Panisperna 28, I-00184 Rome, Italy, and on the UNIDROIT website, <http://www.unidroit.org>.

under the Convention and Protocol.[10] Part IV discusses the principal provisions of the Convention and Protocol that are intended to apply in insolvency proceedings and explains the core insight as to how and why these provisions are intended to make credit more available at a lower cost. Part V then develops the claim that those who would seek to reform and improve insolvency laws must look beyond the effects of those laws on insolvent debtors and other affected persons when debtors are subject to actual insolvency proceedings. Reformers also must take into account the instrumental economic effects of insolvency laws on market participants in general. The insolvency-related provisions of the Convention and the Protocol illustrate the point well. Part VI then concludes the paper.

II. Background of the Cape Town Convention and Aircraft Equipment Protocol

The Convention and the Protocol were opened for signature following a three week diplomatic conference in Cape Town, South Africa in October–November 2001.[11] The diplomatic conference was hosted by the government of South Africa and jointly sponsored by the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organization (ICAO).[12] Sixty-eight states and 14 international organizations participated in the diplomatic conference.[13] The Convention originated with a proposal made to the Governing Council of UNIDROIT in 1988 by the Canadian government.[14] After a study[15] and preliminary meetings,[16] the UNIDROIT Governing Council established a Study Group in 1992 to work towards a draft convention.[17] Early in the process the UNIDROIT Study Group invited a group of aircraft financing experts, representing aircraft and aircraft engine manufacturers and financial institutions, to form the Aviation Working Group (AWG).[18] The AWG, later working with the International Air Transport Association, provided invaluable advice throughout the project. In 1999 and 2000 three Joint Sessions of a UNIDROIT Committee of Governmental Experts and a Subcommittee of the ICAO Legal Committee as well as a meeting of the full ICAO Legal Committee considered the Convention and Protocol.[19] Subsequently a draft Convention and Protocol were approved by

10. Parts II and III are derived in part from Charles W. Mooney, Jr., *The Cape Town Convention on International Interests in Mobile Equipment and the Aircraft Equipment Protocol: A New Era for Aircraft Financing*, 18 Air & Space Law (Summer 2003) 4,7.
11. COMMENTARY at 1.
12. Id.
13. Id.
14. Id. at 3.
15. See International Regulation of Aspects of Security Interests in Mobile Equipment: Study, prepared by Professor R.C.C. Cuming, UNIDROIT 1989 Study LXXII-Doc. 1.
16. The UNIDROIT Governing Council established a preliminary restricted exploratory group in response to the Canadian proposal. COMMENTARY at 3.
17. Id.; Jeffrey Wool, *The Next Generation of International Aviation Finance Law: An Overview of the Proposed UNIDROIT Convention on International Interests in Mobile Equipment as Applied to Aircraft Equipment*, 20 U. Pa. J. Int'l Econ. L. 499, 501 (1999).
18. COMMENTARY at 3.
19. Id. at 4.

the Governing Council of UNIDROIT and the Council of ICAO for submission to a diplomatic conference.[20]

III. The Convention and Protocol in a Nutshell

The project culminating in the Convention and Protocol originally was intended to regulate and facilitate secured financing of various types of mobile equipment. But it soon became obvious that a convention adequate for one type of equipment would not necessarily be appropriate for another type. This observation resulted in the structure finalized at Cape Town. The Convention contains the basic aspects of a legal regime for secured financing of equipment; the Protocol contains specialized provisions necessary to adapt the Convention to the financing of aircraft and aircraft engines.[21] Accordingly, the Convention is not intended to operate on a stand-alone basis; it can be effective only in conjunction with a protocol covering a specific type of equipment.[22]

The Convention and Protocol establish an international legal system for security interests in aircraft equipment (called "international interests" in the Convention).[23] The overarching goal is to facilitate secured financing and leasing.[24] During the next several years manufacturers of commercial aircraft equipment hope to sell, and airlines worldwide hope to buy, more than a trillion dollars worth of products.[25] Yet the local legal regimes in many states are inadequate to support secured asset-based financing. In the absence of legal reform, fewer transactions will take place and those that are completed will feature higher costs of financing and in some cases will require the sovereign credit of states in which airlines are based. The Convention and Protocol provide reforms that in many respects follow the philosophy and approach of Uniform Commercial Code ("U.C.C.") Article 9 (Secured Transactions), in effect in every state of the United States, as well various personal property security acts in effect in several provinces of Canada. The conformity of the Convention and Protocol to principles of secured transactions law in North America is no accident. The United States delegation sought this result throughout the process for the simple reason that our legal regime for secured credit works, and it works well.

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20. Id.

21. Id. at 7.

22. Convention art. 49; COMMENTARY at 7. UNIDROIT is in the process of developing protocols for rail equipment and space equipment. The current draft of the rail equipment protocol may be found at <http://www.unidroit.org/english/internationalinterests/draftrailprotocol/72h-08-e.pdf> (29 February 2004) and the current draft of the space protocol at <http://www.unidroit.org/english/internationalinterests/draftspaceprotocol/72j-10-e.pdf> (29 February 2004).

23. Convention art. 2(1).

24. See COMMENTARY at 7–8 (describing five underlying principles of the Convention and Protocol as "[p]racticality" for "asset based financing," "[p]arty autonomy," "[p]redictability in the application of the Convention," "[t]ransparency" through "registration . . . in order to give notice . . . to third parties," and "[s]ensitivity to national legal cultures").

25. Wool, *supra* note 17, at 504 & n.22 ("These transaction types [secured financing and leasing] are essential to help the world's airlines meet the unprecedented demand for aircraft equipment over the next twenty years, the estimated value of which exceeds U.S.$1.2 trillion."), *citing* AIRBUS INDUSTRIE, GLOBAL MARKET FORECAST 1998–2017 5 (1998); THE BOEING COMPANY, 1998 CURRENT MARKET OUTLOOK 42(1998).

As international, multiparty treaties, the Convention and Protocol offer significant advantages over attempts to reform and harmonize local laws (through a model law or otherwise). The legal regimes of many jurisdictions are hostile to non-possessory security interests.[26] Moreover, local regimes are more likely to favour local interests.[27] As a party to an international intergovernmental agreement, however, a Contracting State should be more likely to ensure that its courts give effect to the letter and goals of the new legal regime.

The Convention and Protocol will enter into force three months after ratification by eight states.[28] At this time the Convention and Protocol have been ratified or acceeded to by four states and have been signed by 26 states, including the United States.[29] Expectations are high that the United States will ratify the Convention and Protocol this year and other states are seriously considering ratification as well.

An international interest under the Convention is autonomous and international in character.[30] It is created under the Convention and the Protocol and is independent of security devices under applicable law. The Convention's interpretive principles are specified in its preamble; it is to be interpreted taking into account its "international character" and the promotion of "uniformity and predictability."[31] The Convention provides that the applicable law is the domestic law that is "applicable by virtue of the rules of private international law in the forum state."[32]

The objects to which the Convention applies are "airframes, aircraft engines and helicopters," "railway rolling stock," and "space assets."[33] But the Convention actually applies to objects *only* if covered by an effective protocol relating to that type of object; other types of objects also may be covered by future protocols.[34] The Protocol covers international interests in "aircraft objects" which include "aircraft," "airframes," "aircraft engines," and "helicopters."[35]

The Convention applies if the debtor is situated in a Contracting State at the time an agreement is concluded.[36] There are four non-exclusive possibilities for determining a debtor's location for this purpose. A debtor is situated in the Contracting State in which the debtor: (i) "is incorporated or formed," (ii) "has its registered office or statutory seat," (iii) "has its centre of administration," or (iv) "has its place of business" ("principal place of business," if it has more than one).[37] The Convention and Protocol also apply to a helicopter or airframe registered on the national register in a Contracting State.[38]

In general the Convention applies whether or not the characteristics of a transaction, an object, or the parties have any "international" aspect. In effect, the type of

26. Wool, *supra* note 17, at 502.
27. *Id.*
28. Protocol art. XXVII(1)
29. Listing of signatory states *available at* <http://www.unidroit.org/english/implement/i-2001-convention.htm> (29 February 2004).
30. *See* Wool, *supra* note 17, at 516–517.
31. Convention Preamble; art. 5(1).
32. *Id.* art. 5(3). The Convention in general does not supplant applicable law concerning issues such as a debtor's power to contract or contractual defenses, liability in tort, the authority of a debtor's agents or officers, or a debtor's existence, organization and legal characteristics. In addition, the Convention does not override governmental regulations such as those governing safety.
33. *Id.* art. 2(3).
34. *Id.* arts. 2(2); 49; 51.
35. *See* Protocol, Art. I(2)(a), (b), (c), (e), (*l*) (defining these terms).
36. Convention art. 3(1).
37. *Id.* art. 4(1), (2).
38. Protocol art. IV(1).

equipment contemplated by the Convention is inherently "international" in character. However, a Contracting State may declare, at the time it becomes a party to the Convention, that the Convention will not apply to an "internal transaction."[39] But even if a state makes such a declaration, the Convention's provisions on registration and priority (discussed below) would apply.[40] In effect, although the Convention and Protocol are international instruments, their principal purpose is to override and reform unsatisfactory local legal regimes.[41]

An international interest is created pursuant to an "agreement," which is defined to include a "security agreement," "title reservation agreement," or "leasing agreement."[42] The formal requirements for creating an international interest closely resemble the requirements for attachment of a security interest under U.C.C. Article 9.[43] First, an agreement must be in "writing," which is defined so as to include records other than traditional paper-and-ink records.[44] Second, the agreement must relate to an object as to "which the chargor, conditional seller or lessor has power to dispose."[45] Third, a security agreement must "enable the secured obligations to be determined" but it need not "state a sum or maximum sum secured."[46] Under the Protocol, the Convention also applies to a contract of sale of an aircraft object.[47] The Protocol contains similar formal requirements for a contract of sale of an aircraft object.[48]

The Convention builds on property interests ("real rights") under applicable law.[49] The Convention in general does not supplant the applicable law concerning issues such as a debtor's property rights or power to transfer property. "An international interest in an object also extends to proceeds of that object," as is the case under U.C.C. Article 9.[50]

An assignment of associated rights also effects an assignment of the related international interest.[51] "Associated rights" consist of rights to payment or performance under an agreement, such as secured obligations, purchase price obligations under a title reservation agreement, or rentals under a leasing agreement.[52] There are formal requirements similar to those under Convention article 7 which must be satisfied for an assignment of associated rights to carry with it the related international interest.[53]

The Convention and the Protocol contemplate the creation and operation of an international registry for the registration of (*i.e.* providing public notice of) international interests. The international registry is addressed in Chapters IV–VII of the

39. Convention art. 50(1); 1(n) (defining "internal transaction").
40. Id. art. 50(2).
41. Because every state in the United States has adopted U.C.C. Article 9, there is no pressing need for the United States to ratify the Convention and Protocol in order to facilitate secured financing and leasing for the benefit of United States-based airlines. However, ratification by the United States would carry substantial symbolic weight and would encourage other states to ratify these instruments.
42. Convention art. 1(a), (ii), (*ll*), (q). The applicable law determines the characterization of the agreement under which an international interest is created. *Id.* art. 2(4).
43. Id. art. 7; Protocol art. V; *see* U.C.C.'9-203(a), (b).
44. Convention arts. 7(a); 1(nn).
45. Id. art. 7(b).
46. Id. art. 7(c).
47. Protocol art. III; *see* Convention art. 41.
48. Protocol art. V(1).
49. See Convention art. 7(b); Protocol art. V(1)(b).
50. Convention art. 2(5); 1(w) (defining "proceeds"); U.C.C.'9-203(f); 9-315(a)(2).
51. Convention art. 31(1).
52. Id. art. 1(c).
53. Id. art. 32(1).

Convention and Chapter III of the Protocol. The international registry will be an object-specific registry (*e.g.* registrations will be made against and searched by criteria such as the manufacturer, model, and serial number of an aircraft object).[54] Although this differs from debtor-name registry under U.C.C. Article 9, Part 5,[55] it will be consistent with the object-specific Federal Aviation Administration (FAA) Registry in the United States. But the international registry will differ from FAA conveyance registry, in which actual transactional documentation is filed for recordation. The international registry will be a fully electronic registry, more closely resembling the state filing offices under the U.C.C. Article 9 "notice-filing" system. A registration will contain only information describing the aircraft object, the parties, and the nature of the transaction. ICAO, as the current supervisory authority designated under the Protocol, is presently working with an advisory commission on regulations to govern the international registry as well as procedures for selecting a registrar to operate the registry.

The Convention and Protocol also address the relationship of the international registry to national registries under the Chicago Convention,[56] such as the United States FAA Registry in Oklahoma City. A Contracting State may declare "designated entry points" within the Contracting State as portals for the registration of international interests.[57] It is contemplated that the United States will designate the FAA Registry as its portal. It also is contemplated that the filings for recordation now made with the FAA Registry will continue to be made. The international registry will not replace national registries under the Chicago Convention.

The priority of international interests generally is based on time of registration of an international interest or prospective international interest.[58] The priority of an international interest also extends to proceeds.[59] The Convention also contains rules dealing with priority between international interests and other interests arising under applicable law, such as nonconsensual rights and interests, and between competing assignments of associated rights.[60]

The Convention provides basic remedies for enforcement of an international interest created pursuant to a security agreement, including the right of the chargee (the creditor under a security agreement) to take possession of the charged object, to sell or lease the object, or to collect or receive income or profits relating to the object.[61] The package of remedies is strikingly similar in substance to the remedies available under U.C.C. Article 9, Part 6.[62] A chargee's remedies must be exercised in a "commercially reasonable manner."[63] Remedies of conditional sellers and

54. *Id.* arts. 18(1); 22(2), (3); Protocol art. VII.
55. *See* U.C.C.'9-519(c)(1) (filing officer required to index filed financing statements according to the name of the debtor).
56. Convention on International Civil Aviation, signed at Chicago on December 7, 1944.
57. Protocol art. XIX.
58. Convention art. 29; Protocol art. XIV. The priority and validity of an international interest in a debtor's insolvency proceedings is discussed in Part IV, *infra*.
59. Convention art. 29(7). This follows U.C.C.'9-322(b)(1).
60. Convention arts. 36, 39; 40.
61. *Id.* art. 8(1).
62. *See*, e.g., U.C.C."9-609 (secured party's right to take possession after default); 9-610 (secured party's right to dispose of collateral after default).
63. Convention art. 8(3); *see* U.C.C.'9-610(b) (secured party's disposition of collateral after default must be "commercially reasonable").

lessors under the Convention are limited to terminating an agreement or taking possession of the object or obtaining a court order for that relief; other remedies are left to the applicable law.[64] This reflects the variety of remedial systems for these transactions among the various legal regimes.

Remedies under the Convention must "be exercised in conformity with the procedure prescribed by the law of the place where the remedy is to be exercised."[65] In a jurisdiction that requires resort to judicial proceedings to recover possession of an object or to dispose of it, for example, "self-help" remedies would not be available. In addition, a Contracting State may declare, at the time it becomes a party to the Convention, that any Convention remedy "may be exercised only with leave of the court."[66]

The Protocol, which controls when inconsistent with the Convention,[67] contains a number of variations from the Convention's remedies provisions. Under the Protocol, a remedy exercised in conformity with a provision of the agreement is deemed to be exercised in a commercially reasonable manner unless the "provision is manifestly unreasonable."[68] The Protocol also adds the additional remedies of de-registration and export of an aircraft.[69] A waiver of sovereign immunity is binding.[70] The Convention and Protocol contain provisions relating to choice of forum and jurisdiction.[71]

The baseline transition rule is that the Convention "does not apply to a pre-existing right or interest."[72] A Contracting State may declare a different transition rule, however, if its declaration specifies a date (not less than 3 years after its declaration) on which the Convention and relevant protocol will apply to pre-existing rights and interests.[73] Creditors would have an opportunity to register their pre-exiting rights or interests in the International Registry so as to preserve the pre-effective date priorities.

The Convention and the Protocol represent law reform at its best. If widely ratified they will effectively export U.C.C. Article 9 to the world in the field of aircraft secured financing. This should materially lower the cost of financing for users in many areas of the world and will boost the sales by manufacturers as well.[74]

IV. Insolvency-related Provisions

Any legal regime for secured credit must take into account the treatment of a security interest should the debtor become the subject of insolvency proceedings. If a

64. Convention art. 10.
65. *Id.* art. 14.
66. *Id.* art. 54(2).
67. *Id.* art. 6(2).
68. Protocol art. IX(3). This generally follows U.C.C. section 9-603(a). The Protocol also contains provisions for special relief in insolvency proceedings; these are discussed in Part IV, *infra*.
69. Protocol art. IX(1), (2).
70. Protocol art. XXII.
71. *See* Convention arts. 42 (choice of forum); 43 (jurisdiction under Convention art. 13 relating to interim relief); 44 (orders against the registrar); 45 (Convention's jurisdiction provisions do not apply to insolvency proceedings); Protocol art. XXI (extending jurisdiction under Convention art. 43 to courts of a Contracting State in which an aircraft is registered).
72. Convention art. 60(1); *see* Convention art. 1(v) (defining "pre-existing right or interest" as a right or interest existing before the effective date of the Convention with respect to a protocol).
73. *Id.* art. 60(2), (3).
74. *See* Part V, *infra*.

security interest is not effective in the debtor's insolvency proceedings then much of the utility of the security interest vanishes. Those involved with the development of the Convention and Protocol took this point quite seriously. In addition to providing for an international interest that would be effective and enforceable against the debtor and third parties, the Convention and Protocol expressly address the treatment to be afforded an international interest in a debtor's insolvency proceedings. Inasmuch as the Convention and Protocol are international instruments, they will override any conflicting domestic law of a Contracting State, including domestic insolvency law. The following discussion identifies and describes the principal insolvency-related provisions of the Convention and Protocol. For convenience, the discussion assumes and proceeds as if the Convention and Protocol were in effect and fully applicable.

A. Validity and priority of international interests in insolvency proceedings

In order to ensure the most basic validity and effectiveness of an international interest, article 30(1) of the Convention provides that an international interest that is registered before commencement of insolvency proceedings will be effective in those proceedings.[75] This is consistent with the general treatment of security interests under United States bankruptcy law.[76] Drafters of the Convention were unwilling to leave this crucial issue to the vagaries of local insolvency legislation, preferring to install this baseline principle in an international instrument carrying enhanced credibility and impact.[77] As the Commentary points out, "[e]ffective," for purposes of article 30(1), "means that the international interest will be recognised as proprietary in nature and therefore in principle rank ahead of the claims of unsecured creditors."[78]

Article 30(1) addresses the effectiveness of a *registered* international interest. Under article 30(2) the Convention also addresses *unregistered* interests. Even an unregistered interest is effective in insolvency proceedings if it is effective under the applicable law.[79] The effect of article 30(2) is that the Convention is a validating instrument, not an invalidating instrument. It does not invalidate in insolvency proceedings interests that would be effective outside of the Convention. Consider an example. Assume that a security interest in an aircraft has been created under U.C.C. Article 9 in a transaction within the scope of the Convention and the Protocol. Assume further that it is properly perfected by compliance with the recordation requirements under the FAA Act,[80] but that the secured party neglected to have

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75. Convention art. 30(1).

76. *See generally* CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY" 7.25–7.28, at 538–555 (The Foundation Press, Inc. Westbury New York 1997).

77. *See* XT, *supra* (discussing benefits of an international convention over a model law or ad hoc local laws).

78. COMMENTARY at 114; "An effective international interest may thus not be set aside or subordinated for the benefit of the debtor, the insolvency administrator or the estate, or other claimants." *Id.*

79. Convention art. 30(2); *see* Convention art. 1(mm) (defining "unregistered interest" as "a consensual interest or non-consensual right or interest (other than an interest to which Article 39 applies) which has not been registered, whether or not it is registrable under this Convention").

80. U.C.C.'9-311(a)(1) (filing a financing statement not necessary or effective to perfect security interest when effectiveness against judicial lien creditor is governed by federal law); 49 U.S.C."44107-11 (date) (system of recording of interests in civil aircraft for validity against third parties without actual notice of interest).

its interest registered with the international registry in accordance with the Convention and Protocol.[81] Because the perfected security interest would not be avoidable in the debtor's insolvency proceedings under the applicable law,[82] the failure to register the interest in the international registry would not impair its effectiveness in the insolvency proceedings.[83]

B. Avoidance powers and procedural rules

The Convention recognizes two material exceptions to the general effectiveness of registered international interests in insolvency proceedings. First, article 30 of the Convention does not affect avoidance rules applicable in insolvency proceedings under which a "preference" or a "transfer in fraud of creditors" may be avoided.[84] Neither the Convention nor the Protocol defines the terms "preference" or "transfer in fraud of creditors," leaving the determination of their scope to the applicable insolvency law.[85] It is clear enough, however, that no other avoidance powers under the applicable law come into play in the case of a registered international interest effective under article 30(1) or an unregistered interest effective under article 30(2).[86] For example, because a registered international interest is effective under article 30(1), it could not be avoided under applicable United States law even if the interest had not been perfected in accordance with U.C.C. Article 9; article 30(1) controls.[87] Moreover, a (hypothetical, for present purposes) legal regime in which all nonpossessory interests were void in insolvency proceedings would

81. See Convention arts. 16–27; Protocol arts. XVII–XX.

82. 11 U.S.C.'544(a)(1) (date) (trustee may avoid transfer subordinate to rights of hypothetical judicial lien creditor); U.C.C.'9-317(a)(2) (security interest is subordinate to interest of judicial lien creditor before security interest is perfected or before financing statement is filed and one of the steps specified in U.C.C.'9-203(b)(3) (*e.g.* debtor has signed a security agreement) has occurred).

83. Convention art. 30(2). The creditor nonetheless may have behaved foolishly because its failure to register its interest in the international registry rendered the interest vulnerable to being subordinated to a conflicting international interest in the same aircraft or cut off by a buyer before it is registered. Convention art. 29(1), (2), (3); Protocol art. XIV(1). Note also that if the interest had been registered in the international registry it would be effective in the debtor's insolvency proceedings under article 30(1) even it had *not* been perfected under the U.C.C. and the FAA Act.

84. Convention art. 30(3)(a).

85. As an active participant in the drafting and negotiation process for the Convention over several years, I clearly recall that the decision not to attempt to define these terms was a deliberate one. The consensus view was that insolvency systems so differed from one another that it would not be feasible to fashion definitions that would adequately mesh with all systems. Moreover, any such attempt likely would have resulted in definitions that unintentionally would have been both underinclusive and overinclusive.

86. COMMENTARY at 115 ("Article 30(3) is *confined* to the avoidance of preferences and transfers in fraud of creditors. It follows that other grounds of avoidance that would ordinarily be applicable cannot be invoked to impeach an international interest effective under Article 30(1) or (2)."") (emphasis added).

87. In effect, as a matter of United States federal law the registered international interest would be invulnerable to the interest of a judicial lien creditor notwithstanding the contrary rule under U.C.C. section 9-317(a)(2), which subordinates most unperfected (under U.C.C. Article 9) security interests to a judicial lien creditor. *See* Convention arts. 1(mm) ("unregistered interest" includes a "nonconsensual right or interest (other that an interest to which Article 39 applies)"); 30(1) ("registered interest" has priority over "unregistered interest"); COMMENTARY at 140 ("non-consensual right or interest" includes "the interest arising from the attachment of the debtor's equipment by way of execution of a judgment debt"). However, if the international interest were neither registered in the international registry nor perfected (or a filing made and a 9-203(b)(3) step taken) under U.C.C. Article 9, then a trustee in bankruptcy could avoid the interest under Bankruptcy Code section 544(a)(1) and U.C.C. section 9-317(a)(2) by asserting the rights of a hypothetical judicial lien creditor.

not expose a registered international interest to avoidance *unless* that regime could be characterized as either a preference or a fraud against creditors, a characterization that I believe would be implausible.[88] Article 30 also does not affect "rules of procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator."[89] The most obvious example of a relevant rule of procedure is the injunction or stay of enforcement proceedings against a debtor or its assets during the continuation of an insolvency proceeding.[90]

C. Cure or recovery of possession of aircraft objects: shades of United States Bankruptcy Code section 1110

The most striking insolvency-related provisions are two alternative provisions found in article XI of the Protocol, Alternatives A and B. Under Protocol article XXX(3), a Contracting State may, at the time it becomes a party to the Convention and Protocol, choose to adopt one or the other of the two alternative provisions or it may choose not to adopt either of the alternatives. If the Contracting State elects one of the alternative versions of article XI, then that version will apply when the Contracting State is a debtor's "primary insolvency jurisdiction."[91]

Both alternative versions of article XI were inspired by section 1110 of the United States Bankruptcy Code.[92] Section 1110 applies only to the holders of security interests in, lessors of, and conditional vendors of large commercial aircraft and vessels operated by air carriers and water carriers.[93] In general it provides that the right of a secured party, lessor, or conditional vendor to take possession of and enforce its rights against an aircraft or vessel are not affected by any provision of the Bankruptcy Code, including the automatic stay.[94] However, an exception provides that the automatic stay will apply if within the 60-day period following the order for relief[95] the trustee, with court approval, "agrees to perform all of the obligations of the debtor" under the relevant security agreement, lease, or conditional sales contract and (with certain exceptions) cures all defaults before the 60-day period expires.[96]

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88. While the hypothetical avoidance rule might derive from concerns about fraud on creditors and the problem of ostensible ownership, the better view is that the mere fact that the creditor is not in possession of the collateral would *not* constitute an avoidance power based on a fraud on creditors within the meaning of article 30(3)(a). This is an especially compelling argument inasmuch as the creditor would have provided public notice of its interest by virtue of the registration in the international registry and in view of the credit facilitation policies underlying the Convention and Protocol. Nevertheless, the example does highlight the fact that in the future counsel giving legal opinions as well as the courts will find it necessary to give meaning to the scope of article 30(3)(a).

89. Convention art. 30(3)(b).

90. COMMENTARY at 115–116, *Illustration 27*; *see, e.g.*, 11 U.S.C.'362(a) (date) (filing of bankruptcy petition triggers an automatic stay).

91. Protocol arts. XI(1); XXX(3); *see* Protocol art. 1(n) (defining "primary insolvency jurisdiction" as "the 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 place where the debtor is incorporated or formed, unless proved otherwise").

92. Wool, *supra* note 17, at 533; *see* 11 U.S.C.'1110 (date).

93. 11 U.S.C.'1110(a)(3) (date).

94. *Id.*'1110(a)(1) (date).

95. An order for relief occurs under the Bankruptcy Code upon the filing of a voluntary petition. *Id.*'301 (date).

96. *Id.*'1110(a)(2) (date). The trustee need not cure defaults such as *ipso facto* defaults based on insolvency or the filing of a bankruptcy petition. *Id.* Also, the trustee and the relevant secured party, lessor, or conditional vendor may agree to extend the 60-day period. *Id.*'1110(b) (date).

Alternative A of article XI closely resembles section 1110; the Commentary refers to Alternative A as the "'hard', or rule-based, version" of article XI.[97] Under Alternative A, the debtor's "insolvency administrator"[98] or the debtor must give possession of the relevant aircraft object to the creditor holding an international interest in the object before the expiration of the "waiting period."[99] Instead of specifying a period of time following the commencement of insolvency proceedings, such as the 60 day period provided by section 1110, Alternative A of article XI permits a Contracting State, in its declaration with respect to that article, to specify the applicable "waiting period" that will apply when the Contracting State is a debtor's primary insolvency jurisdiction.[100] As under section 1110, if the insolvency administrator or debtor "cures all defaults . . . and has agreed to perform all future obligations under the agreement," the insolvency administrator or debtor "may retain possession of the aircraft object."[101]

The Commentary describes Alternative B of article XI as the "'soft', or discretion-based, version."[102] The description is apt indeed inasmuch as that alternative does not provide a creditor with any right to obtain possession of an aircraft object in insolvency proceedings. Instead, the insolvency administrator or debtor, on a creditor's request, merely is required to give the creditor notice whether the administrator or debtor will cure defaults and perform future obligations and permit the creditor to take possession of the aircraft object.[103] This notice must be given within a time specified in the Contracting State's declaration.[104] If the administrator or debtor fails to give the required notice or notifies the creditor that it will allow the creditor to take possession of an object but fails to do so, then "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."[105]

Other than taking care to see that Alternative B was technically adequate, the United States delegation and the AWG generally were much less concerned with the substance of Alternative B than with Alternative A during the process from which the Convention and Protocol eventually emerged. Alternative B establishes little more than a procedural structure under which a creditor may beg and plead for a court's mercy. It was proposed and developed by states opposed to Alternative A, ostensibly as alien to their domestic regimes and as too restrictive of judicial discretion. These states were primarily civil law jurisdictions (with France leading the charge). However, the objections by these proponents of Alternative B made no sense in the context of article XI, which was always conceived as an *option* for a Contracting State and not a mandatory provision of the Protocol. Any Contracting

97. COMMENTARY at 200.
98. Convention art. 1(k) (defining "insolvency administrator" as "a person authorised to administer the reorganisation or liquidation, including one authorised on an interim basis, and includes a debtor in possession if permitted by the applicable insolvency law").
99. Protocol art. XI(2) (*Alternative A*).
100. *Id.* art. XI(3) (*Alternative A*).
101. *Id.* art. XI(7) (*Alternative A*). However, "a default constituted by the opening of insolvency proceedings" need not be cured. *Id.*
102. COMMENTARY at 200.
103. Protocol art. XI(2) (*Alternative B*).
104. *Id.*
105. *Id.* art XI(5) (*Alternative B*).

State would have been free to choose to reject article XI even if Alternative B had never been proposed and included in the Protocol. Why should a civil law jurisdiction care whether *another* state has the choice of adopting article XI in the form of Alternative A or not at all?[106]

The operation of article XI may be assisted by another provision of the Protocol, article XII, to which a Contracting State may elect to be bound in its declaration.[107] Article XII requires the courts of a Contracting State that so elects to "co-operate to the maximum extent possible with foreign courts and foreign insolvency administrators in carrying out the provisions of Article XI." This may be especially important in the case of an aircraft object physically located in the Contracting State that has adopted article XII and when the debtor's primarily insolvency jurisdiction is another Contracting State that has adopted one of the alternative versions of article XI.[108]

It is unlikely that the United States will choose either alternative of article XI if it becomes a Contracting State by ratifying the Convention and Protocol. Given the relative satisfaction with section 1110 of the Bankruptcy Code, there is little need for article XI with respect to airline debtors for which the United States is the primary insolvency jurisdiction.

V. Taking Seriously the Role and Impact of Insolvency Law Outside Insolvency Proceedings

The foregoing summary of the insolvency-related provisions of the Convention and Protocol may suggest to some that the primary function and effect of these provisions will be to ensure the effectiveness of international interests in insolvency proceedings and, at least when Alternative A or article XI is in effect, to ensure either compliance with the agreement relating to the interest or a prompt possessory remedy in those proceedings. But that would be wrong. Instead, the principal effects will take place outside bankruptcy in the form of the facilitating financing that would be unavailable (or available only at a substantially higher cost) under the prevailing domestic legal regimes of many states. Of course, the effectiveness of an international interest in a debtor's insolvency proceedings will sometimes be put to the actual test, but I hypothesize that *most* debtors that become subject to the Convention and Protocol regime will *not* become subject to insolvency proceedings.

The excellent 1999 study of the then-draft Convention and Protocol by Professor Saunders, Mr Srinivasan, Professor Walter, and Mr Wool supports the claim that

106. While I cannot prove it, my participation in and observations of the process of negotiation and debate convinced me that the *only* reason for the objections to including the substance of Alternative A alone a choice for a Contracting State is that Alternative A follows closely United States law—section 1110 of the Bankruptcy Code. Having witnessed the Convention and Protocol being modeled on the substance and policies of U.C.C. Article 9 and the Canadian personal property security acts, perhaps borrowing from United States bankruptcy law was simply "too much" for the objecting states.

107. Protocol arts. XII; XXX(1).

108. See COMMENTARY at 203.

the principal effects of the Convention and Protocol regime will take place outside insolvency proceedings.[109] As they explained:

> This study has identified the micro and macro economic impact of the proposed Convention/Aircraft Protocol. It concludes that, to the extent adopted and effectively implemented, these proposed legal instruments will achieve significant economic gains. These gains will be widely shared among airlines and manufacturers, their employees, suppliers, shareholders, and customers, as well as the national economies in which they are located. The economic gains will be substantial and complementary. Relying on conservative assumptions, the gains are estimated at several billion dollars on an annual basis. Such gains are the foundation of any durable legal innovation capable of attracting strong, broad-based international support.[110]

Particularly relevant to this paper is that study's analysis of the market impact of clarifications to section 1110 made in the Bankruptcy Reform Act of 1994 ("Reform Act").[111] The authors analysed the market prices of publicly traded United States airline stocks for the week before and the week after passage of the Reform Act.[112] They found that there was an "abnormal return" on these stocks of 4.65%, corresponding to an increase in market value of $442.8 million, as a direct result of the Reform Act's section 1110 clarifications.[113] They identified a source of increased projected earnings from the change in law as decreased costs of financing for the airlines.[114] Significantly, they concluded that the likely economic benefits around the world from adoption of the Convention and Protocol were likely to be much greater than the more conservative benefits resulting from clarifying section 1110 in the United States.[115] The study demonstrates clearly that the principal effects of section 1110 and the potential effects of the Convention and Protocol regimes are *not* merely the exercise of more effective remedies in airline insolvencies. The airlines considered in the study did not achieve greater future earnings potential because investors believed that if the airlines failed their secured creditors would have more effective access to their collateral. If anything, the effects of a stronger, clearer section 1110 would increase the concerns of shareholders in that context. The higher expectations resulted instead from the market's realization that the airlines would continue to receive financing and at lower costs.[116]

The study's conclusions reflect exactly what section 1110 and article XI, Alternative A, are intended to achieve. It is no coincidence that section 1110 applies to vessels and commercial aircraft and that article XI of the Protocol also applies to large aircraft; financing expensive vessels and commercial aircraft is essential to the

109. 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 (1999).
110. *Id.* at 351–352.
111. Pub. L. No. 103-394, 108 Stat. 4106,'201 (codified at 11 U.S.C.'1110 (date)).
112. Saunders *et al.*, *supra* note 109, at 331–334.
113. *Id.* at 332–333.
114. *Id.* at 333.
115. *Id.* at 333–334.
116. The study also emphasized the importance of nonbankruptcy enforcement remedies. *See id.*, at 325–326 (discussing "self-help" remedies and the right to speedy interim relief); *See* Convention arts. 13 (relief pending final determination); 54(2) (contracting state may declare that remedies may be taken "only with leave of court"); Protocol art. X (modifications to Convention art. 13).

businesses of commercial water carriers and airlines.[117] As the Commentary notes, "[w]ork in advance of the Diplomatic Conference identified this provision [Protocol article XI] as the single most significant provision economically."[118]

To be sure, not every change in the applicable law governing insolvency proceedings will have effects outside insolvency that are as direct and significant as a provision such as section 1110 or article XI, Alternative A, or the creation of a generally effective regime for secured financing such as the Convention and Protocol. But anyone who would seek to reform or harmonize insolvency law must appreciate the *principle* that insolvency law imposes instrumental effects outside of insolvency proceedings. Indeed, every investment contract of any kind with a firm must contemplate at some level the potential impact on the investment of a future insolvency proceeding of the firm.[119] For example, the excessive delays and expense often attributed to reorganizations under Chapter 11 in the United States provide an example of attributes of insolvency law that could chill otherwise efficient investments.[120] This is not to say that it is the proper domain of insolvency law to rewrite nonbankruptcy law to the end that different rules would apply to primary behaviour depending on whether the rule were applied inside or outside an insolvency proceeding; it is not.[121] But, in recognizing the instrumental role of insolvency law, the insolvency-related provisions of the Convention and Protocol generally seek to honour, vindicate, and give effect to international interests that are created and exist outside of insolvency proceedings.

Insolvency law cannot be understood or evaluated through a static analysis that supposes that a change in law will affect only the operation of that change in an

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117. *See* Saunders *et al.*, *supra* note 109, at 312 (footnotes omitted):

> [T]he average contribution of external finance to airline capital expenditures over the 1991–94 period alone was 76.7%. Specifically, because of its technology and capital-intensive nature, cyclical nature and competitive structure, the commercial airline industry is heavily dependent on external finance. This suggests that constraints on the availability of external finance and/or the high cost of external finance will have a greater adverse impact on this industry than most other sectors of the economy.

118. COMMENTARY at 199. The commentary continues:

> If the sound legal rights and protections embodied in the Convention and . . . Protocol are not available in the insolvency context, they are not available when they are most needed. . . . [G]iven the legal and policy importance of this provision, a special Insolvency Working group, made up on international experts from differing legal systems, was formed to develop this provision. Article XI, as modified in the subsequent intergovernmental negotiations, is the result of that work. *Id.*

119. Some have suggested that debtors should be entitled to contract for bankruptcy terms with creditors and other investors or to provide for them in corporate charters. *See, e.g.* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51 (1992); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Texas L. Rev. 515 (1999); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L. J. 1807 (1998).

120. A report by a committee of bankruptcy practitioners and judges provides evidence of the need to shorten the length and reduce the costs of chapter 11 cases. *See* FIRST REPORT OF THE SELECT ADVISORY COMMITTEE ON BUSINESS REORGANIZATION ("SABRE") 57 BUS. LAW. 163 (2001). SABRE, a special committee of the Business Bankruptcy Committee of the American Bar Association Section of Business Law, was formed "to consider the perception that chapter 11 business reorganizations take too long and cost too much and, if appropriate, to develop legislative solutions to reduce the time and cost." *Id.* at 166. Apparently SABRE concluded that the length and cost of chapter 11 cases do present problems, inasmuch as the report makes three specific legislative proposals. *Id.* at 169.

121. I have explained this claim in detail elsewhere in posing and defending a normative theory of bankruptcy law that I call "procedure theory." Charles W. Mooney, Jr., A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure (December 24, 2003) (unpublished manuscript, on file with the author).

actual insolvency proceeding.[122] Obvious as this point may be, bankruptcy experts do not always appreciate the point. Vigilance is essential. Even in the United States, where a modern secured financing law (U.C.C. Article 9) is in effect in every state, a few members of the United States Congress recently launched an assault on debtors that wish to obtain secured credit. Section 101 of the Employee Abuse Prevention Act of 2002 would have made a huge range of routine secured transactions avoidable in bankruptcy (although the bill's sponsors probably did not intend such a broad attack).[123] Happily that section and other offending provisions were dropped and the bill was never enacted. There are, of course, some critics of legal regimes that afford full priority to security interests in insolvency proceedings.[124] But to date these critics generally have been ignored by lawmakers in the United States. And certainly their views have been soundly rejected by the states and organizations that participated in the diplomatic conference in Cape Town.

VI. Conclusion

I applaud the many efforts to improve the state of insolvency law, both domestic and transnational, during recent years. But the goal of this essay is to issue a cautious reminder that insolvency law can cast a long shadow. It can have an enormous impact on transactions and behaviour outside of insolvency proceedings. Those that toil in the insolvency law reform projects must keep this in mind. Moreover, those who seek to harmonize and improve private law, such as the law of secured transactions and laws dealing with the transfer of securities, for example, must keep in mind as well the impact of insolvency law. As with the creation of the Convention and Protocol, private law reform sometimes must dictate changes to insolvency law if it is to achieve optimal results.

122. Consider a simple illustration of this point. Imagine that applicable insolvency law in the United States denied any legal effect, in an insolvency proceeding, to a mortgage given by an individual debtor on her or his personal residence. Would this mean that typically, in an individual's insolvency proceeding, the general creditors would share in the non-exempt portion of the value of a debtor's residence on an equal basis with the lender who financed the residence? Of course not. It would mean instead, typically, that *the debtor would not own a residence* because, in the absence of a mortgage effective in insolvency, the debtor could not have purchased a residence in the first place (or could have purchased only a much less valuable residence).

123. Employee Abuse Prevention Act of 2002, S. 2798, 107th Cong.'101 (2002); H.R. 5221, 107th Cong.'101 (2002). For a critique, see William M. Burke *et al.*, Report on Avoidance, Subordination, Super Priority, and Recharacterization Provisions of the Proposed Employee Abuse Prevention Act of 2002 (September 3, 2002) (unpublished manuscript, on file with author).

124. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996). Bebchuk and Fried argue that projects pursued with secured credit under full priority are likely to be unsound because of the negative externalities arising out of the inability of involuntary unsecured creditors (such as governmental taxing authorities and tort creditors) to adjust to the presence of security. *Id.* at 864–865, 895–921. For views more supportive of full priority, see, e.g. Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 Va. L. Rev. 2021 (1994); Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 Cornell L. Rev. 1349 (1997); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 Duke L. J. 425 (1997). Concerning security interests and bankruptcy policy, compare G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 Am. Bankr. Inst. L. Rev. 3 (2001) with Steven L. Harris & Charles W. Mooney, Jr., *Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 Am. Bankr. Inst. L. Rev. 85 (2001).