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## International Interests in Mobile Equipment: A Transnational Juridical Concept

Sir Roy Goode\*

\*University of Oxford, St. John's College, Oxford,

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# International Interests in Mobile Equipment: A Transnational Juridical Concept

Sir Roy Goode QC

## **Abstract**

[extract] The Convention on International Interests in Mobile Equipment, with its associated Aircraft Equipment Protocol, was concluded at Cape Town in November 2001 and, so far as I am aware, is unique, first, in creating a truly transnational form of real right, the international interest in mobile equipment, and, secondly, in providing for the establishment of an international register to record such interests and dealings in them. The absence in the past of an international substantive law regime for the protection of security interests and title-retention rights in equipment of high unit-value, such as aircraft objects, railway rolling stock and space assets, has seriously inhibited the extension of credit and leasing facilities for the acquisition of such assets and, where such facilities have been extended, has significantly increased the cost.

**KEYWORDS:** security interests, international securities, personal property, mobile equipment, Convention on International Interests in Mobile Equipment

# INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT: A TRANSNATIONAL JURIDICAL CONCEPT

*Sir Roy Goode OBE, QC\**

It is a privilege to be invited to contribute to this collection of essays in honour of David Allan and Mary Hiscock, friends and colleagues of long standing and a husband and wife team whose many years of academic partnership must surely be unique. Quite apart from being major players in the development of different law schools, they have made an immense contribution to our understanding of the legal and policy issues of development finance, particularly through their massive 11-volume work *Law and Development Finance in Asia*. Both have played leading roles on the international scene; both are past Presidents, and David is Honorary Life President, of the International Academy of Commercial and Consumer Law; and both are *bons viveurs* with a huge capacity for enjoying life and friendship.

In selecting my subject for this modest contribution I have been influenced by their enduring fascination with the subject of personal property security, an area of law which captured my own interest some 40 years ago and which continues to throw up problems of baffling complexity.

## **Introduction**

The Convention on International Interests in Mobile Equipment, with its associated Aircraft Equipment Protocol, was concluded at Cape Town in November 2001 and, so far as I am aware, is unique, first, in creating a truly transnational form of real right, the international interest in mobile equipment, and, secondly, in providing for the establishment of an international register to record such interests and dealings in them. The absence in the past of an international substantive law regime for the protection of security interests and title-retention rights in equipment of high unit-value, such as aircraft objects, railway rolling stock and space assets, has seriously inhibited the extension of credit and leasing facilities for the acquisition of such assets and, where such facilities have been extended, has significantly increased the cost. In relation to ships and aircraft there are international conventions governing security interests but these are for the most part limited to the recognition of rights created under the law of nationality registration of the ship or aircraft, rights of arrest and the priority of different types of non-consensual lien as between themselves and vis-à-vis consensual interests. The deficiencies in such an approach are apparent. The

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\* Emeritus Professor of Law in the University of Oxford and Emeritus Fellow of St. John's College, Oxford.

law of nationality registration may be hostile to non-possessory security and may not recognise various kinds of security interest accepted elsewhere; the rules governing creation, perfection, priorities of competing consensual interests and the impact of insolvency will vary from State to State; the types of dealing susceptible to entry on the register may be limited; and the legal regime governing remedies and their enforcement may be seriously defective. Moreover, there are no such conventions to protect interests in railway rolling stock, satellites or other space assets. The uncertainties generated by the lack of uniform substantive law rules are particularly serious in the context of financing transactions which may involve tens or even hundreds of millions of dollars.

The Cape Town Convention addresses these issues by prescribing a simple legal regime for the creation of international interests in aircraft objects, railway rolling stock and space assets; by providing a set of basic default remedies, including speedy relief pending final determination of the creditor's claim; by establishing an International Registry in which international interests and certain other kinds of interest can be registered; and by laying down a set of simple priority rules based on the order of registration, coupled with protection of the international interest in the event of the debtor's insolvency. The effect is that the creditor is guaranteed a high degree of legal protection in all Contracting States, while there are also built-in safeguards for the debtor. As regards aircraft objects, the Convention is supplemented in various ways by the Aircraft Equipment Protocol, for example, by the provision of additional remedies particular to aircraft and by special provisions governing the creditor's remedies on insolvency. A unique feature of the Convention is that it takes effect subject to and on the terms of the Protocol, which can thus override the Convention.

As regards aircraft objects the Convention requires eight ratifications. The first of these, by Panama, has already been deposited, and others are expected to follow in short order. The Convention and Protocol are both complex and lengthy; together they run to 99 Articles. Accordingly in the limited space available I have confined myself to four topics: the scope of application of the Convention; the requirements for the constitution of the international interest; its characterisation and relationship with national law; and the rules governing priorities and protection on insolvency, which provide the acid test for the effectiveness of security and title-retention interests.<sup>1</sup>

### **Scope of Application**

In order for the Convention to apply the parties must have concluded a security agreement, a title reservation agreement or a leasing agreement; the agreement must relate to an airframe, aircraft engine or helicopter or to railway rolling stock

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<sup>1</sup> For a comprehensive analysis, see the Official Commentary, prepared by the writer and published by UNIDROIT in September 2002.

or space assets, in each case as defined by and uniquely identifiable in accordance with the Protocol; the agreement must be constituted in accordance with the provisions of the Convention; and the debtor must, at the time of conclusion of the agreement, be situated in a Contracting State.<sup>2</sup> Where these conditions are satisfied the Convention applies, with an exception of limited effect enabling a Contracting State to exclude some provisions of the Convention in the case of purely internal transactions.<sup>3</sup> An international interest is an interest (a) granted by the chargor under a security agreement or (b) vested in a person who is the conditional seller under a title reservation agreement or (c) vested in a person who is the lessor under a leasing agreement.<sup>4</sup> These three categories (which do not encompass outright sales) are mutually exclusive, and for reasons which will become apparent there is an express provision that an interest which falls within category (a) does not also fall within category (b) or (c). Characterisation is left to the applicable law. As regards these two last categories it should be noted that the register is not an ownership register. In most cases the conditional seller or lessor will have acquired ownership before entering into the agreement, but it is only upon such entry that its Convention interest arises and becomes registrable.

### **Constitution of the International Interest**

The rules for the constitution of the international interest are laid down in Article 7 and are for the most part simple. They are that the agreement is in writing,<sup>5</sup> relates to an object of which the chargor, conditional seller or lessor has power to dispose, enables the object to be identified in accordance with the Protocol and, 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. The only one of these requirements calling for explanation is the power to dispose. A person has power to dispose of the object if it has the right to dispose, eg. as owner or as a person authorised by the owner to dispose of the object, or if, though not having

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2 Art. 2. In the case of aircraft objects an alternative to the debtor's being situated in a Contracting State is that the agreement relates to a helicopter, or to an airframe pertaining to an aircraft, registered in a nationality register of a Contracting State (Protocol, art. IV(1)).

3 Art. 50. A transaction is an internal transaction where the centre of main interests of all the parties is situated, and the relevant object located, in the same Contracting State at the time of conclusion of the contract. But even if a declaration is made the registration provisions and priority rules will continue to apply, as will some of the provisions on remedies, so that the exclusion is very narrow in compass.

4 With or without an option to purchase (art. 1(q)). A person may be both a debtor and a creditor, as where a lessee grants a sub-lease and thereby obtains a registrable interest himself, the register recording both the interest of the lessor under the head lease and that of the lessee under the sub-lease.

5 Defined in art. 1(nn) to include an electronic or other record of information capable of being reproduced in tangible form on a subsequent occasion and indicating by reasonable means a person's approval of the record.

the right to dispose, it has the legal power to make a disposition which is binding on the owner. This power may derive either from exceptions to the *nemo dat* principle under the applicable law - for example, disposal by an agent acting outside his actual authority but within his ostensible authority or, in civil law jurisdictions, delivery by a person lawfully in possession to a *bona fide* purchaser - or from the priority rules of the Convention itself. Thus if, before the lessor has registered its interest, the lessee wrongfully charges the object to a creditor who registers the security interest, the chargee acquires priority under Article 29(1). It necessarily follows that the lessee is to be considered as having a power to dispose within Article 7.

### **The Relationship of the Convention - Interest to National Law**

A question of some importance is the relevance of national law to the Convention and the relationship between interests created under national law and Convention interests. The first point to note is that the international interest is the creature of the Convention and in principle does not derive from or depend on national law. So the fact that a security interest constituted by the Convention is not of a kind that would be recognised under the applicable law as determined by the rules of private international law of the forum State is irrelevant. Conversely, an interest validly created under the applicable law is not an international interest if the conditions set out in Articles 2 and 7 of the Convention are not satisfied. In practice, an interest created in conformity with national law will in many cases also constitute an international interest without further steps having to be taken.<sup>6</sup> What is the effect of this duality of interests? National law will continue to apply to the interest *qua* national interest but it will lose its priority to another interest registered first in the International Registry and, on the other hand, will upon registration obtain priority over another national interest not then registered even if under national law the latter interest would otherwise have had priority. So while the rules of national law will continue to determine priorities so long as all competing interest remain unregistered (i.e. in the International Registry), those rules will be displaced by the Convention's priority rules upon registration of one of the competing interests.

There are other respects in which national law continues to play a role.

(1) Whether an international interest is a security interest or an interest held by a person as conditional seller or lessor is to be determined by the applicable law.<sup>7</sup> The characterisation is relevant in that the provisions for default remedies are much more detailed for security agreements than for conditional sale and leasing agreements, reflecting the fact that in most countries the conditional seller

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6 Registration is not an element in the constitution of an international interest, merely in its perfection so as to give protection against the claims of third parties.

7 Art. 2(4).

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or lessor retains absolute ownership and is therefore entitled, on terminating the agreement and repossessing the object, to do what it likes with the object. However, in the United States, Canada and New Zealand conditional sale agreements and certainly types of lease are characterised as security agreements. It was therefore necessary for the Convention to provide that an interest arising under a security agreement was not also to be considered an interest held by a conditional seller or lessor. The effect is that in those countries the default remedies of a conditional seller, and of a lessor whose lease is treated as a security agreement, will be governed by Articles 8 and 9 of the Convention dealing with security agreements, not by Article 10 dealing with conditional sales and leases.

(2) Not only does national law apply to characterise the agreement, it also determines whether the ingredients of a valid contract exist at all. So if it is asserted that a purported agreement is invalid for want of consensus, lack of *causa* or consideration or the existence of some other vitiating factor, the issue will be determined by the applicable law.

(3) Whether a chargor, conditional seller or lessor has power to dispose is determined partly by the applicable law, partly by the Convention. If there is a power of disposal under the applicable law this satisfies the requirement in Article 7(b) and it is then unnecessary to see whether such a power is also conferred by the Convention's priority rules.

(4) The Convention itself provides for various issues to be determined by the applicable law. There is the provision now standard in international conventions that questions concerned matters governed by the Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the applicable law.<sup>8</sup> Issues specifically left to the applicable law are remedies and forms of interim relief additional to those provided by the Convention,<sup>9</sup> rights in an item, other than an object,<sup>10</sup> installed on or removed from an object,<sup>11</sup> the effectiveness of an international interest in insolvency even if not registered under the Convention,<sup>12</sup> defences and rights of set-off available to the debtor against an assignee of associated rights,<sup>13</sup> the acquisition of associated rights and the related international interest by subrogation,<sup>14</sup> and the priority of a pre-existing right or interest under the transitional provisions.<sup>15</sup>

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8 Art. 5(3).

9 Arts. 12, 13(4).

10 i.e. other than an aircraft object, an item of railway rolling stock or a space asset.

11 Art. 29(7).

12 Art. 30(2).

13 Art. 31(3). Associated rights are rights to payment or other performance by a debtor under an agreement which are secured by or associated with the object (art. 1(c)).

14 Art. 38(1).

15 Art. 60(1).

(5) The priority of competing registrable but unregistered interests is determined by the applicable law, though any such priority is provisional in that it is open to the holder of one of the interest to jump ahead by registering it.

### Priorities

One of the more remarkable achievements of the Convention is to provide a set of priority rules for international interests within the confines of a single article. The emphasis has been on simplicity rather than sophistication, so that Article 29, which lays down the priority rules, eschews a number of the exceptions and qualifications to be found in national law. The priority rules are based on registration in the International Registry and permit registration not only of existing international interests but also of prospective international interests in order to secure the priority of any ensuing interest. The registry is envisaged as a central registry operational 24 hours a day, seven days a week, and providing a purely electronic registration system, registrations being effected and searches and responses to searches being made by computer without the need for human intervention. There would be a separate registration for each of the three categories of equipment. The concept of an international registry to record interests in equipment is one of the several unique features of the Convention. The necessary technology is available and the system should be easy to run and relatively inexpensive for users. The Registrar will be strictly liable for loss caused by errors, omissions and system failures.<sup>16</sup>

Article 29 embodies five priority rules. There are separate rules governing the priority of competing assignments of associated rights and the related international interest which are not dealt with here.<sup>17</sup>

(1) *Priority determined by order of registration*

The primary rule is that a registered interest has priority over any other interest subsequently registered and over an unregistered interest.<sup>18</sup> In general, it is irrelevant to this priority rule whether the interest not appearing on the register was or was not registrable under the Convention.<sup>19</sup> Mention has already been made of the ability to register a prospective international interest, assuming, of course, that the object to which this relates is identifiable. If this matures into an actual interest, this is to be treated as registered as from the time of registration of the prospective international interest provided that such registration was still current immediately before the international interest was constituted as provided

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<sup>16</sup> Art. 28(1).

<sup>17</sup> For an explanation of these see the *Official Commentary*, pp. 126 *et seq.*

<sup>18</sup> Art. 29(1). The priority extends even to value given by the registrant after knowledge of a subsequent interest (art. 29(2)(b)), whether registered or not.

<sup>19</sup> See the definition of unregistered interest in art. 1(mm).



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by Article 7.<sup>20</sup> Moreover, this rule operates automatically upon the international interest coming into existence. The creditor need take no additional step so long as the registration information already on file is sufficient for registration of the international interest itself.<sup>21</sup> As a corollary, a person searching the register will be told in the search certificate only that the registrant has acquired or intends to acquire an international interest, not whether what is registered is an international interest or a prospective international interest.<sup>22</sup>

(2) *Exceptions*

There are three exceptions to the primary rule. An outright buyer acquiring its interest before the registration of the international interest takes free from it even if the buyer has actual knowledge of it.<sup>23</sup> The case of outright purchase was considered so common as to justify protection of the buyer, whose purchase does not constitute a registrable interest. A conditional buyer or lessee takes free from an interest registered after the registration of the international interest held by its conditional seller or lessor.<sup>24</sup> The purpose of this rule is to ensure on the one hand that a conditional buyer or lessee is protected against disturbance of its quiet possession by a chargee from the conditional seller or lessor and on the other that the chargee is not affected by the rights of a conditional buyer or lessee of which he had no notice. A conditional or buyer or lessee does not as such have an interest capable of registration, but the effect of the rule is that it can shelter behind the priority of its seller or lessor. So the latter will be protected provided that its seller or lessor registers its international interest before the chargee registers its security interest. Similarly, on a sale and lease-back subject to an existing lessee, the original lessee (having now become a sub-lessee) is, by virtue of its original lessor's registration, protected against its new lessor, i.e. the sub-lessor, as well as against the buyer. The third exception relates to non-consensual rights or interests covered by a Contracting State's declaration under Article 39 enabling it to preserve non-consensual rights or interests having priority under its law over an interest equivalent to that of the holder of an international interest - for example, a non-consensual lien on an aircraft for unpaid navigation charges or an unsecured claim for unpaid taxes or wages which under the declaring State's law is given priority even over a secured claim and which under that State's declaration is to be given priority even against registered international interests. As stated earlier, the Convention does not determine the priority of competing registrable but unregistered interests.

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20 Art. 19(4).

21 Art. 18(3).

22 Art. 22(3).

23 Art. 29(3)(b). The irrelevance of actual knowledge is to preserve the integrity of the registration system and to avoid factual disputes as to whether a person did or did not have knowledge.

24 Art. 29(4).

(3) *Variation of priorities by agreement*

The Convention expressly provides for the common case of priority/subordination agreements by which a creditor whose interest would otherwise have priority over that of another creditor agrees to be subordinated to that creditor.<sup>25</sup> But the Convention does not stop there. It adds a useful rule that the assignee of the subordinated interest is not bound by the subordination unless at the time of the assignment this had been registered.<sup>26</sup> The purpose of this is to avoid prejudice to an assignee whose assignor fails to disclose the subordination, thereby leading the assignee to assume that it is the senior creditor. The effect of the rule is that the assignee *will* be the senior creditor, notwithstanding the subordination, if the subordination agreement was not registered.

(4) *Priority extends to proceeds*

Any priority given by the Convention to an interest in an object extends to its proceeds.<sup>27</sup> However, the Convention gives a restricted meaning to 'proceeds', in effect limiting these to insurance proceeds and to sums paid by way of compensation on confiscation, condemnation or requisition of the object.<sup>28</sup> The reason for this restriction is that general proceeds, such as receivables arising from the sale of an object subject to a security agreement, are not within the Convention, since this would broaden its scope beyond the categories of objects covered by the Convention.

(5) *Installed items*

Article 29(7) deals with items, other than an object of a kind to which the Convention applies, which become installed on or after installation are removed from an object. Examples are a computer system, an audio or video system or spare parts incorporated into an airframe or aircraft engine. Under Article 29(7) the installation is not to affect pre-existing rights in the item where these are preserved by the applicable law. Similarly, if such an item, after installation, becomes detached from the object and disposed of separately, the Convention does not prevent the creation of rights in favour of the assignee where under the applicable law those rights are created.

## **Protection Against Insolvency**

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25 Art. 29(5).

26 *Ibid.*

27 Art. 29(6).

28 Art. 1(w).

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Article 30 of the Convention deals with the effect of insolvency of the debtor on an international interest. Under Article 30(1), if prior to the commencement of the insolvency proceedings the interest was registered in conformity with the Convention, it is effective in the insolvency proceedings. By 'effective' is meant that the proprietary character of the international interest must be recognised, so that it will continue to enjoy any priority given by the Convention and will in principle rank ahead of the claims of unsecured creditors. This is a rule of validation, not of invalidation, for Article 30(2) provides that nothing in the Article impairs the effectiveness of an international interest in the insolvency proceedings where it is effective under the applicable law. Of course, the international interest is not as such governed by the applicable law at all, being the creature of the Convention. What the provision means is that if, *qua* national interest, the international interest would be recognised as effective - for example, where the perfection requirements under national law, such as registration in a national register, have been complied with - then the fact that it has not been registered as an international interest is irrelevant to its effectiveness.

There are two qualifications to the rule in Article 30(1). Rules of law applicable in the insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors are not affected. So provisions of the insolvency law rendering a security interest void or voidable under insolvency law as having, for example, been given for past value during a prescribed period prior to the commencement of the insolvency, will continue to bite. But the international interest is protected against other grounds of avoidance that might otherwise apply under national law. The two grounds selected are those commonly found in insolvency laws. The second qualification is that nothing in the Article affects any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator. This is designed to preserve procedural insolvency rules which provide, for example, for an automatic stay of enforcement in reorganisation proceedings.

### **Effect of the Aircraft Equipment Protocol**

The Aircraft Equipment Protocol - the only one concluded so far - modifies and expands the Convention in a number of respects as regards aircraft objects. First, it provides an alternative connecting factor.<sup>29</sup> Secondly, the registration provisions and priority rules are extended to outright sales,<sup>30</sup> for which similar formalities are prescribed.<sup>31</sup> It was thought useful to take advantage of the registration system to allow an outright purchaser of an aircraft object to perfect its interest by registration and thus secure its priority. The effect is to dispense with the need of the special priority rule in the Convention in favour of outright

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29 See n. 2 above.

30 Art. III.

31 Art. V.

buyers, since the buyer of an aircraft object can protect itself by registration of its interest, and to substitute a rule equivalent to the primary priority rule in the Convention.<sup>32</sup> Thirdly, on default the creditor is given the additional remedies of procurement of de-registration of the aircraft and its export and physical transfer to another jurisdiction, subject to the prior consent in ranking of the holders of senior interests.<sup>33</sup> Finally, Article XI contains important provisions as to enforcement of the creditor's right to possession upon the debtor's insolvency. Article XI, which is likely to be controversial, applies only where a Contracting State that is the primary insolvency jurisdiction<sup>34</sup> has made a declaration applying it.

The declaring State is given a choice between options, Alternative A and Alternative B. Alternative A, the so-called 'hard' option, provides for possession to be given up to the creditor by the end of the waiting period specified by the declaring State unless the insolvency administrator has by then cured all defaults, other than a default constituted by the opening of the insolvency proceedings, and agreed to perform all future obligations under the agreement. Adoption of this alternative precludes the imposition of any stay on enforcement of the creditor's remedies and deprives the insolvency court of any jurisdiction to modify the debtor's obligations without the creditor's consent or prevent or delay exercise of the creditor's remedies once the grace period has expired. Alternative B requires the insolvency administrator, upon the request of the creditor, to state within the time specified in the Contracting State's declaration, whether it will cure all defaults and agree to perform all future obligations or will instead give the creditor the opportunity to take possession. If the insolvency administrator does not furnish this statement or if, having agreed to give the creditor the opportunity to take possession, it fails to do so, it is left to the court to decide whether to permit the creditor to take possession.

A Contracting State must adopt Alternative A or Alternative B in its entirety but may adopt different alternatives for different types of insolvency proceeding.<sup>35</sup> If a Contracting State makes no declaration, its national insolvency rules will continue to apply except so far as limited by Article 30(3) of the Convention previously referred to.

### **Potential Benefits of the Convention**

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32 Art. XIV(1).

33 Art. IX(1), (2).

34 I.e. the jurisdiction in which the centre of the debtor's main interests is situated, which is deemed to be the place of its statutory seat or, if none, the place where it was incorporated or formed (art. I(2)(n)).

35 Art. XXX(3).

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By providing an international legal regime for international interests in mobile equipment the Convention removes much of the uncertainty attaching to the recognition, enforceability, priority and insolvency protection of interests arising under security, conditional sale and leasing agreements, and helps to open up access of developing countries to credit and leasing facilities for high-value aircraft objects, railway rolling stock and space assets, as well as reducing the costs of borrowing and of export credit protection.

In relation to aircraft, a study commissioned by the Aircraft Protocol Group<sup>36</sup> and carried out under the auspices of the Institut Européen d'Administration des Affaires (INSEAD) concluded that adoption of the Convention could reduce borrowing costs by several billion US dollars a year, while more recently the Export-Import Bank of the United States, the official US export credit agency, has announced that buyers of large US commercial aircraft in foreign countries that ratify the Cape Town Convention will qualify for a reduction of one-third in Ex-Im Bank's exposure fee<sup>37</sup> - a dramatic illustration of the economic benefits of the Convention and one that it likely to accelerate the rate of ratifications by developing countries. But the Convention should also prove intellectually engaging to scholars, creating as it does a wholly new form of real right which is largely independent of national law and rests on rules of attachment, perfection and priorities prescribed not by any one legal system but by the Convention itself.

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36 Anthony Saunders and Ingo Walter, Proposed Unidroit Convention on International Interests in Mobile Equipment as Applicable to Aircraft Equipment Through the Aircraft Equipment Protocol: Economic Impact Assessment, September 1998.

37 News release 31st January 2003.