Security Interests under the Cape Town Convention on International Interests in Mobile Equipment

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The Cape Town Convention and the Concept of the International Interest

I. INTRODUCTION

A. The Need for Credit

CREDIT HAS BEEN described as the oil of a market economy,[1] something on which an enterprise's lifecycle depends.[2] Regardless of whether the enterprise in question is a small business or a large aircraft manufacturer, it will need to invest funds in hiring staff, renting premises, acquiring equipment and other costs of running the business before receiving any benefits of the trade. To make ends meet between the outlay of funds and the receipt of profit, the enterprise will often need to rely on the creditor to provide funding. However, the debtor's financial circumstances may change, and even highly reputed enterprises may be struck by insolvency.

When the debtor is faced with financial difficulties, the creditor may learn that the assets of the troubled enterprise are not sufficient to satisfy the claims of its creditors. The debtor's employees may demand their wages, rent for the premises and the equipment may need to be paid, the debtor's trade creditors may demand payment for materials supplied, and some of the creditors may have even obtained a court order for the repayment. The prospects of repayment can be even bleaker if some of the debtor's key assets have been moved and are now in a different country under a different legal system. In some cases, the circumstances may have changed so much that the property is no longer even located on Earth at all. For instance, a creditor financing the construction of a satellite, may learn that

[1] U Drobnig, 'Secured Credit in International Insolvency Proceedings' (1998) 33 *Tex Int'l LJ* 53, 54.

[2] E McKendrick (ed), *Goode on Commercial Law*, 5th edn (London, Penguin Books 2016) 623–24.

the object will be difficult if not impossible to seize on the debtor's default or insolvency once it has been successfully launched into outer space.[3]

How is a creditor to ensure that it can obtain the repayment of the borrowed funds and the agreed interest? According to a principle of insolvency law well known to many legal systems, the debtor's assets should be distributed between the creditors on an equal or a *pari passu* basis.[4] In effect, the creditors should share the assets of the insolvent debtor in proportion to their pre-insolvency entitlements.[5] If the value of the debtor's assets is less than that of its liabilities, some creditors may receive less than expected or nothing at all.

Security interests are taken by the creditors precisely to avoid the consequences of the *pari passu* principle.[6] By taking a security interest in the debtor's property, a secured creditor can ensure that in the case of the debtor's default or insolvency, it can apply this property to the discharge of the debt prior to the distribution of the remaining assets between the debtor's unsecured and junior secured creditors.[7] Effectively, the insolvent debtor's estate available for equal distribution between its creditors is said to be comprised of whatever remains after the secured creditors have enforced their claims.[8] Another reason for taking a security interest is to ensure that the secured obligation is performed. In many cases, the value of the object used as a security or 'collateral' for the performance of an obligation is significantly larger than the amount of the debt.[9] Because a secured creditor can enforce its security on the debtor's default, the debtor may prefer to repay the debt rather than lose the collateral.[10] Finally, from the debtor's perspective,

[3] S Davis, 'Unifying the Final Frontier: Space Industry Financing Reform' (2001) 106 *Com LJ* 455, 459; P Larsen and J Heilbock, 'UNIDROIT Project on Security Interests: How the Project Affects Space Objects' (1998–99) 64 *J Air L Com* 703.

[4] For an explanation of the *pari passu* principle, see R Calnan, *Proprietary Rights and Insolvency*, 2nd edn (Oxford, OUP 2016) Part 1; D Cunningham and T Werlen, 'Cross-Border Insolvencies in Search of a Global Remedy' (1996) 15 *Int'l Fin LR* 51, 52. For the manifestation of the *pari passu* principle under English law, see s 107 of the Insolvency Act 1986, r 4.218 of the Insolvency Rules 1986.

[5] G McCormack, *Secured Credit under English and American Law* (Cambridge, CUP 2004) 11.

[6] McKendrick (n 2) 623–24.

[7] This principle is not without exceptions. For a brief overview of various legal systems allowing preferential creditors priority over secured creditors, see P Wood, *The Law and Practice of International Finance Series, Volume 2: Comparative Law of Security Interests and Title Finance*, 2nd edn *(London, Sweet & Maxwell 2007)* 231–33.

[8] H Beale, M Bridge, L Gullifer and E Lomnicka, *The Law of Security and Title-Based Financing*, 2nd edn (Oxford, OUP 2012) 7.

[9] See L Gullifer (ed), *Goode on Legal Problems of Credit and Security*, 5th edn (London, Sweet & Maxwell 2013) 1–2.

[10] As, for instance, was the case in *In re Panama, New Zealand and Australian Royal Mail Company* (1869–70) LR 5 Ch App 318, 319, where the company was able to grant its undertaking worth more than £600,000 as a security for two loans totalling £150,000.

an ability to grant a security interest in an object held by the debtor may present the possibility of obtaining finance which would otherwise be unavailable to it or only able to be procured at a great price.[11]

Performance of an obligation can be also secured by utilising various forms of transactions involving the retention or reservation of the creditor's interest in the object until certain conditions are satisfied. These transactions can be structured in many ways. A conditional sale contract, whereby the seller transfers possession of the goods to the buyer but retains title in them until the purchase price is paid, is one example. Should the buyer default, the seller can exercise its rights as the owner. This way, the seller's retained title serves the same function as a security interest.[12] A lease, involving the retention of title and transfer of possession of the object in return for the rentals, is another example. A lease can take the form of an 'operating' lease, whereby the goods are hired out to different lessees for short periods of time and a 'finance' lease, whereby the lessor hires the object out for the duration of its economic life and receives by way of the rentals its expenses in acquiring the object and the profit. Since the lessee under the finance lease enjoys the possession and use of the object for the duration of its useful life, the lessor's retained title performs the same function as that of the security interest, in that it ensures that the lessee's obligations under the lease are fulfilled.[13] Due to this functional similarity, some jurisdictions treat these retention of title (RoT) devices as forms of security interests and others, while refusing to recognise them as such, often refer to them as *quasi* security interests.[14]

Security interests can be *real*, that is proprietary, or *personal*, whereby the performance of the debtor's obligation is supported by the personal undertaking of the debtor itself or, more frequently, by a third party. The latter can take the form of a suretyship guarantee, a demand guarantee or a grant of a negotiable instrument as a security of performance.[15] Security interests can be taken over tangible and intangible objects, and existing and future assets, and take possessory (that is, requiring the transfer of possession of the collateral to the creditor) forms or non-possessory forms which do not depend on the transfer of possession. This book focuses on *real* security interests in tangible and existing objects held by the debtor, such as aircraft, railway and space objects.

[11] Gullifer (n 9) 2.
[12] Beale, Bridge, Gullifer and Lomnicka (n 8) 249.
[13] See *Celestial Aviation Trading 71 Ltd v Paramount Airways Private Ltd* [2010] EWHC 185 (Comm), [2010] 1 CLC 165; *On Demand Information plc v Michael Gerson (Finance) Ltd plc* [2000] 4 All ER 734, 737.
[14] Gullifer (n 9) 3–4.
[15] *Ibid* 5.

B. A Brief Introduction to the Cape Town Convention

This book focuses on the security interests that can be created as international interests under the UNIDROIT Convention on International Interests in Mobile Equipment ('the Convention'). The Convention provides a uniform legal regime for the creation, perfection, priority and enforcement of the international interests in objects such as aircraft, railway and space objects. The financing and leasing of these types of equipment, which can be accomplished by means of a secured loan, a conditional sale or a lease, can be a risky and highly unstable investment. Their nature is such that they are likely to constantly physically cross national borders, rendering a creditor's interest in them unprotected.

The advantages of a validly created and perfected security interest granted to a secured creditor in one legal system can be subverted if it has to be enforced in a different legal system. Among the problems which the secured creditor may encounter are, for instance, varied attitudes towards security interests in different jurisdictions. Some jurisdictions are supportive of secured creditors' rights, in that they recognise non-possessory security interests created with little formality and protected with readily available and adequate remedies that, in many cases, can be exercised extra-judicially; however, other jurisdictions can be more restrictive.[16] In addition, although some jurisdictions recognise foreign security interests, provided that they are similar to the ones existent in the country of enforcement and in line with that country's formal requirements, some jurisdictions do not recognise foreign security interests.[17] Some forms of security interests may be unfamiliar to a jurisdiction where a secured creditor hopes to enforce it. The concern of the secured creditor in this case will be that its security will not receive the same treatment as it would have received in the country of origin.[18] Furthermore, the high mobility of aircraft and railway objects and the fact that space assets, such as satellites, are often intended to be launched into space, mean that the conflict of laws rules pointing to, for example, the law of the object's location (*lex rei sitae)* to govern the interests of a secured creditor, conditional seller and lessor in these objects are not well suited. Reliance on the conflict of laws rules also means

[16] Wood (n 7) 18–19.

[17] See G Ferrarini, 'Foreign Law Mortgages, Hypotheques and Charges in Italy' (1991) 6 *JIBL* 191, 192; H Waasgren, 'Rights of Financiers in Aircraft: a Finnish Perspective on the 2001 Cape Town Instruments' (2004) 9 *Unif LR* 557, 562.

[18] R Goode, 'Security in Cross-Border Transactions' (1998) 33 *Tex Int'l LJ* 47, 48; G Kajtar, 'Hungary—Foreign Investment: Security for the Interests of Foreign Lenders' (1993) 8 *JIBL* 162, 163.

dependence on different jurisdictions with varying attitudes to security and RoT transactions.[19]

The lack of the international uniform substantive rules governing creditors' rights in such types of equipment as aircraft, railway and space objects has in the past generated uncertainty and affected the availability of financing, which is particularly significant given the high cost of these objects.[20] The main purpose of the Convention, which is supported by three equipment-specific Protocols, is to provide the much needed uniform legal regime for the creation, registration and protection of the interests of a secured creditor, conditional seller and lessor held in these types of objects.[21] One of the Convention's unique features is that it provides for the creation of an autonomous international interest in these types of equipment, which does not depend on any domestic law.[22] Another important creation of the Convention is an electronic asset-based International Registry (IR), where creditors can register their interests held in aircraft objects.[23] The international registries for the registration of interests in railway objects and space assets are expected to follow in due course. The creditor's international interest is supported by an elaborate system of remedies exercisable in the case of the debtor's default or insolvency.[24] These features of the Convention and the Protocols are aimed at promoting predictability and transparency in the financing of mobile equipment, which should reduce the risks and costs of borrowing to the benefit of all stakeholders.

The Convention and Aircraft Protocol were concluded at the Diplomatic Conference held in Cape Town in October–November 2001 under the auspices of the International Institute for the Unification of Private Law (UNIDROIT)[25] and the International Civil Aviation Organization (ICAO).[26] The Cape Town Convention (CTC or 'the Convention') and Aircraft Protocol came into force on 1 March 2006, when the number of ratifications

[19] R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment*, 3rd edn (Rome, UNIDROIT 2013) 14–15; G Mauri and B Itterbeek, 'The Cape Town Convention on International Interests in Mobile Equipment and its Protocol on Matters Specific To Aircraft Equipment: A Belgian Perspective' (2004) 9 *Unif L Rev* 547, 550.

[20] R Goode, 'International Interests in Mobile Equipment: A Transnational Juridical Concept' (2003) 15 *Bond L Rev* 9, 10.

[21] See the Convention's Preamble.

[22] Art 2 CTC. See L Weber and S Espinola, 'The Development of a New Convention Relating to International Interests in Mobile Equipment, in Particular Aircraft Equipment: a Joint ICAO-UNIDROIT Project' (1999) 4 *Unif L Rev* 463, 463–65.

[23] Art 16 CTC. R Cuming, 'Considerations in the Design of an International Registry for Interests in Mobile Equipment' (1999) 4 *Unif L Rev* 275, 276–79.

[24] See chapter three.

[25] For the history and purposes of the UNIDROIT, see http://www.unidroit.org/about-unidroit/overview.

[26] See generally www.icao.int/about-icao/Pages/default.aspx.

reached eight as required by the Protocol.[27] The Rail Protocol was concluded in Luxembourg on 23 February 2007[28] and the Space Protocol was adopted at a Diplomatic Conference in Berlin in March 2012.[29] The Luxembourg and the Space Protocols are not yet in force.[30] The Convention establishes a set of rules to be utilised if it is considered useful and feasible to extend its application to the objects not currently covered by it, provided that such objects are uniquely identifiable.[31] Presently, extensive work is being undertaken by UNIDROIT on the development of a fourth Protocol, relating to agricultural, construction and mining equipment ('the MAC Protocol').[32]

The idea that a uniform legal regime for the creation and protection of security interests in mobile equipment should be established was first advocated by Mr TB Smith QC, a Canadian member of the Governing Council of UNIDROIT presiding over the Diplomatic Conference in Ottawa in 1988.[33] The desirability and feasibility of the project was further confirmed by the positive responses to a questionnaire prepared by Professor Ronald Cuming. Great care was taken not only in the drafting of the substantive provisions of the Convention and the Protocols, but also in ensuring that all interest groups were involved in their development. The exploratory working groups and several specialist groups set up to examine specific issues (such as the Aircraft Working Group (AWG), the Registration Working Group, the Insolvency Working Group and the Public International Working Group) consisted of a mixture of academic and practising lawyers from different legal systems, representatives of the relevant business organisations and, in the case of the Aircraft Protocol, participants from organisations such as ICAO and the International Air Transport Association (IATA).[34] The consistent and close cooperation of various interest groups in preparing the Convention and the Protocols was vital in ensuring that the resulting documents reflected the needs and gained support of the industries concerned.

[27] Art XXVIII of the Aircraft Protocol.

[28] See generally R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Luxembourg Protocol Thereto on Matters Specific to Railway Rolling Stock*, (Rome, UNIDROIT 2008).

[29] See generally R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Space Assets* (Rome, UNIDROIT 2013).

[30] Art XXIII of the Luxembourg Protocol and Art XXXVIII of the Space Protocol, drafted in similar terms, provide that the Protocols enter into force on the first day of the month following the expiration of three months after the date of the deposit of the forth (in the case of the Luxembourg Protocol) and the tenth (in the case of the Space Protocol) instrument of ratification, acceptance, approval or accession. Both Protocols provide that they will not enter into force until the date when the IR in relation to these objects is fully operational.

[31] Art 51 CTC.

[32] See generally http://www.unidroit.org/work-in-progress/mac-protocol.

[33] R Goode, H Kronke and E McKendrick, *Transnational Commercial Law: Text, Cases and Materials*, 2nd edn (Oxford, OUP 2015) 394.

[34] See generally www.iata.org/about/pages/index.aspx.

C. Main Features of the Convention

i. Applicability

The Convention will apply if the following requirements are met. First, the parties must conclude a security agreement, a title reservation or a leasing agreement.[35] Secondly, the agreement must relate to uniquely identifiable mobile equipment, currently comprising: (a) an airframe, an aircraft engine or a helicopter; (b) railway rolling stock; and (c) space assets.[36] Once the new MAC Protocol is adopted, the types of agricultural, construction and mining equipment, covered by the Protocol will be added to this list.[37] Thirdly, the agreement must be constituted in accordance with the CTC's formal requirements. The agreement must: be in writing; relate to an object of which the chargor, conditional seller or lessor has power to dispose; enable the object to be identified in conformity with the Protocol; and, in the case of the security agreement, enable the secured obligations to be determined, but without the need to indicate the sum secured.[38]

Of these four formalities, the requirement of power to dispose may give rise to some important questions, which will be considered later in this book. The Convention does not explain the circumstances in which the power to dispose arises. It seems clear that the power to dispose includes the right to dispose, that is, where the chargor, conditional seller and lessor are the owners of the object or have the owner's authority to deal with it. But the power to dispose is wider than the right to dispose and covers other situations where a non-owner chargor, conditional seller or lessor can deal with the object in a way that will bind the true owner, even if the latter did not authorise the disposition.[39] The fact that the Convention does not explain the meaning of the requirement of power to dispose is regrettable because it brings uncertainty in relation to this significant issue. Unless this requirement is met, a valid international interest cannot be created. Another difficulty with this requirement is that it can be wrongly applied in determining priority disputes among competing interests. This book will examine the Convention's rules on priority and registration to help identify the circumstances in which the power to dispose may arise.

Finally, the Convention will only apply if its requirement relating to the connecting factor, namely the location of the debtor, is met.[40] The debtor

[35] Art 2(2) CTC.
[36] Art 2(3) CTC.
[37] Art 51 CTC. For a draft MAC Protocol, see http://www.unidroit.org/english/documents/2017/study72k/cge01/s-72k-cge01-02corr-e.pdf (last visited December 2017).
[38] Art 7 CTC.
[39] R Goode, 'The International Interest as an Autonomous Property Interest' (2004) 1 *ERPL* 18, 24.
[40] Art 3(1) CTC.

must be situated in a Contracting State at the time of the conclusion of the international interest agreement. There are several alternative ways to determine whether the debtor is located in a Contracting State.[41] If the debtor is incorporated or formed, or has a registered office or statutory seat, a centre of administration, a place of business or habitual residence in a Contracting State where it is located at the time of the conclusion of the agreement, the requirement of the connecting factor is satisfied.[42] The Aircraft Protocol provides the alternative connecting factor in relation to a helicopter or an airframe pertaining to an aircraft.[43] In the case of these objects, the Convention will also apply if the helicopter or the airframe is registered in a national aircraft register of the State of Registry. The State of Registry means the State of the national register in which the aircraft is registered and the State of location of the common mark registering authority which maintains the aircraft register in accordance with Article 77 of the Convention on International Civil Aviation 1944.[44] The alternative connecting factor cannot apply to the aircraft engines because there are, generally, no national registries in relation to these objects.

ii. The Two-Instrument Approach

In the early stages of the project, it was expected that the Convention would consist of a single document relating to all types of mobile equipment which it intended to cover. However, it soon became clear that the traditional route of international treaty making might not be the best one for the CTC.[45] The AWG was well ahead of the rail and space groups. If the Convention's drafters had been required to wait until all the equipment groups completed their work, the project's progress would have been considerably delayed. To resolve the matter, the AWG and IATA proposed a novel solution, under which the Convention would only govern the issues relating equally to all types of equipment. It would then be complemented by the Protocols, which would deal with issues specific to a particular type of equipment. The novelty of this proposal was the idea that the Protocol would prevail over the

[41] The main purpose of providing various alternative ways of establishing the connecting factor is to widen the applicability of the Convention.

[42] Art 4 CTC.

[43] Art IV(1) of the Aircraft Protocol.

[44] Art I (h), (p) of the Aircraft Protocol. The Convention on International Civil Aviation ('the Chicago Convention') is a public law treaty designed to promote safe and secure flights, whereas the CTC is a private law treaty and its main objective is to facilitate financing and leasing of aircraft, railway and space objects. The CTC should not be, generally, interpreted by reference to the Chicago Convention.

[45] R Goode, 'The Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment' (1999) 4 *Unif L Rev* 265, 269–71.

Convention in the case of an inconsistency between the two instruments.[46] Another alternative was to have a set of stand-alone Conventions relating to each type of equipment. It was soon realised that this would multiply the work, as each time the drafters would have to reconsider and evaluate the provisions of the original Convention. More importantly, this approach could undermine the CTC's integrity and uniform application.

In contrast, the novel solution of the base Convention, supplemented by the equipment-specific Protocols, had several advantages and was ultimately adopted at the Diplomatic Conference. It allowed each equipment-specific working group to proceed at its own speed.[47] Leaving the issues relating to various types of equipment to the Protocols also meant that the CTC's text could be kept as simple as possible. At the same time, the Protocols could be drafted in a way which would better reflect the nature of the equipment and the needs of the industry concerned.[48] Finally, the separation of the base Convention and the Protocols allowed Contracting States to choose which Protocol to ratify and that, in turn, helped secure a greater number of ratifications.

iii. The International Interest

The Convention is mostly concerned with three types of financing of mobile equipment, namely a secured loan, a conditional sale and a lease.[49] Some jurisdictions, such as the United States, Canada and New Zealand, characterise conditional sale and some leases as security interests. Other jurisdictions distinguish between the 'true' security interests on the one hand, and conditional sale and leases on the other hand, and subject them to different legal regimes. Reaching an agreement on the uniform approach to the characterisation of the CTC's interests was impracticable and it was decided that this issue should be left to the applicable domestic law. But a solution that would reflect the differences between a security interest, conditional sale and a lease and still treat them in a similar manner was needed under

[46] C Chinkin and C Kessedjian, 'The Legal Relationship between the Proposed UNIDROIT Convention and its Equipment Specific Protocols' (1999) 4 *Unif L Rev* 323, 323–25.

[47] Goode, Kronke and McKendrick (n 33) 402–06.

[48] *Ibid* 402–06.

[49] The Convention does not govern outright sale of objects. However, the Aircraft Protocol makes an exception for an outright sale and a prospective sale (which do not constitute international interests) of the aircraft objects, which can be registered in the IR. See Arts III, V of the Aircraft Protocol. Similarly, Art IV of the Space Protocol extends the application of this Protocol to an outright sale and a prospective sale. The Luxembourg Protocol takes a different approach and only permits registration of a notice of sale (but not the prospective sale) for information purposes, so that the holder of such an interest cannot benefit from the CTC's priority rules. See Art XVII of the Luxembourg Protocol.

the Convention. This gave rise to the creation of the truly unique concept of the 'international interest'.[50]

An international interest can take the form of a security interest, title reservation or lease.[51] All three types of international interests are subjected to the same rules regarding creation, registration and priority. The distinction between them becomes important when the creditor needs to exercise its remedies, because this is the moment when the nature of its title in the object becomes relevant. This is why the CTC provides for separate remedial rules for the secured creditor and the conditional seller and lessor.[52]

The Convention delegates the issue of the interest's characterisation to the applicable law.[53] At the same time, it provides definitions of security agreement, title reservation agreement and leasing agreement.[54] The meaning of these terms under the Convention and the applicable law may not always coincide, which raises an important issue of the relationship between the two routes of defining these interests and the types of transactions that fall into the Convention's scope. The Official Commentary (OC) advances the view that the Convention's definitions should be used for the 'initial' characterisation of an interest to decide whether the transaction falls into its scope. Provided that this issue is resolved positively, the applicable domestic law should then be used to characterise the transaction again.[55] However, it is suggested that this two-stage exercise can create dissonance between the characterisations under two different legal regimes. Under the OC's approach, it is not clear whether the transaction would fall within the Convention's scope and, if so, how broad or specific should the characterisation be under the applicable law.

This book examines these issues and suggests a different explanation of the relationship between the Convention and the applicable domestic law in relation to the characterisation of interests.[56] It will be argued that to determine whether the transaction falls within the Convention's scope, the agreement should be characterised by the applicable domestic law.[57] Once this issue is established, the interest arising out of this agreement is subjected to the CTC's legal regime and its definitions. Under this approach, the transaction is only characterised once, so there is no danger of it being re-characterised later. It can also bring predictability to the creditor in relation to its remedies. The role of the applicable law should cease after the

[50] Art 2 CTC. Goode (n 19) 266–68.
[51] Art 2(2) CTC.
[52] Arts 8, 9, 10 CTC.
[53] Art 2(4) CTC.
[54] Art 1(q), (ii), (ll) CTC.
[55] Goode (n 19) 267.
[56] See chapter one.
[57] As prescribed by Art 2(4) CTC.

creditor's interest is characterised. For example, an interest characterised by the applicable law as that of the conditional seller cannot avoid the requirement of the registration in the IR to attain the CTC's priority even if the registration would not be required under the domestic law.

iv. The International Registry

Another unique feature of the Convention is that it establishes an electronic asset-based notice-filing International Registry (IR) for the registration of registrable interests in mobile equipment.[58] At present, only the aircraft IR, which is situated in Dublin, is in operation. Registration allows a registrant to give notice of the international interest's existence to third parties, secure its priority among competing interest holders and ensure that the registered interest is effective in the case of the debtor's insolvency. The registrations and searches must be made against the object and not the name of the debtor. For this reason, the objects should be uniquely identifiable. Consequently, international interests in future or after acquired property cannot be registered in the IR. This raises an interesting question whether it is possible to create and register a floating security interest in the aircraft and other objects under the Convention, an issue considered in this book.[59]

The IR is extensively used by aircraft manufacturers, financiers and other stakeholders, with the number of registrations exceeding 100,000 in 2014.[60] The fact that it is electronic and operational 24 hours 7 days a week means that it can be accessed globally, a factor of great significance in cross-border transactions. The IR is regulated by the Convention, the Aircraft Protocol and the Regulations and Procedures. The latter two documents lay down the rules for the IR's practical operation and can be revised when the need arises. This innovative approach enables constant development and further improvement of the IR to reflect the needs of its user community. For instance, when the IR was first established, the interests held in several aircraft objects, such an airframe and the engines pertaining to it, had to be registered in separate registration sessions. This practice was repetitive and wasteful of time and resources. As soon as it became technologically possible, the IR developed a new facility, 'multiple object registration', allowing a registering party to group several objects and register interests held in them in a single registration session. Similarly, the Regulations have recently been revised to implement a new facility, the 'closing room', enabling several financiers to assemble the information required for multiple registrations relating to one or several aircraft objects, collect consents and negotiate the

[58] Art 16 CTC.
[59] See chapter two.
[60] See the IR's Annual Statistical Report at www.internationalregistry.aero/ir-web/annualStatisticalReport/findAll (last visited July 2016).

chronological order of the registrations before this information is released into the IR so as to become searchable.[61] The main features and the process of the registration in the IR as well as some challenges presented by its electronic nature and the first cases emerging from its operation are examined in this book.

v. Remedies

A registered international interest which cannot be enforced will not be of great value to its holder. To ensure that the international interest can be protected, the Convention establishes remedial rules exercisable in the case of the debtor's default or insolvency.[62] Since the conditional seller and lessor are often considered as owners of the object, the Convention distinguishes between the remedies available to them and those exercisable by the secured creditor.[63] On the debtor's default, the secured creditor can enforce its international interest by taking possession or control, selling, or leasing the object.[64] The secured creditor can also collect or receive any income or profits arising from the management or use of the object to obtain repayment of the debt.[65] In addition, if at any time after default, the debtor and other interested persons agree, the ownership (or any other interest held by the debtor) of the object covered by the security agreement can be vested in the secured creditor in or towards the satisfaction of the debt.[66] In contrast, the remedies of the conditional seller and lessor are confined to the power to terminate the agreement and repossess or take control of the object.[67]

The Convention also provides for the remedy of 'speedy relief' pending final determination of the claim, inspired by the remedy of interim relief known to many domestic legal systems.[68] The Convention's speedy relief is viewed by some commentators as the form of an advance enforcement of default remedies.[69] This book explores the nature of the remedy of speedy relief and argues that it cannot be equated with the advance enforcement of default remedies. Although speedy relief is akin to the remedy of interim relief, it has its own unique features and, being the CTC's creature, must be interpreted according to its principles and policies.[70]

[61] See chapters three and four.
[62] Chapter III CTC.
[63] Arts 8, 9, 10 CTC.
[64] Art 8(1) CTC.
[65] Art 8(1)(c) CTC.
[66] Art 9(1) CTC.
[67] Art 10 CTC.
[68] Art 13 CTC.
[69] G Cuniberti, 'Advance Relief under the Cape Town Convention' (2012) *Cape Town Convention Journal* 79.
[70] See further chapter six.

In addition to the CTC's remedies, the Protocols also provide for equipment-specific remedies. For instance, the Aircraft Protocol provides for the remedies of de-registration and export and physical transfer of the object to another jurisdiction. These remedies should enable the creditor to cancel the aircraft's current registration in a national registry and re-register the aircraft in a different jurisdiction which may be more favourable to the protection of its interests. The remedy of de-registration has been recently enforced in a decision of the High Court of New Delhi.[71] The Luxembourg Protocol also provides that in the case of the debtor's default, the creditor may physically transfer a railway object from the territory in which it is situated, to another country.[72] However, the Convention recognises that the repossession of railway rolling stock may cause disruption to the carriage of passengers and freight. For this reason, the exercise of this remedy is subject to the public service exemption.[73] If the railway object is habitually used to provide a service of public importance, it cannot be repossessed by the creditor. One issue considered in this book in the light of this exception is whether the creditor's interest is adequately protected and whether it can still obtain repayment of the debt. Similar issues arose in the drafting of the Space Protocol, as space assets often play a central role in delivering services of public importance.[74] This resulted in the imposition of the limitations on the creditor's exercise of the remedies in respect of the space assets providing public service.[75]

The Convention offers an elaborate remedial scheme exercisable in and out of the debtor's insolvency and this book assesses its effectiveness. It examines the concept of a default, amounting under the Convention to such 'a default which substantially deprives the creditor of what it is entitled to expect under the agreement'.[76] The Convention does not explain what amounts to the creditor's expectation under the agreement and its substantial deprivation. This book explores what factors are relevant when considering these issues. Further, the remedies must be exercised in a commercially reasonable manner, but the meaning of this requirement and the consequences of a failure to comply with it are not specified in the Convention. The scope of application, the meaning and general considerations relating to the requirement of commercial reasonableness in the context of specific remedies are extensively examined in chapter six.

[71] *Awas 39423 Ireland Ltd & Ors v Directorate General of Civil Aviation & Anr* (WP(C) 871/2015) and *Wilmington Trust SP Services Ltd v Directorate General of Civil Aviation & Anr* (WP(C) 747/2015). For the discussion of this case, see chapter six.

[72] Art VII(1) of the Luxembourg Protocol.

[73] Art XXV of the Luxembourg Protocol.

[74] See J Atwood, 'A New International Regime for Railway Rolling Stock Asset-Based Financing' (2008) 40 *UCC LJ* 3, Art 2.

[75] Article XXVII of the Space Protocol.

[76] Art 11 CTC.

vi. System of Declarations

Another important feature of the Convention and its Protocols is their elaborate system of declarations.[77] There are opt-in declarations which must be made if a particular provision is to have effect in a Contracting State. For example, the Convention does not normally apply to pre-existing rights or interests (PERI), which remain subject to the priority rules under the applicable law. However, a Contracting State can make a declaration under Article 60, indicating that the priority rules of the Convention will apply to PERI if certain conditions are met.

If a Contracting State wishes to exclude the application of certain provisions of the Convention, it can make an opt-out declaration. For instance, some jurisdictions do not allow an extra-judicial exercise of remedies. An opt-out declaration under Article 54(2) could preclude the creditor from exercising remedies under the Convention without resorting to a court. One of the remedies exercisable by a chargee on the debtor's default is the right to grant a lease of the object. This remedy is available subject to a declaration of a Contracting State, precluding the grant of a lease of the object while it is located on or controlled from its territory.[78] A Contracting State may also make a declaration, excluding the Convention's provisions dealing with relief pending final determination and issues of jurisdiction.[79]

Some declarations are mandatory and must be made by a Contracting State to enable it become a party to the Convention. Examples of these types of declarations can be found in Article 48(2), regarding matters within the exclusive competence of the regional economic integration organisation and Article 54(2), on whether the remedies which, under the Convention do not require application to a court, may be exercised only with the leave of court. There are also declarations which can be made by a Contracting State in relation to matters of its own law. A declaration relating to non-registrable non-consensual rights or interests (NCRIs) under Article 39 falls into this category. A Contracting State depositing such a declaration may indicate that certain NCRI which, under that State's law, do not require registration and prevail over an interest which is equivalent to the international interest, should be treated in priority to registered international interests under the Convention.

Finally, there are declarations which may be made under the Protocols. The Aircraft Protocol provides for two alternative sets of rules (Alternative A and Alternative B) in relation to the creditor's right of repossession exercisable

[77] The list presented here is not exhaustive. Declarations can also be made under Arts 40, 50, 52, 53 CTC.

[78] Art 54(1) CTC.

[79] Arts 13, 43, 55 CTC.

in the case of the debtor's insolvency.[80] The Luxembourg Protocol adds a third alternative, Alternative C, to these options.[81] The Contracting State can declare which of the alternatives it chooses to apply on the occurrence of an insolvency related event or in the case of the debtor's insolvency. If none of the options is chosen, the domestic insolvency rules will continue to apply. The complex system of declarations under the Convention and the Protocols may be criticised as undermining their uniform application. At the same time, the strength of this regime is that it allows Contracting States to retain their positions on important policy issues, which may help secure a greater number of ratifications.[82]

D. Interpretation of the Convention

A common feature of many international private law conventions is the requirement for uniform application and respect for their international character.[83] Similar to other conventions, the CTC must be interpreted *autonomously*, that is in accordance with its own concepts and definitions. The provisions of the Convention should not be interpreted with reference to any domestic law.[84] This is clear from Article 5(1), which provides that:

> In the interpretation of this Convention, regard is to be had to its purposes as set forth in the preamble, to its international character and to the need to promote uniformity and predictability in its application.

Article 5(2) provides guidance on how to proceed if a particular matter is not expressly settled in the Convention:

> Questions concerning matters governed by this 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.

If the Convention does not expressly deal with a particular matter, it must, first, be ascertained whether this issue is *governed* by the Convention at all. As stated above, the Convention applies to asset-based financing and

[80] Art XI of the Aircraft Protocol.

[81] Art IX of the Luxembourg Protocol.

[82] See J Wool, 'Rethinking the Notion of Uniformity in the Drafting of International Commercial Law: A Preliminary Proposal for the Development of Policy-Based Unification Model' (1997) 2 *Unif L Rev* 46, 46–53.

[83] See Art 31(1) of the Vienna Convention on the Law of Treaties 1969; Art 7(1) of the Vienna Convention on International Sale of Goods 1980; Art 6 of the Convention on International Financial Leasing 1988; Art 4 of the Convention on International Factoring 1988.

[84] M Gebauer, 'Uniform Law, General Principles and Autonomous Interpretation' (2000) 5 *Unif L Rev* 683, 686–87.

leasing of uniquely identifiable mobile equipment and there is a plethora of issues which may arise in this regard. These issues will be addressed in this book. Once it is established that the matter is governed by the Convention, it should be resolved in accordance with the general principles underlying the Convention. These principles include: party autonomy, reflecting the fact that the parties engaged in the kind of transactions covered by the Convention will be knowledgeable and experienced and, for this reason, their agreements should, generally, be enforced; predictability in the application of the Convention, which is reflected in clear rules on priority; transparency, which can be found in the rules on registration, making the interests of senior and junior creditors visible to other parties; and the protection and ready enforceability of remedies in the case of the debtor's default or insolvency.[85] If the matter is found not to be governed by the Convention, it should be settled in accordance with the applicable law.[86]

E. Aims of this Book

The area of cross-border security interests is fraught with numerous complex issues, which stem from the multiplicity of jurisdictions with varying attitudes to security interests. Another reason for the complexity in this area of the law stems from the variety of legal issues which have to be considered before a comprehensive security agreement can be put together. For instance, before a security agreement is entered into, a prospective secured creditor needs to ascertain whether the aircraft object is already encumbered and evaluate its potential priority standing among other creditors. This task may be difficult to accomplish because some interests, such as non-registrable NCRI, may be binding even though they are not visible in the IR and other interests, such as prospective international interests, which are visible, may no longer be in existence.

The CTC aims to provide a uniform set of substantive rules for the creation, perfection, priority and enforcement of security interests and interests of conditional sellers and lessors in mobile equipment, which, given the complexity of this area of the law, is an ambitious task. One aim of this book is to examine the provisions of the Convention and the Protocols and to test whether the legal regime created by it can operate successfully and help facilitate financing and leasing of aircraft, railway and space objects. To test the effectiveness of the Convention, its provisions will be evaluated in the context of various factual scenarios, which, considering the limited number of cases which have been brought under the Convention,

[85] Goode (n 19) 22–25.
[86] Art 5(2) CTC.

were largely inspired by the experience of some major domestic jurisdictions, such as the UK and the US.[87] This exercise may shed some light on the strengths and weaknesses of the Convention and the Protocols in comparison with these systems.

The evaluation of the Convention will also involve the identification of questions the answers to which are not entirely clear. For instance, the concept of 'deficiency' is not expressly mentioned in the Convention, which gives rise to the question whether the secured creditor may claim the remainder of the debt if the sale of the repossessed object did not generate enough proceeds to extinguish the debt. This book identifies such issues and proposes solutions and/or possible interpretations of the relevant provisions of the Convention.

This book primarily deals with the issues of the definition, creation, registration, priority and enforcement of security interests under the Convention. Security interests in aircraft, railway and space objects are one of the most frequently used mechanisms, employed to ensure the repayment of the debt and to support the financing of these types of equipment. It is their significance, effectiveness and frequency of use that explains this book's focus and scope. But the category of international interest is not confined to security interests and includes the interests of a conditional seller and lessor. For this reason, these international interests will be examined to the extent that they help illuminate the concept of security interests. The Convention also deals with the effect, formal requirements and priority of assignment of associated rights and international interests. Since the main focus of this book is on security interests, the issues relating to the assignment of associated rights and international interests are only briefly touched upon in the part that deals with the registrable interests under the Convention.

The present chapter addresses the following issues. Part II examines the concept of a security interest and the definition of a security agreement under the Convention. It also explores the essence of the *formal v functional* divide, relating to the understanding of what amounts to a true and *quasi* security interest. Part III examines the concept of an international interest and the two routes of characterising a transaction. It also suggests an explanation of the relationship between the two routes of defining eligible interests under the Convention. Finally, Part IV considers the legal nature of international interests. The Convention does not expressly specify whether international interests are personal or proprietary. It will be argued that its provisions, in particular those relating to the priority of registered interests,

[87] There have been a few cases decided under the Convention concerning the operation of Art 44 and the issue of jurisdiction to make orders against the Registrar to discharge bogus registrations. However, the substantive provisions of the Convention have not yet been tested in court. The cases concerning the discharge of registrations are examined in chapter four.

ability to be traced into the proceeds, and effectiveness in the debtor's insolvency, confirm their proprietary nature.

II. THE CONCEPT OF A SECURITY INTEREST

A. What is a Security Interest?

The definition of a security interest is approached differently by various legal systems. Rather than starting with a definition of security, some legal systems tend to examine a transaction by looking at the balance of rights and obligations of the parties to decide whether it falls into one of the forms of recognised security interests.[88] Other legal systems look at the function of the transaction. If it performs the functions of a security, that is, if it secures the performance of the main obligation, ensures that the creditor enjoys priority among other creditors and is able to survive the debtor's insolvency, it is recognised as the transaction giving rise to a true security interest even if labelled differently by the contracting parties.[89] As a result, a transaction can be considered as a security interest by some legal systems and not seen as such by others.[90]

In spite of diverse approaches to the question of what amounts to a security interest, it seems that the general understanding of the concept of a security is shared by most legal systems. Generally speaking, a security interest involves a grant of a right in a property by an obligor (the debtor) to an obligee (the creditor) to secure or ensure that the obligor performs its obligation.[91] For instance, a debtor manufacturing an aircraft will need finance to cover its expenses. A financier which may be willing to provide the loan will need some assurance that the debt will be repaid to it. To this end, the financier can take a security interest in the financed aircraft. By granting a security interest, the debtor recognises that, in the case of its

[88] Jurisdictions such as those of England and Wales, Hong Kong, Malaysia and Singapore follow this approach. See P Ali, *The Law of Secured Finance: An International Survey of Security Interests Over Personal Property* (Oxford, OUP 2002) 15. For the position under English law, see *Agnew v Commissioner of Inland Revenue* [2001] UKPC 28, [2001] AC 710 at [32]; *Re George Inglefield* [1933] Ch 1; *Helby v Matthews* [1895] AC 471; *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148; *Smith v Bridgent CBC* [2001] UKHL 58, [2002] 1 AC 336. See also Beale, Bridge, Gullifer and Lomnicka (n 8) 75–97.

[89] For instance, §1-201(b)(35) of the United States Uniform Commercial Code (UCC) defines a security interest as 'an interest in personal property … which secures payment or performance of an obligation'. As long as the transaction performs this function, it is considered as a security. See J White and R Summers, *Uniform Commercial Code*, 6th edn (St Paul, Minn, West Group 2010) 1153–55.

[90] S Worthington, *Proprietary Interests in Commercial Transactions* (Oxford, Clarendon Press 1996) 11.

[91] Gullifer (n 9) 3.

default, the financier will be able to exercise its remedies, including repossession and sale of the object to discharge the debt. The threat of enforcement of the security interest can serve as a strong incentive for the repayment of the debt. The grant of a security in the object also means that even in the case of the debtor's insolvency, the financier will, generally, be able to obtain the discharge of the debt before the other creditors of the debtor.

B. The Definition of a Security Agreement under the Convention

The Convention defines a security interest as 'an interest created by a security agreement'.[92] Article 1(ii), in turn, provides that a security agreement as 'an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure the performance of any existing or future obligation of the chargor or a third person'.[93] Several points flow from this definition. First, because Article 1(ii) refers to an 'agreement', only consensual forms of security interests are included in this definition.[94] This does not mean that non-consensual security interests are excluded from the Convention's scope altogether. For instance, Article 40 allows a Contracting State to make a declaration that NCRI can be registered in the IR and then be treated as registered international interests. Thus, provided that a Contracting State made the appropriate declaration, a right of a creditor arising out of a legal right of detention where an aircraft engine has been taken for repair and the work has not been paid for by the debtor, can be registered. A registered NCRI will be considered as an international interest and take priority over a subsequently registered and unregistered interest.[95]

Secondly, a security interest can ensure the performance of the existing and future obligations of the chargor or a third person. This means that a security agreement can be used as a continuing facility, which may be particularly convenient in long-term projects. When the value of the collateral is greater than the loan, the parties can use the same collateral for further advances. This will allow the parties to cut unnecessary transaction costs associated with legal fees and the negotiation of the terms of the agreement. Crucially, the Convention distinguishes between security over a future obligation and security in future property. The registration in the asset-based IR is effected against a uniquely identified object and, for this reason, it is

[92] Art 1(jj) CTC.
[93] Art 1(ii) CTC.
[94] B.P Honnebier, 'The New International Regimen Proposed by UNIDROIT as a Means of Safeguarding Rights *in Rem* of the Holder of an Aircraft under Netherlands Law' (2001) 6 *Unif L Rev* 5.
[95] See chapter three for the discussion of registrable NCRI.

not possible to use as collateral an object which does not yet exist, such as an aircraft which does not have the manufacturer's serial number because it has not yet been constructed. At the same time, provided that the collateral is sufficiently identifiable, it is possible to use it as a security for all obligations owed by the debtor to the secured creditor now or in the future.[96] The definition of the security agreement also indicates that a chargor can use the collateral to secure performance of an obligation owed to the chargee by a third person. This position of the Convention reflects a common feature of modern financing where companies forming part of a corporate group provide the lender with cross-guarantees securing performance of obligations of its member companies.[97]

Thirdly, a security interest can arise by a grant of an interest (including an ownership interest) in or over an object. The following points emerge from this part of the definition.

i. An Interest in a Uniquely Identifiable Object

The Convention's security interest must be created in or over an 'object', which is defined as 'an object of a category to which Article 2 applies'.[98] These categories currently comprise: (a) airframes, aircraft engines and helicopters; (b) railway rolling stock; and (c) space assets.[99] These objects must be uniquely identifiable in accordance with the Protocols' requirements.[100] For instance, the Aircraft Protocol provides an exhaustive description of the types of airframes, aircraft engines and helicopters by reference to their jet propulsion, shaft horsepower and other technical particulars.[101] It further provides that the requirement of the unique identification is satisfied if the description of an aircraft object contains its manufacturer's serial number, the name of the manufacturer and its model designation.[102] Similarly, the Luxembourg and Space Protocols provide definitions of the railway rolling stock[103] and the space assets falling into their scope.[104] However, these Protocols override the Convention's requirement of the unique identification of objects for the constitution of international interests. This is because

[96] Goode (n 19) 54.
[97] See *Re Conley* [1938] 2 All ER 127; *Saltri Iii Ltd v MD Mezzanine Sa Sicar* [2012] EWHC 3025 (Comm). See also Gullifer (n 9) 10.
[98] Art 1(u) CTC.
[99] Art 2(3) CTC.
[100] Art 2(2) CTC.
[101] Art I of the Aircraft Protocol.
[102] Art VII of the Aircraft Protocol.
[103] Art I(e) of the Luxembourg Protocol.
[104] Art I(k) of the Space Protocol.

the unique identification is only required when the interest in the object needs to be registered in the asset-based IR.[105] Both Protocols delegate the issue of the unique identification of objects to the Regulations.[106] With the addition of the new MAC Protocol, the current categories will be extended to agriculture, construction and mining equipment. The draft MAC Protocol replicates the bifurcated approach to object identification adopted by the Luxembourg and Space Protocols. While the MAC equipment can be described in general terms in the agreement constituting an international interest, it will have to be uniquely identified for the registration of interests in the IR, which is envisaged to be asset based.[107]

ii. The Debtor Need Not be the Owner of the Charged Object

A security interest can arise by a grant by a chargor to a chargee of 'an interest (including an ownership interest)' in or over the object. Thus, the CTC recognises a security by way of ownership transfer, pledge, or charge, or any other form of consensual security in personal property.[108] At the same time, the size, and ability to speedily cross national borders, of aircraft, railway and space objects can dictate the way in which financial transactions involving them are structured, rendering some forms of security interest more advantageous than others. For instance, a pledge involving the delivery of possession of the object as a security of the performance of an obligation is unlikely to be frequently used in cross-border transactions involving objects governed by the CTC.[109] This is because a debtor, situated in jurisdiction A and intending to acquire a railway rolling stock in jurisdiction B to operate it in jurisdiction C, may find it commercially impractical if, in order to obtain finance for its acquisition, it needs to deliver possession of the object to the financier, situated in jurisdiction D. Likewise, the financier, such as a bank, may find it inconvenient if, in order to secure the repayment of the debt, it has to take possession of the object, thereby not only depriving the debtor from the opportunity to generate profit from its use, but also incurring expenses relating to its maintenance.

[105] See Art V of the Luxembourg Protocol and Art VII of the Space Protocol indicating that the railway rolling stock and the space assets can be broadly defined in the agreement. Art XXX of the Space Protocol delegates the issue of unique identifications of space assets to the Regulations.

[106] Art XXX of the Space Protocol and Art XIV of the Luxembourg Protocol delegate the issue of unique identifications to the Regulations.

[107] See Art V and Art XVI of the draft MAC Protocol.

[108] Goode (n 19) 263.

[109] M Bridge and R Stevens (eds), *Cross-Border Security and Insolvency* (Oxford, OUP 2001) 18–19.

In contrast, a transfer of ownership by way of security, such as a mortgage, represents a better practical solution.[110] This way, the debtor can transfer ownership of the object as a security for the performance of an obligation to the financier and retain its possession. It will then be able to use the object and repay the debt out of proceeds received from its operation. Once the debt is repaid, the ownership will revert back to the debtor. Not all jurisdictions recognise the transfer of ownership in movable objects as a valid security interest and the Convention's express permission for the constitution of such a security may create an incentive for reform in such jurisdictions.[111]

The CTC does not insist that the debtor must be the owner of the object in order to grant a security interest in it. Article 1(ii) specifically provides that a chargor can grant to a chargee '*an interest* (including an ownership interest)'.[112] The debtor can transfer any interest it holds in the object even if it is less than ownership. For instance, an airline-lessee can grant a security interest to the secured creditor in an aircraft object held by it even though its interest in that object is merely possessory and does not amount to ownership.

Moreover, the 'grant of an interest' does not seem to exclude the creation of a new interest not amounting to ownership or possession. Thus, the debtor can grant an interest to the secured creditor in the form of an encumbrance on the object by way of a charge or hypothecation. This means that both ownership and possession remain with the debtor, but the object is appropriated to the satisfaction of the secured obligation, entitling the secured creditor to enforce its security in it to discharge the debt in priority to the debtor's unsecured and junior creditors.[113] Security by way of a charge may be potentially beneficial both to the debtor and the secured creditor in cross-border transactions because it allows the debtor to retain possession and use the object and at the same time keep it encumbered by the debt.[114]

An English floating charge is unlikely to arise under the Convention. English law distinguishes between a fixed and a floating charge, both of

[110] Under English law, ownership may be transferred by way of security by a mortgagor to a mortgagee. Once the secured obligation is performed, the ownership reverts back to the mortgagor. See *Keith v Burrows* (1876) 1 CPD 722; *Santley v Wilde* [1899] 2 Ch 474; *Maugham v Sharpe* (1864) 17 CB NS 443, 141 ER 179; *Kreglinger v New Patagonia Meat and Cold Storage Company Ltd* [1914] AC 25; *Ulframe (UK) v Fielding* [2005] EWHC 1638. Transfer of ownership by way of security is used in some other countries too. See Drobnig (n 1) 58.

[111] Mauri and Itterbeek (n 19) 549.

[112] emphasis added.

[113] *Carreras Rothmans Ltd v Freeman Mathews Treasure* [1985] Ch 207 at 227; *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431. See also Gullifer (n 9) 36.

[114] Bridge and Stevens (n 109) 23.

which may be taken against the present and future property.[115] While the parties can in principle create a charge in respect of the present property, they cannot do so in relation to future aircraft objects, since the Convention does not permit the use of a future property as collateral.[116] The fixed charge allows a secured creditor to take a security in the debtor's specific asset(s) and can, for this reason, be created and registered under the Convention.[117] In contrast, the floating charge does not attach to a particular asset until some specified crystallising event occurs (eg the debtor's default or insolvency).[118] Instead, the floating charge hovers over a specified fund of assets, comprising constantly changing objects, which allows the debtor to dispose of any of them without obtaining the creditor's consent.[119] Until such crystallisation occurs, the secured creditor does not have an interest in any specific property of the debtor.[120] Because Article 2(2) prescribes that the interest of the creditor should relate to a uniquely identified object, it seems unlikely that the constitution of a floating charge is possible under the Convention in relation to aircraft objects.

iii. The Interest is Granted for the Purpose of Securing the Obligation

A security agreement is concluded only for the purpose of securing performance of an obligation. Once the obligation is performed, the secured creditor's interest ceases to exist and the debtor's interest in the object reverts back to it or resumes its unencumbered state. The transfer of an interest to the secured creditor cannot be absolute even if it is by way of the transfer of

[115] *Holroyd v Marshall* (1862) 10 HL Cas 191. See, generally, S Atheton, 'Charges over Chattels: Issues in the Fixed/Floating Jurisprudence' (2005) *Comp Law* 10; R Goode, 'Charges over Book Debts: A Missed Opportunity' (1994) *LQR* 592; R Goode, 'Charge-Backs and Legal Fictions' (1998) 114 LQR 178; M Bridge, 'Fixed Charges and Freedom of Contract' (1994) *LQR* 340.

[116] The position is different in relation to the railway objects, space assets and the MAC equipment because all three Protocols permit description of existing and future objects in broad terms in the international interest agreement. However, even if a floating security interest is created in these types of equipment, its registration in the IR will require unique identification of each object which means that floating security in future unidentified property cannot be registered. Lack of registration will not invalidate the international interest, but will preclude its holder from securing its priority position among others interest holders. This will severely limit the effect of the international interest.

[117] *Agnew v Commissioner for the Inland Revenue* [2001] AC 710.

[118] *Re Florence Land and Public Works Company* (1871) 10 Ch D 530 CA; R Pennington, 'The Genesis of the Floating Charge' (1960) 23 *MLR* 630; R Gregory and P Walton, 'Fixed and Floating Charges—A Revelation' [2000] *LMCLQ* 123.

[119] *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979; *Re Panama, New Zealand and Australian Royal Mail Company* (1870) 5 Ch App 318; *Hodson v Tea Company* (1880) 14 Ch D 459.

[120] *Re Cosslett (Contractors) Ltd* [1998] Ch 495.

ownership. In contrast, an agreement stating that the debtor agrees to transfer the property absolutely without the opportunity of redemption cannot amount to a security interest.

iv. Security is by Grant and Not RoT

Finally, security interest arises by a 'grant' of an interest. Consequently, a security interest cannot be created by the RoT by the creditor. Thus, a conditional sale agreement, involving a RoT by the seller, cannot amount to a security interest. This way, the Convention preserves the distinction between the traditional forms of security interests and other financial arrangements, such as conditional sale or lease, which perform a similar function to security interests but are not considered as such by some legal systems. The distinction between true and *quasi* security interests lies at the heart of the so-called *formal v functional* divide.

C. The Essence of the Formal v Functional Divide

i. The Formal Approach: True Security Interests and Quasi Security Interests

Under the *formal* approach, followed by most civil law jurisdictions, the United Kingdom and other legal systems belonging to the common law family outside North America and New Zealand, the law broadly distinguishes between *the grant* by the debtor of an interest by way of security and *the reservation of title* by the creditor under the RoT agreements such as conditional sale, hire purchase and leasing.[121] According to this approach, true security interests generally arise when the debtor transfers or grants an interest in the collateral to the creditor as security for the performance of an obligation.[122] For instance, under German law, the debtor can transfer its title in the property to the secured creditor, or it can deposit the goods with the creditor and confer on it a right of sale, or it can unconditionally assign receivables due to it to the creditor as a security.[123]

English law traditionally recognises only four forms of consensual security, namely the pledge, the contractual lien, the mortgage and the charge.[124] The debtor may grant by way of security its ownership (mortgage)[125]

[121] R Goode, *The Hamlyn Lectures: Commercial Law in the Next Millennium* (London, Sweet & Maxwell 1998) 63.
[122] Gullifer (n 9) 3–5.
[123] See B Jakel in Bridge and Stevens (n 109) 99–101.
[124] Gullifer (n 9) 5.
[125] *Santley v Wilde* [1899] 2 Ch 474; *Re Sir Thomas Spencer Wells* [1933] Ch 29.

or deliver actual or constructive possession of the collateral (pledge),[126] or encumber the property as a security for the performance of the obligation (charge).[127] A contractual lien, arising out of the express terms of the contract or, if not explicitly provided for in the contract, by operation of law, can arise when the goods are initially delivered for the purpose other than security.[128] For instance, the goods delivered for repair may be used as a security for the payment due to the creditor from the debtor. Other financial and business arrangements, performing the function of a security, are not viewed as such by English law.

Another example can be provided by the Polish Civil Code, stating that for the creation of a valid mortgage over real property, the contract should, among other things, unequivocally declare that the owner of the property agrees to *grant* its interest by way of mortgage as a security for the performance of the secured obligation.[129] A Polish possessory pledge is created when the debtor, who must be the owner of the pledged property, delivers it to the creditor or another agreed third party.[130] The Civil Code of the Russian Federation[131] and the Federal Law on the Hypothec (the Pledge of Immovable Property) of the Russian Federation[132] indicate that both possessory and non-possessory pledges of property presuppose that the pledgor grants to the pledgee its interest (which can be less than ownership) in the property as security for the performance of the obligation.[133] Finally, French law on security interests prescribes that, as a general rule, security over tangible movable property is created and perfected by physical delivery of the collateral to the pledgee or other agreed third party.[134] In each of these examples, it is the debtor—clothed in such terms as the pledgor, the mortgagor or the chargor—which must grant the interest held by it to the secured creditor for a true security to arise.

[126] *Coggs v Bernard* (1703) 2 Ld Raym 909; *Donald v Suckling* (1866) LR 1 (QB) 585; *Halliday v Holgate* (1868) LR 3 (Exch) 299; *Singer Manufacturing Company v Clark* (1879) 5 Ex D 37; *Mathew v Sutton* [1994] 1 WLR 1455.

[127] On the difference between a charge and a mortgage, see *Swiss Bank Corporation v Lloyds Bank Ltd* [1982] AC 584, 595.

[128] *George Barker (Transport) Ltd v Eynon* [1974] 1 WLR 462.

[129] L Choroszucha, 'Secured Transactions in Poland: Practicable Rules, Unworkable Monstrosities and Pending Reforms' (1994) 17 *Hastings Int'l Comp L Rev* 389, 400.

[130] Polish law recognises non-possessory pledges, but these are only available to banks. See Choroszucha (n 128) 404–06.

[131] '*Гражданский Кодекс Российской Федерации, Части Первой*', The Civil Code of the Russian Federation, Part One, 30 November 1994, N 51-ФЗ.

[132] '*Федеральный Закон об Ипотеке (Залоге Недвижимости)*', The Federal Law on the Hypothec (the Pledge of Immovable Property), 16 July 1998, N 102-ФЗ, approved by the Council of the Federation on 9 July 1998, adopted by the Parliament ('*Gosudarstvennaya Duma*') on 10 July 1998. This federal law was first officially published in *Финансовая Россия* (Financial Russia), 1998, N 27 and *Российская Газета* (Russian Gazette), 1998, N137.

[133] B Bennett, 'Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns' (1999) 77 *Tex L Rev* 1443, 1447.

[134] M Gdanski in Bridge and Stevens (n 109) 59.

Security interests recognised by domestic laws are not the only means which a financier can employ to provide its customer with the required finance while, at the same time, ensuring that it will be repaid. Various business arrangements, broadly defined as RoT transactions, can perform a function similar to that of a security and at the same time possess other features which parties to a transaction may find more advantageous. Because of their chameleon-like nature, allowing them to serve as a security, RoT agreements are often described as *quasi* security interests. These financial arrangements include RoT clauses in conditional sale agreements, sales and lease-backs, hire purchase and leasing agreements.

a. Retention of Title

The term 'retention of title' can be used to describe various financial devices where the ownership of an object remains with the creditor as a security for the performance of an obligation (usually payment of money) and the possession is transferred to the debtor. For example, hire purchase and lease can be described as RoT agreements.[135] In addition, the term 'retention of title' is also used to refer to the RoT clauses, frequently found in conditional sale agreements.[136] While there exist many varieties of RoT clauses, their general purpose seems to be universal. By means of such a clause, the seller intends to reserve the ownership of the goods delivered to the buyer until the latter performs certain conditions, often amounting to the payment of the purchase price.[137]

A valid RoT clause can be used by the conditional seller as a security designed to ensure that the buyer pays the purchase price.[138] Similar to security interests, the RoT clause protects the conditional seller in the case of the buyer's insolvency.[139] Since the conditional seller retains ownership of the goods, they do not become part of the buyer's estate on insolvency and the unpaid seller is generally entitled to repossess the goods. In contrast with the traditional security interests, RoT clauses, generally, do not require registration.[140] This circumstance is particularly advantageous to the parties

[135] Beale, Bridge, Gullifer and Lomnicka (n 8) 235.

[136] The legal basis of RoT clauses under English law is to be found in Sale of Goods Act 1979, s 2(3) and s 19(1). See also *Clough Mill Ltd v Martin* [1985] 1 WLR 111; *Armour v Thyssen Edelstahlwerke AG* [1991] 2 AC 339 and *Hendy Lennox (Industrial Engines) Ltd v Graham Puttick Ltd* [1984] 1 WLR 485.

[137] G McCormack, 'Personal Property Security Law Reform in England and Canada' (2002) *JBL* 113, 133.

[138] Worthington (n 90) 41.

[139] *Clough Mill Ltd v Martin* [1985] 1 WLR 111, 122.

[140] The position is different under the US UCC, adhering to the functional approach, which states that the interest of unpaid seller under the RoT clause amounts to a registrable security interest. See §1-201(35) UCC.

intending to enter several sales agreements, as registering each clause every time a new agreement is concluded is burdensome.[141]

In spite of the fact that RoT clauses perform the function of a security, English law, in line with the formal approach, does not consider them as true security interests. The main reason for this is that, in contrast with true security interests, the conditional seller (the creditor) does not rely on the debtor's grant of an interest, but retains its ownership until the obligation is performed.[142] Curiously, while English courts have accepted the validity of 'simple' clauses, under which ownership to the goods is not to pass to the buyer until the purchase price under the contract is paid, as well as the 'current account' or 'all monies' clauses, allowing the seller to retain ownership until *all* debts and not just the purchase price due from the buyer are paid, they have refused to treat more extended forms of RoT clauses as such.[143] When the conditional seller attempts to retain its ownership in the original goods used by the buyer in the process of mixture or manufacture of new products, or in the proceeds received by the buyer as a result of the sale of original goods, English courts usually treat these clauses as charges and not RoT clauses.[144] This generally seems to happen because title to the goods is deemed to have passed to the buyer at the moment of the irreversible mixture of the original goods with the other goods of the buyer, or the sale of the original goods to a third party.[145] On this view, the interest held by the conditional seller is considered to have been obtained by the grant by the buyer and not RoT by the seller.[146]

The difference between the true security interests by the grant and *quasi* security interests by the RoT is followed with varied rigidity by various jurisdictions. While English law maintains strongly that the true security interests arise by the grant of an interest by the debtor to the creditor and not the RoT by the creditor, other legal systems adopt a slightly different approach. Thus, German law, similar to English law, does not consider such RoT agreements as leasing as a true security interest: the lessor is deemed to retain the unconditional title to the leased goods and is entitled to terminate

[141] McCormack (n 136) 124.

[142] The position is different in the jurisdictions adhering to the functional approach, where the conditional seller is considered as a secured creditor and both ownership and possession are transferred to the conditional buyer. See J Sampson and B Brown, 'Retention of Title under New Zealand's Personal Property Securities Act 1999' (2002) 17 *JIBL* 102; M Bridge, R Macdonald, R Simmonds and C Walsh, 'Formalism, Functionalism, and Understanding the Law of Secured Transactions' (1999) 44 *McGill LJ* 567, 587–98.

[143] *Borden (UK) Ltd v Scottish Timber Products Ltd* [1981] Ch 25; *Armour v Thyssen Edelstahlwereke AG* [1991] 2 AC 339.

[144] *Re Peachdart* Ltd [1984] Ch 131.

[145] See *Borden (UK) Ltd v Scottish Timber Products Ltd* [1981] Ch 25, where it was held that the supplier's title in the resin disappeared once it was used in the process of chipboard manufacture.

[146] *Ian Chisholm Textiles Ltd v Griffiths* [1994] BCC 96.

the lease and repossess the goods in case of the lessee's default.[147] At the same time, RoT clauses, allowing the unpaid seller to retain ownership until the buyer performs conditions precedent to the transfer of the title, are seen as true security interests.[148]

b. Hire Purchase[149]

Hire purchase can be considered as a form of a RoT agreement aimed at providing the creditor with security against the debtor's default.[150] Hire purchase is essentially a contract, whereby the owner (the creditor) lets the goods on hire to the hirer (the debtor) in return for the payment of rentals.[151] It is similar to conditional sale in that the hirer, like the conditional buyer, obtains possession of the goods and can use them in its business in return for periodic payments. The two arrangements are also similar as they both perform a security function. In both cases, the owner/conditional seller retains ownership of the goods to ensure that the hirer/conditional buyer makes timely payments.[152] Some legal systems, however, distinguish between a hire purchase and a conditional sale on the basis that unlike the conditional buyer, who is obliged to purchase the goods, the hirer has merely an option to do so, but may choose not to exercise that option.[153] Another difference between the two under English law is that because hire purchase is not considered to be a sale, the hirer cannot transfer good title to a bona fide third party, should it decide to sell the hired goods.[154] Since hire purchase does not involve a grant of an interest by the hirer and is accomplished by the retention of title by the owner, English law, for instance, does not consider it as a true security interest.[155] As a consequence, hire purchase does not, generally, require registration as many security interests do.

[147] Jakel in Bridge and Stevens (n 109) 104.

[148] I Fletcher and O Swarting, *Remedies Under Security Interests* (London, Kluwer Law International 2002) 135.

[149] See, generally, R Goode, *Hire Purchase Law and Practice*, 2nd edn (Butterworth & Co Publishers 1970); AG Guest, *The Law of Hire Purchase* (Sweet & Maxwell 1966).

[150] A Diamond, 'A Review of Security Interest in Personal Property', HMSO, DTI, 1989.

[151] Beale, Bridge, Gullifer and Lomnicka (n 8) 255.

[152] *Ibid* 256; H Johnson, 'Problems with Hire Purchase' (1993) 12 *IBFL* 39.

[153] *Jobson v Johnson* [1989] 1 WLR 1026.

[154] M Bridge, 'Form, Substance and Innovation in Personal Property Security Law' (1992) *JBL* 1, 6. But see s 27 of the Hire Purchase Act 1964 indicating that, under English law, a trade or finance purchaser of a motor vehicle from the hirer takes subject to the interest of the owner. At the same time, an innocent private purchaser takes free from such interest. See further Beale, Bridge, Gullifer and Lomnicka (n 8) 486.

[155] *McEntire v Crossley Bros Ltd* [1895] AC 457.

c. Leasing

Leasing involves the transfer of possession of the goods by the lessor to the lessee for a certain period of time in return for the rentals.[156] There are different ways of structuring the transaction, but in a basic form it usually starts with a lessee, who, having found the equipment it needs, approaches the lessor so that the latter can buy this equipment and lease it to the lessee.[157] In some cases, when the lessor does not wish to purchase the equipment itself, the lessee, who has better knowledge of the particulars of the equipment it needs, may buy such equipment, sell it to the lessor and lease it back. This is often referred to as sale and lease-back, whereby 'the buyer' (lessor) agrees to allow 'the seller' (lessee) to retain possession of the equipment in return for the payment of a rent. Alternatively, instead of leasing the equipment back, the seller may agree to re-purchase it at a later stage.[158]

English law distinguishes between conditional sale, hire purchase and lease on the basis that unlike conditional sale or hire purchase, leasing does not impose on the lessee an obligation or option to purchase the goods.[159] In fact, the title is never intended to be transferred to the lessee and is retained as security for the rentals by the lessor. There are different forms of leases reflecting the needs of particular industries and lessees, but the most commonly accepted classification is that between operational and finance leases. The operational lease usually denotes a short-term hire contract, whereby goods having a reasonably long economic life are let on hire for short periods of time to different lessees.[160] In contrast, a finance lease is a true financial tool involving a lessor who hires the goods out for the duration of their useful economic life to a lessee in return for rental payments.[161] Such rental payments amount to the return of sums which the lessor spends on the acquisition of the goods and its profit. Like RoT clauses under conditional sale, finance lease operates 'in the nature of security'. Thus, the lessee has the possession of the goods, while the lessor secures periodic payments through the retention of title in them as the true owner.[162]

[156] See, generally, *Tolley's Leasing in the UK*, 4th edn (Butterworths Tolley Ltd 2002).
[157] Beale, Bridge, Gullifer and Lomnicka (n 8) 260–65.
[158] *Ibid* 266.
[159] The distinction between these transactions may become less clear if, as is often the case, the lessee under a finance lease is given the right to receive the proceeds of sale of the equipment. See *On Demand Information plc v Michael Gerson (Finance) Ltd plc* [2004] 4 All ER 734.
[160] The operational leases do not perform the function of security. See Law Commission Consultation Paper No 164, *Registration of Security Interests: Company Charges and Property other than Land*, para 7.30 (hereafter '*Consultation Paper*').
[161] *Ibid* 7.30–7.34.
[162] *On Demand Information plc v Michael Gerson (Finance) Ltd plc* [2004] 4 All ER 734, 743.

ii. The Choice between a True Security and a Quasi Security Interest and Aspects of Characterisation

The types of transactions discussed above illustrate that, apart from recognised security interests, there also exist other ways of meeting the debtor's needs by providing it with finance or possession of the required goods and at the same time securing the creditor's position.[163] The parties to a transaction can opt for either a true security or a *quasi* security interest because they are treated differently by law which, in turn, has important practical implications. First, while security interests often require registration,[164] *quasi* security interests generally do not, which helps cut costs associated with the registration and ensure that the transaction's particulars remain confidential.[165] Secondly, if, following the debtor's default, the creditor repossesses and sells the collateral at the price exceeding the amount of debt, it will be entitled to keep the surplus in the case of a *quasi* security, but will have to hand it over to the debtor in the case of a true security. Thirdly, the retained ownership of the object as a *quasi* security will also provide the creditor with a super-priority badge on the debtor's insolvency. Since the object belongs to the creditor, it will not constitute part of the insolvent debtor's estate and will have to be handed back to the owner before the distribution among other secured and unsecured creditors begins.[166]

The main reason why *quasi* security creditors enjoy super-priority stems from the nature of their interest in the object. As true owners, they simply claim something that belongs to them and do not assert their rights in the debtor's property, as secured creditors do. There may be other reasons for opting for either a true or a *quasi* security. For instance, the financier can be precluded from lending a loan to the borrower, but allowed to provide the same finance by other means, such as by buying and re-selling the equipment to the borrower. The taxation implications may differ depending on the choice of the parties and the accounting considerations may also play a role when the choice is made by the parties.[167]

In some cases, the *quasi* security interests mimic the functions of the true security interests to such an extent that it is difficult to distinguish one

[163] For a detailed examination of these and other functionally similar devices, see Beale, Bridge, Gullifer and Lomnicka (n 8) Chapter 7.

[164] Thus, under English law, many charges created by companies are registrable under s 859A of the Companies Act 2006. But possessory security interests, such as pledge, usually do not require registration on the basis that possession in itself signals the existence of the interest. See Gullifer (n 9) 82. For a similar position in French law see Gdanski in Bridge and Stevens (n 109) 65.

[165] *Consultation Paper* (n 159) 6.3.

[166] *Re George Inglefield Ltd* [1933] Ch 1, 26–27, per Romer LJ.

[167] Beale, Bridge, Gullifer and Lomnicka (n 8) 81.

from the other. For instance, a railway operator wishing to raise finance to acquire a new rolling stock may sell some of its existing equipment to a finance house and agree to buy it back later. Such an arrangement can be considered as a true sale and buy-back transaction, whereby ownership passes to the creditor and the debtor agrees to retain possession and buy the property back by making instalment payments. This way, the debtor can receive the required funds and continue to use the property. The creditor, in contrast, can be considered as providing a loan to the debtor on the security of equipment, which is being repaid by periodic payments with interest. In this case, the court will have to decide whether the transaction amounts to a security or a genuine sale and buy-back agreement. If it is found to be a genuine sale/buy-back, all is well. If, as the case may be, the court decides that the transaction is in fact a disguised loan on security, it may be found void for a lack of registration or some other formality with which a true security must comply. The problems of characterisation and the necessity to subject true and *quasi* security interests to different legal regimes raises a question whether *quasi* security should be treated as a true security interest. Some commentators in the common law jurisdictions consider the *formal* approach, which divides economically similar devices into different categories, as artificial and unnecessarily complicating the law.[168] This issue has been considered by many legal commentators and was most clearly emphasised in the Diamond Report on security interests.[169] Professor Diamond suggested, among other things, that security interests and the functionally equivalent *quasi* securities, such as RoT agreements, should be equated and subjected to the same requirements of notice-filing or registration. His proposals were based on the United States Article 9 UCC, which essentially treats all devices intended to provide a security as true security interests. The proposals in the Diamond Report have not been adopted in the UK so far. Some legal scholars suggest that it is merely a question of time and eventually the courts will accept the *quasi* security interests into the category of true security interests.[170] Other jurisdictions, notably, Canada and New Zealand have shown more flexibility and, following legal reforms, adopted the functional approach.[171]

[168] Goode (n 120) 62–63.

[169] A Diamond, 'A Review of Security Interest in Personal Property', HMSO, DTI, 1989. For the discussion of the Diamond Report and other reports on the subject, see Consultation Paper (n 159) paras 1.27–1.31.

[170] Bridge (n 153).

[171] See, generally, I Davies, 'Floating Charges and Reform of Personal Property Legislation' (1988) *Comp Law* 47; N Howcroft, 'Canada: Security for Lending—Personal Property Security Act' (1988) *JIBL* 157.

iii. The Functional Approach: The Unitary Concept of Security Interest

The distinction between a true and *quasi* security interest is largely extinguished by the *functional* approach, treating all security devices as security interests. The *functional* approach originated in the US law under Article 9 UCC.[172] The pre-Code US law on secured transactions, somewhat similar to the formal approach, recognised distinctions between various security devices and governed them by different laws.[173] This was changed by the 1962 Article 9, which introduced a new *unitary* concept of a security interest, taking under its umbrella all old forms of security devices in personal property without regard to their form or location of the title.[174]

The key provisions of Article 9 for understanding whether a transaction is governed by it are mainly §1-201(35) on 'security interests', §9-109 on the 'scope' and §9-102 on the 'definitions'. §1-201(35) defines a security interest as 'an interest in personal property or fixtures which secures payment for performance of an obligation'. Accordingly, a transaction which confers only personal rights on the creditor will not be sufficient to create a valid security interest. In contrast, so long as the security device denotes some interest in the personal property it may amount to a security interest 'regardless of its form'.[175] This means that in addition to the traditional security interests, such as pledges, mortgages and charges, Article 9 regards many others, including some leases, consignments, RoT clauses under conditional sales, account receivables financing, factoring, deposit accounts and other security devices, as security interests.[176] At the same time, as broad as Article 9 appears to be, some devices will be out of its reach. For instance, the subordination agreements, allowing one creditor of the debtor to agree to subordinate its claim to that of another creditor, and negative pledges, prohibiting the debtor from creating a new security interest in its property until the debt to the present secured creditor is paid, are not considered as security interests.[177]

[172] The UCC, the drafting of which was initiated by Mr William A Schnader in 1940, was first published as the '1952 Official Text' under the auspices of the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI). The UCC is a comprehensive code dedicated to commercial issues comprised of 11 Articles, Article 9 being titled as Secured Transactions. The UCC has been revised on many occasions and the last revision was conducted in 2009–2010. See W Schnader, 'A Short History of the Preparation and Enactment of the Uniform Commercial Code' (1967) 22 *U Miami L Rev* 1.

[173] See, generally, D Baird and T Jackson, *Security Interests in Personal Property: Cases, Problems, and Materials*, 2nd edn (New York, The Foundation Press, Inc 1987); G Gilmore, *Security Interests in Personal Property* (Boston & Toronto, Little, Brown and Company 1965).

[174] Broude in Bridge and Stevens (n 109) 50.

[175] §9-109(a)(1) UCC.

[176] D Garland, 'Revised Art 9: Understanding the Changes to Secured Transactions' (2001) 64 *Tex Bar J* 974.

[177] White and Summers (n 89) 1154.

Article 9 provides a comprehensive set of legal rules guiding a security interest through its major development stages: attachment, perfection, priority and enforcement. Attachment refers to all necessary steps to be taken for the creation of a security interest which will be valid between the creditor and the debtor. Perfection of security generally denotes the steps to be taken by the parties to secure the position of the secured creditor against third parties. One usually 'perfects' by filing the financing statement or taking control or possession of the collateral in order to publicise its position as a secured creditor to the world at large. At the stages of priority and enforcement, the secured creditor's position in the line of other secured creditors is determined and it is then able to exercise the remedies under Article 9.[178]

Article 9 has been characterised as 'fundamentally sound',[179] 'rational and modern',[180] 'awe inspiring, scary and spectacular'[181] and simply 'genius'.[182] Such countries as New Zealand,[183] Canada (with the exception of the civil law province of Quebec),[184] Gaza and the West Bank drafted their Personal Property Security Acts on the model of Article 9.[185] It has inspired several international initiatives in the field of security interests in personal property.[186] It is generally thought to eliminate problems associated with the formal approach such as compartmentalisation, complexity and difficulty in determining priorities. Instead of grouping different security devices into various compartments and subjecting them to different laws, Article 9 provides a single uniform legal regime for all of them, ridding the system of unnecessary complexity.

[178] For detailed examination of these stages, see White and Summers (n 89) Chapters 23–26.

[179] H Ruda, 'Art 9 Works—How Come?' (1994) 28 *Loy L A L Rev* 309, 309.

[180] J Ziegel, 'The New Personal Property Security Regimes—Have We Gone too Far?' (1989–90) 28 *Alta L Rev* 739, 741.

[181] H Hughes, 'Aesthetics of Commercial Law—Domestic and International Implications' (2007) 67 *Louisiana L Rev* 689, 730–32.

[182] R Cuming, 'Article 9 North of 49: The Canadian PPS Acts and the Quebec Civil Code' (1996) 29 *Loy L A L Rev* 971, 989.

[183] On the discussion of the New Zealand Personal Property Security Act, see H Gabriel, 'The New Zealand Personal Property Securities Act: A Comparison on the North American Model for Personal Property Security' (2000) 34 *Int'l L* 1123; R Carnachan and M King, 'New Zealand: Personal Property Securities Act 1999' (2001) 3 *J Int'l Fin Markets* 80; C Taylor and M King, 'New Zealand: Personal Property Securities Act' (1999) 1 *J Int'l Fin Markets* 75.

[184] See, generally, Howcroft (n 170); R Cuming and C Walsh, 'Revised Art 9 of the Uniform Commercial Code: Implications for the Canadian Personal Property Security Acts' (2000–2001) 16 *Bank Fin L Rev* 339; M Sheppard and L Champion, 'The Personal Property Security Act of Alberta—Implications for Oil and Gas Lenders' (1991) 29 *Alta L Rev* 33.

[185] Bridge, Macdonald, Simmonds and Walsh (n 141) 569.

[186] J Spanogle, 'A Functional Analysis of the EBRD Model Law on Secured Transactions' (1997) *NAFTA: L Bus Rev Americas* 82; F Dahan and G McCormack, 'International Influences and the Polish Law on Secured Transactions: Harmonisation, Unification or What?' (2002–3) 7 *Unif L Rev* 713; I Davies, 'The New *Lex Mercatoria:* International Interests in Mobile Equipment' (2003) 52 *ICLQ* 151, 154.

The unitary concept of Article 9 and the functional approach in general is not, however, welcomed by all. Some have commented that the unitary concept of security interests brought more confusion than clarity as regards the very essence of a security interest and that this concept should not be taken at face value.[187] For instance, RoT clauses, under which ownership is reserved by the conditional seller, are treated as a security interest under Article 9. The traditional English law distinction between 'simple' and 'all debts' RoT clauses and more advanced 'proceeds' and 'products' RoT clauses, construed as charges, is irrelevant under Article 9.[188] The conditional seller is considered as a secured creditor.[189] Once the debtor (conditional buyer who becomes the owner of the goods) obtains possession of the goods, the creditor's (conditional seller's) claim is equated with that of the claim of a secured creditor. It follows that to compete with other secured creditors of the buyer, the conditional seller must file the financing statement or, in other words, perfect its security, to avoid being treated as an unsecured creditor. The 'super-priority' enjoyed by the conditional seller as a true owner, which was previously taken for granted, is denied to it under the functional approach and must be clawed back by filing the financing statement or complying with the Article 9 requirements for the perfection of the purchase money security interest.[190] Another consequence of the functional approach applied to the RoT is that on repossession, the conditional seller is no longer entitled to deal with the goods as the owner. As a secured creditor, it has to sell them and account for any surplus to the buyer. Viewed from this perspective, the functional approach may seem to disrupt the general perception shared by business persons of what conditional sale and RoT clauses are.[191]

Furthermore, a substantial body of US case law on the distinction between true leases and security interests demonstrates that the problem of the characterisation persists under the functional approach.[192] True leases are governed by Article 2A UCC and need not be perfected or filed under Article 9 as a security interest.[193] If the lessor is in reality a secured

[187] Bridge, Macdonald, Simmonds and Walsh (n 141) 574.

[188] McCormack (n 5) 39–99.

[189] §9-110 UCC provides in part that a security interest arising under §2-401 (seller who retains title as security interest), §2-505 (seller who ships under RoT), §2-711(3) (buyer in possession of rejected goods) is subject to Article 9.

[190] Purchase money security interest (PMSI) is generally said to arise when the creditor provides the debtor with funds to enable it to purchase specific goods. PMSI is granted super-priority status which upsets the general rule of priority according to which priority is granted on the basis of the first-to-file criterion. See White and Summers (n 89) 1196–99.

[191] McCormack (n 136) 113.

[192] See, for example, *Leasing Services Corp v American Nat Bank & Trust Co*, 1976 WL 23674, 19 UCC (DNJ 1976); *In re Lerch*, 147 BR 455, 20 UCC Rep Serv 2nd 260 (Bankr C D Ill 1992).

[193] M Livingston, 'Certainty, Efficiency and Realism: Rights in Collateral under Art 9 of the Uniform Commercial Code' (1994) 73 *North Carolina L Rev* 115, 125–26.

creditor retaining a security to ensure performance of the debtor's obligation, Article 9 applies and the secured creditor loses its privileged position unless it complies with its requirements, such as the filing of the financing statement.[194] The issue is rather complex and some have even suggested that both true leases and those leases amounting to security interests should be subjected to the requirements of filing to eliminate the need for the characterisation.[195] To summarise, Article 9 is sometimes described as the 'most modernised, rational and comprehensive system of security interests in the present world'.[196] While this may be the case, many legal systems have chosen to retain the formal approach to the definition of security interests.

III. THE CONCEPT OF THE INTERNATIONAL INTEREST

A. What is an International Interest?

One of the main objectives of the Convention is to establish an effective international legal framework for the creation, perfection, priority and enforcement of international interests held in the uniquely identifiable high value mobile equipment. The international interest is the key category of the interests governed by the Convention.[197] Provided that the interest is created in accordance with Articles 2 and 7 CTC, it will constitute a valid international interest even if it would not have had such an effect under the national law.[198] Likewise, an interest validly created under the domestic law will not constitute an international interest unless it complies with the Convention's requirements.[199] If the formal requirements for the constitution of the international and national interests coincide, they will come into existence simultaneously. In this case, the creditor can exercise the rights given to it by domestic law as long as they do not conflict with the Convention's provisions. At the same time, a registered international interest can give the secured creditor stronger protection since it will enjoy priority over a domestic interest, as well as subsequently registered and unregistered Convention interests, and will survive the debtor's insolvency.[200]

Although the international interest is the key category of registrable interests, the CTC does not provide a comprehensive definition of this concept.

[194] White and Summers (n 89) 1155–63.

[195] D Baird and T Jackson, 'Possession and Ownership: An Examination of the Scope of Art 9' (1983) 35 *Stan L Rev* 175, 189–94. For the opposite view, see C Mooney, 'The Mystery and Myth of 'Ostensible Ownership' and Art 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases' (1988) 39 *Alabama L Rev* 683.

[196] McCormack (n 136) 141.

[197] For an overview of other interests governed by the Convention, see chapter three.

[198] Goode (n 19) 266–68.

[199] Goode (n 20) 12.

[200] Goode (n 19) 56.

Instead, its meaning has to be ascertained from Articles 2 and 7. First, the international interest must be either: (a) granted by the chargor under a security agreement; (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.[201] Secondly, the international interest must relate to one of the objects of mobile equipment listed in Article 2(3), namely aircraft and railway objects or space assets.[202] Thirdly, an international interest agreement must be: (a) in writing; (b) relate to the object of which the chargor, conditional seller or lessor has power to dispose; (c) enable the object to be identified in conformity with the Protocol; and (d) in the case of security agreement, enable the secured obligation to be determined, but without the need to state the maximum sum secured.[203]

To establish an international interest one should, among other things, determine whether a transaction can be characterised as a security, title reservation or a leasing agreement. It is not clear whether the issue of characterisation should be dealt with under the applicable law or under the Convention. First, Article 2(4) provides that it is the applicable law that should deal with this issue. The applicable law is said to refer to the 'domestic law of the State whose law is applicable by the rules of private international law of the forum'.[204] Secondly, the meaning of these terms can be ascertained from the definitions provided by Article 1 CTC. The section below considers both routes of characterising a transaction and explains the relationship between them.

B. Defining the International Interest: Applicable Law or the Convention?

i. Article 2(4) Route: Applicable Law

Article 2(4) provides that it is the applicable law and not the Convention that determines whether an interest is a security agreement, title reservation or a leasing agreement. The reason why this characterisation was left to the applicable domestic law was that finding a uniform approach on this issue was thought to be impracticable.[205] This is due to the sharp divide between the formal and functional approaches adopted by various legal systems in defining security interests and other functionally similar devices.[206] Initially, the sub-committee of the Study Group responsible for the preparation of

[201] Art 2(2) CTC.
[202] Art 2(2), (3) CTC.
[203] Art 2(2) CTC and Art 7 CTC.
[204] Art 5(3) CTC.
[205] Goode (n 19) 267.
[206] *Ibid* 267.

the uniform rules on security interests concluded that the draft Convention should adopt the functional approach to the definition of security interests, embracing the notions of the RoT and lease.[207] This was in line with the proposals of Professor Cuming expressed in his Report[208] and was confirmed by the positive response to the Questionnaire on the issues of security interests distributed among banks, financial institutions, buyers and sellers.[209] However, some delegates from the legal systems adhering to the formal approach and the representatives of the European Leasing Industry, insisted on preserving the distinction between the traditional security interests and the RoT and lease.[210] This is why the uniform characterisation of interests seemed impracticable and it was decided to leave this issue to the applicable law.

Since the transaction can be viewed differently by various legal systems, its characterisation by the applicable law may result in it being considered either as a security, RoT or a lease. The difference between these categories under the CTC is primarily relevant to the creditor's remedies.[211] If the agreement is characterised as a title reservation agreement, the creditor can exercise the remedies available to it under Article 10 CTC and can terminate the agreement and take possession or control of the object. Since the creditor is the owner of the object, the debtor cannot claim an interest in the surplus which can be generated by the object's subsequent sale. In contrast, if the agreement is defined as a security agreement, the creditor will have to proceed under Articles 8 and 9 CTC as a secured creditor. Provided that the debtor agrees, the creditor can take possession or control of the object, sell or grant a lease, or collect or receive any income or profits arising from the object's management or use.[212] These remedies must be exercised in a commercially reasonable manner[213] and in the case of the proposed sale or lease the creditor must give prior written notice to all interested persons.[214] Sums collected by the creditor must be applied towards discharge of the secured obligation and any surplus must be distributed among the holders of the subsequently ranking interests and the debtor.[215]

The delegation of the issue of characterisation to the applicable domestic law allows the Convention to stay outside the long-standing debate between

[207] Davies (n 185) 161.
[208] R Cuming, 'International Regulation of Aspects of Security Interests in Mobile Equipment' UNIDROIT 1989, Study LXXII Doc 2.
[209] Davies (n 185) 158–59.
[210] *Ibid* 161.
[211] Goode (n 19) 267.
[212] Art 8(1) CTC.
[213] Art 8(3) CTC. For the examination of the requirement of commercial reasonableness, see chapter six.
[214] Art 8(4) CTC.
[215] Art 8(6) CTC.

the formal and functional approaches. It is a compromise solution allowing Contracting States to adhere to the approach they adopted.[216] The fact that Article 2(2) expressly distinguishes between the security agreement, title reservation and leasing agreements indicates that the legal systems adopting the formal approach can utilise these categories to introduce the transaction into the bigger category of the international interest.[217] From the functional approach perspective, the true security and *quasi* security interests can be subsumed under the Article 2(2)'s category of a 'security agreement'.

This mechanism allows both formal and functional approaches to co-exist at the stage of the constitution of the international interest. United as 'international interests', all three types of interests are then subjected to the Convention's uniform legal regime governing creation, registration and priority.[218] The distinctions between the three categories do not, however, become wholly irrelevant and when the issue of the remedies arises, the transaction's characterisation once again becomes important. The remedies of the secured creditor are more detailed than those of other holders of international interests because a secured creditor, unlike a conditional seller and lessor, is not considered to be the owner of the object.[219] In countries following the functional approach, the RoT and some leases are treated as security interests. When the transaction is characterised as such, the creditor will only be able to exercise the remedies available to it as a secured creditor, and not as the conditional seller or lessor.[220] This is the effect of Article 2(2) providing that the categories enumerated therein are mutually exclusive. Once a transaction has been characterised as, for instance, a title reservation agreement it cannot be later re-characterised as a security interest.

ii. Article 1(q), (ii), (ll) Route: The Convention

Although Article 2(4) prescribes that it is the applicable law that determines whether a transaction amounts to a security, RoT or a lease agreement, Article 1 also provides for the definitions of these types of interests and agreements. It appears that the Convention provides for two different routes of determining whether a transaction falls into one of the categories of Article 2(2) and does not explain the relationship between these routes. This issue is important because the characterisation under the applicable law and the Convention may not always coincide.

[216] See R Goode, 'Rule, Practice, and Pragmatism in International Commercial Law' (2005) *ICLQ* 539, 560.
[217] Honnebier (n 94) 17–22.
[218] For instance, Art 16(1)(a), enumerating the registrable interests does not distinguish between security, title reservation and lease and defines them as 'international interests'.
[219] Goode (n 19) 280–81.
[220] *Ibid* 280.

Consider an agreement whereby an owner is letting an aircraft object on hire to the hirer, the latter having an option to purchase the object. Such an agreement will have to be characterised to establish whether it can qualify as the Convention's international interest. If Article 2(4) is relied upon and, say, English law applies, the agreement may be characterised as a hire purchase and will not fall into either of the categories of Article 2(2).[221] In contrast, if the agreement is defined under the Convention, it may be considered as a lease and amount to an international interest. English law distinguishes a lease and hire purchase on the basis that while a lease does not entail an option to purchase and the object must be returned to the lessor at the end of the agreement, hire purchase provides the hirer with this option.[222] In contrast, the broad definition of the leasing agreement under Article 1(q) includes any agreement by which 'one person (the lessor) grants a right to possession or control of an object (with or without option to purchase) to another person (the lessee) in return for a rental …'. This definition would allow characterising this agreement as a lease and the lessor's interest could qualify as an international interest.

The uncertainty relating to the characterisation of interests may be seen as being clarified by the OC's comment relating to the definition of a lease under Article 1(q): 'leasing agreement … covers leases and sub-leases … with or without an option to purchase … *whether or not* the transaction would be characterised by national law as a leasing agreement, *though under Article 2(4) it is left to the applicable law to determine whether the agreement is to be characterised as a security agreement or a title reservation agreement*'.[223] This comment confirms that the characterisation of the transaction can differ under the Convention and the national law. It also seems to suggest that the characterisation under the Convention is a two-stage exercise. First, the CTC's definitions must be used for the 'initial characterisation' to determine whether a transaction gives rise to an interest which, in principle, can be governed by the Convention.[224] If, applying Article 1, a creditor's interest can be defined as that of a secured creditor, conditional seller or the lessor, this interest will be governed by the Convention. Secondly, once this is established, then the transaction should be characterised by the applicable domestic law for the purpose of other provisions of the Convention and, in particular, those, relating to the creditor's remedies.[225]

[221] See Beale, Bridge, Gullifer and Lomnicka (n 8) 255.

[222] This distinction between hire purchase and lease may become less clear if, as is often the case, the lessee is given the right to receive any proceeds of sale of the goods at the end of the lease. See Beale, Bridge, Gullifer and Lomnicka (n 8) 261.

[223] Goode (n 19) 257 (emphasis added).

[224] *Ibid* 267.

[225] *Ibid* 267.

In line with this view, the agreement of hire of the aircraft object with the option to purchase should be initially characterised as a lease under Article 1 CTC. This will bring the agreement within the Convention's scope. Once the international interest of the lessor is constituted, the interest must, once again, be characterised under the applicable law pursuant to Article 2(4). The subsequent characterisation is needed to determine which interest-sensitive provisions of the Convention should apply to it. Thus, if the interest of the owner/lessor is later re-characterised by the applicable law as a security interest, it will exercise the remedies of a secured creditor and not those of a lessor.

The OC's explanation of the relationship between the two routes of defining various interests is not entirely satisfactory. For instance, a transaction initially characterised by the Convention as a lease with an option to purchase may later be re-characterised as a hire-purchase agreement by the applicable domestic law. In this case, it is not clear whether such an interest would fall within the Convention's scope. It would be an undesirable outcome breeding uncertainty if a transaction characterised as falling within the Convention's scope at the first stage could later be excluded from its legal regime due to its subsequent re-characterisation by the applicable domestic law at the second stage of this exercise.

In support of the view expressed in the Commentary, it is potentially arguable that characterisation under the applicable law should have the effect of simply distinguishing between security interests and RoT agreements in the broad sense. If this is correct, then a hire purchase agreement with an option to purchase could be re-characterised under the applicable law as the title reservation agreement in the sense that the owner retains its title until the hirer pays the rentals and decides to exercise the option to purchase. This argument can probably be supported by the OC's remark relating to the definition of the lease that 'under Article 2(4) it is left to the applicable law to determine whether the agreement is to be characterised *as a security agreement or a title reservation agreement*'.[226] This view would correspond to the Convention's general distinction between the interests of a secured creditor and the conditional buyer and lessor as far as the remedies are concerned. Indeed, the Convention does not distinguish between the remedies of the conditional seller and lessor. Accordingly, it is irrelevant whether the applicable law views the transaction as a hire purchase, lease or conditional sale. Provided that it is a transaction involving the retention of title by the owner/lessor or the conditional seller, the holder of such an interest can exercise the Convention's remedies designed to suit the needs of the conditional seller and lessor.

[226] Goode (n 19) 257 (emphasis added).

The approach adopted in the Commentary is difficult to justify because it is not supported by the text of the Convention. Article 2(4) expressly provides that it is the applicable law that should determine whether an interest is a security interest, a title reservation or a lease. In addition, the fact that its drafters did not intend the Convention to be used for this purpose flows from Article 2(4) of the Draft Convention, which reads as follows: '[t]he Convention does not determine whether an interest to which paragraph 2 applies falls within sub-paragraph (a), (b) or (c)'.[227] This wording confirms that the definitions of the security, title retention and lease contained in Article 1 should not be used to decide whether a transaction falls into one of the categories of Article 2(2).

The intention of the CTC's drafters is also evident from the comments to the Draft Convention presented by the delegation from Japan:

> since the characterisation is always the first step to determine the applicability of relevant provisions, i.e. the remedies under the Convention, and thus, this paragraph seems to be so important to be argued and interpreted repeatedly by the relevant parties in future, the explicit provision [that it should be governed by the applicable law and not the Convention] is preferable to avoid future confusions and misunderstandings.[228]

Further, Article 1, defining the CTC's terms, provides that these definitions should only be used as long as the context of the Convention does not require otherwise. Therefore, it is clear that Article 2(4) should be given priority over the definitions of a security, title retention and lease provided in Article 1 for the characterisation of a transaction.

It is suggested that the transaction must be characterised by the applicable domestic law to ascertain whether it falls into one of the categories of Article 2(2). Once characterised by the applicable law, the meaning of the terms 'security interest', 'retention of title' and 'lease', whenever they appear in other provisions of the Convention, should be read in accordance with Article 1. This approach is different to the one adopted in the Commentary in that the Convention's definitions are not used for the initial characterisation of the creditor's interest. Instead, the interest is characterised by the applicable domestic law, as required by Article 2(4), to establish whether it is governed by the Convention. The proposed approach can also eliminate the possibility of the re-characterisation of the creditor's interest at a later stage and bring predictability to the creditor in relation to its remedies. Once the interest is characterised by the applicable domestic law, it is

[227] Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment: Diplomatic Conference to Adopt a Mobile Equipment Convention and an Aircraft Protocol—Acts and Proceedings. Draft [UNIDROIT] Convention on International Interests in Mobile Equipment, DCME Doc No 3, 6 April 2001.

[228] *Ibid* 186. DCME Doc No 32, 31 October 2001.

subjected to the legal regime of the Convention, including its defined terms. Consequently, in relation to other provisions of the Convention, such as the rules on priority and registration, the creditor's interest should be defined in accordance with Article 1.

For example, if the creditor's interest is characterised by the applicable domestic law as that of the conditional seller, it does not mean that such an interest need not be registered and should be granted super-priority simply because the creditor is considered as the owner of the object, even if this would be the consequence of its characterisation under the applicable law. The role of the applicable law ceases once the creditor's interest is characterised as that of the conditional seller. After that, it should be considered in accordance with the definitions in Article 1. Thus, the conditional seller will not be granted super-priority and will have to register its interest in the IR to secure its priority against subsequently registered and unregistered interests.

IV. THE LEGAL NATURE OF INTERNATIONAL INTERESTS: PROPRIETARY OR CONTRACTUAL?

Consider the following situation. A creditor is willing to make a loan to the debtor to manufacture a new satellite. To assure the creditor that the loan and the interest will be repaid, the debtor transfers the ownership in the satellite to the creditor by way of a security. The parties agree that once the debt is discharged, the ownership in the satellite will revert back to the debtor. The satellite will be operated at low Earth orbit and thus out of reach of any jurisdiction known to the creditor. Concerned about possible practical complications relating to taking possession or selling the satellite in the case of the debtor's default, the creditor wishes to support its security by some other means.[229]

To achieve this end, the directors of the debtor company provide the creditor with the personal guarantees whereby they undertake to repay the borrowed sums together with the interest, should the debtor default. Both arrangements are entered into to assure the creditor that the borrowed sums will be repaid. For this reason, some jurisdictions treat such arrangements as different types of security interests. For instance, the Russian Civil Code considers a personal guarantee as one of the means of securing performance of an obligation and treats it alongside other forms of security, such as a hypothec over movable and immovable property, a pledge, a right

[229] Unlike other Protocols, The Space Protocol covers not only interests in tangible space assets, but also rights assignments and rights reassignments which must be linked to the physical space assets. See D Panahy and R Mittal, 'The Prospective UNIDROIT Convention on International Interests in Mobile Equipment as Applied to Space Property' (1999) 4 *Unif L Rev* 303, 306. See also Goode (n 29) 164, 421–22.

of retention and others.[230] Other legal systems take the view that the legal nature of these two arrangements is so different that it is necessary to treat them almost as different institutions of the law.[231]

The arrangement between the creditor and the debtor provides the former with a *proprietary* interest in the property of the latter and is often referred to as a *real* security. By obtaining ownership in the satellite as a means of securing repayment of the debt, the creditor obtains an interest in the property itself. Because it is an interest in the object and not simply a right against a particular contracting party with respect to the object, the creditor will, in theory, be able to pursue the satellite into the hands of a third party, should the debtor sell it and dissipate the proceeds of sale.[232] By earmarking this particular satellite to the discharge of the debt, the creditor can also ensure that, in the case of the debtor's insolvency, it will be able to obtain repayment by means of realising its security in priority to the other creditors. The property encumbered by the creditor's real security will no longer be available for distribution among the insolvent debtor's unsecured creditors. Generally speaking, the creditor holding a real security in the debtor's object will be able to take this object out of the insolvent debtor's estate, sell it and use the proceeds towards the discharge of the unpaid debt.

In contrast, the arrangement between the creditor and the directors with respect to the personal guarantee confers no such powers on the creditor. Similar to the real security, a personal guarantee affords the creditor additional security in that it may rely on the directors for the repayment of the debt should the debtor default. However, a personal guarantee, whereby the guarantor undertakes to honour the obligation owed to the creditor by the debtor, is a mere contractual obligation and confers no proprietary interest in the property of the directors on the creditor. For this reason, such a security is often called a *personal* security as opposed to the *real* one.[233]

Assuming that the Convention applies and that the domestic law characterises both arrangements as security interests, can both of them amount to international interests? On the one hand, Article 2(4) provides that it is the applicable domestic law that should characterise agreements as a security, title retention or lease, which necessarily implies that the Convention has no role to play in this exercise. On this view, both agreements can be considered as international interests. On the other hand, the Convention's provisions demonstrate that it governs the international interests of a proprietary

[230] The Civil Code of the Russian Federation, Part One, 30 November 1994, N 51-ФЗ. See Chapter 23, in particular Art 329, Arts 361–367 of the Civil Code.

[231] Gullifer (n 9) 5.

[232] See R Goode, 'Ownership and Obligation in Commercial Transactions' (1987) *LQR* 433, 433–34.

[233] Ali (n 88) 176.

rather than personal nature.[234] It follows that although the Convention does not state so expressly, the proprietary nature of an interest is a necessary criterion to be met for it to fall within the Convention's scope.

Since the contractual and proprietary interests attract different legal consequences, the distinction between them is of considerable practical significance. Many legal systems recognise that a property interest implies exclusive dominion over the object which can be asserted against the whole world.[235] In contrast, a contractual obligation, or a personal right, merely reflects the rights and obligations of the contracting parties.[236] The universality of property interests can explain their major feature: in principle, property interests remain valid in the case of the debtor's insolvency.[237] This consequence flows from a widely recognised principle of insolvency law, according to which only those assets which belong to the insolvent company are available for the distribution among its creditors. If the creditor demonstrates that it has a property and not simply a personal right in an identifiable asset of the insolvent debtor, such property will no longer be considered as available for distribution among its other creditors. For this reason, the unpaid seller who has validly retained ownership of the goods can, in principle, take them back if the buyer is struck by insolvency. Since the unpaid seller has a property interest in the goods until it is paid the purchase price, such goods cannot be treated as the property of the insolvent debtor. Similarly, if the secured creditor holds a proprietary interest by way of a security in the insolvent debtor's object, it can, in principle, segregate this object from other assets of the debtor and obtain the repayment of the loan from the proceeds of sale. The liquidator or trustee in bankruptcy of the insolvent debtor will not be able to keep the holder of the property interest on the sidelines while it pays the debts owed by the insolvent debtor to its general creditors. This does not mean that the personal right is completely destroyed by the insolvency of the debtor. Rather, it is transformed into a right to prove for its monetary value along with other creditors of the insolvent debtor.[238] Since the value of the assets of the insolvent debtor is often considerably smaller than its liabilities, the holder of a personal right usually has only minuscule chances of obtaining the discharge. This feature of property interests on its own makes it clear why a creditor may be eager to establish that it has a property rather than a personal right over some identifiable assets of the insolvent debtor.

[234] Goode (n 19) 38.

[235] U Mattei, *Basic Principles of Property Law: A Comparative Legal and Economic Introduction* (Contributions in Legal Studies, N 93, Greenwood Press 2000) 78–79; M Bridge, *Personal Property Law*, 4th edn (Oxford, OUP: Clarendon Law Series 2015) 1–3.

[236] S Panesar, *General Principles of Property Law* (Pearson Education 2001) 219.

[237] Calnan (n 4) Chapter 2.

[238] McKendrick (n 2) 29.

The Convention does not explicitly define international interests as either personal or property interests. The representatives of the aviation industry, taking part in the drafting of the Convention and the Aircraft Protocol, insisted that its final text should reflect the vital principles of asset-based finance and leasing and ensure that the interest acquired by the holder of the international interest is of a proprietary nature.[239] Likewise, the Restricted Working Group (RWG), which consisted of representatives of financial institutions, industries and practicing lawyers, concluded that the international interest should denote a proprietary interest in the asset of the debtor. The RWG stated that as a proprietary interest, the international interest should afford its holder an opportunity to *follow* the asset into the hands of third parties and to obtain the discharge of the debt *prior* to other creditors of the debtor.[240]

Although the Convention does not explicitly refer to international interests as proprietary interests, its provisions allow one to conclude that the holder of the international interest acquires a property rather than simply a personal right in the object.[241] For example, Article 30 provides that in the insolvency proceedings against the debtor an international interest remains 'effective' if registered in the IR prior to the commencement of such proceedings. 'Effective' is said to reflect the proprietary nature of the international interest,[242] which means that, as a general rule, registered international interests will rank ahead of the claims of the junior secured and unsecured creditors of the insolvent debtor.[243]

A proprietary international interest will not only be effective during the insolvency proceedings, but is also likely to survive the debtor's insolvency. Although no cases decided under the Convention have yet been reported to support this point, one English case may prove to be useful in this regard.[244] In this case, Hugh Lind, in return for a loan, mortgaged the possibility of becoming possessed in the future of a share of his mother's personal estate first to the Norwich Union Life Insurance Society and three years later to another lender—HL Arnold. In the same year he was adjudicated bankrupt and obtained his discharge. Neither Norwich Union nor Arnold tried to enforce their security at that time. Six years later, Mr Lind's mother died and he became entitled to a share in her estate. He assigned this share to the plaintiffs.

[239] J Wool, 'The Case for a Commercial Orientation to the Proposed UNIDROIT Convention as Applied to Aircraft Equipment' (1999) 4 *Unif L Rev* 289, 291.

[240] Davies (n 185) 159–60.

[241] See Goode (n 19) 38, stating that proprietary nature of international interests is reinforced by the Convention's choice of words that the security interest is 'granted' by the chargor to the chargee and that the interest of a conditional seller and lessor is 'vested' in it.

[242] Goode (n 19) 343.

[243] Panahy and Mittal (n 228) 311.

[244] *In Re Lind, Industrial Finance Syndicate, Limited v Lind* [1915] 2 Ch 345.

The plaintiffs argued that the security interests of the first two lenders were of no value. This was based on the bankruptcy and the discharge of the debtor and that after the discharge the debtor was entitled to a 'fresh start' free from the old contractual obligations.[245] The court's reasoning turned on the question whether assurances of Mr Lind to the prior creditors rested in the contract, or whether they amounted to a real security in the potential share of Mr Lind and became enforceable once such property came into existence. It was held that because the assurances given to Norwich Union and Arnold were security interests and conferred on the secured creditors a proprietary and not merely a personal right in the share of Mr Lind, these security interests survived his bankruptcy and had to be ranked ahead of the plaintiff's interest. By analogy with this case, if the holder of a registered international interest fails to enforce its security at the start of the debtor's insolvency proceedings, its security should not simply disappear. Since the security interest is of proprietary nature and 'effective' in insolvency, it is likely to survive the debtor's insolvency and rank ahead of the junior secured and unsecured creditors of the debtor.

Article 29 CTC serves as another indicator of the proprietary nature of the international interests. Article 29(1) provides that 'a registered interest has priority over any other interest subsequently registered and over an unregistered interest'.[246] The privileged treatment of the prior registered international interest can be explained by its proprietary nature. Once the debtor transfers its proprietary interest in the object to the secured creditor, who registers its interest, it becomes the holder of such a proprietary interest.[247] As the holder of the registered property interest in the object, the secured creditor is entitled to take this object in priority to the holders of the subsequently registered and unregistered interests.[248]

The priority enjoyed by the secured creditor over the unsecured creditors or the liquidator of the insolvent debtor is evident from many cases decided under English law.[249] In one case, a company obtained a loan from

[245] *Ibid* 357.

[246] Priority, along with effects in insolvency and ability to pursue the asset into the hands of a third party are often said to be common incidents of property rights. These incidents are frequently considered to be integral to security interests *because* of its proprietary nature. Presumably, if one can find all three incidents in an interest (such as international interest under the Convention), its legal nature must necessarily be proprietary.

[247] L Ponoroff and F Knippenberg, 'Having One's Property and Eating it Too: When the Article 9 Security Interest Becomes a Nuisance' (2006) 82 *Notre Dame L Rev* 373, 393–95.

[248] *Ibid* 393–95.

[249] Priority enjoyed by the secured creditor is often subjected to the restrictions imposed by the law in various jurisdictions for policy reasons (eg to protect vulnerable unsecured creditors). For instance, under English law, failure to register a registrable charge within 21 days of its creation will invalidate it in the case of the debtor's liquidation which may have effect on the order of priority among the debtor's other creditors. See Companies Act 2006, s 861(3); Gullifer (n 9) 108, 191–92.

the plaintiffs in exchange for a security in 'all the stock, plant, chattels, and effects which may from time to time be held by the company'.[250] Before the principal money became due or the interest had fallen into arrears, the debtor went into liquidation. The liquidators of the insolvent company took possession of all its property and were about to apply it for the benefit of its ordinary creditors. In the dispute between the secured creditors (the plaintiffs) and the liquidators of the insolvent company, the court gave priority to the secured creditors even though the time for the repayment of the debt had not yet arrived. It was held that once the company had become insolvent, security had become immediately enforceable and the secured creditor should not be kept on the sidelines while unsecured creditors obtained their discharge out of the property encumbered by security.

The priority flowing from the proprietary nature of the interest held by the secured creditor was also evident in another case, where the insolvent company owed money both to unsecured and secured creditors.[251] One of the unsecured creditors obtained judgment against the insolvent company. Instead of approaching the insolvent company for the repayment of the debt, the unsecured creditor served a garnishee order nisi on the debtor of the insolvent company. In accordance with the garnishee order nisi, the debtor was required to pay its debt to the unsecured creditor instead of its original creditor. The secured creditor argued that the debt belonged to the insolvent company and was for this reason encumbered by security. It was held that the garnishee order nisi did not transfer the ownership in the debt from the insolvent company to the unsecured creditor. The debt remained encumbered by the security and the secured creditor was able to obtain the discharge out of this money prior to the unsecured creditor. The proprietary nature of the security and the privileged treatment which it affords to a secured creditor allowed it to extend its hands to such property of the insolvent debtor which had not yet even reached its intended recipient!

Finally, another case demonstrates just how strong a privileged position of the secured creditor can be.[252] In this case, a company obtained a secured loan and duly paid all interest to the secured creditor. The principal sum had not yet become payable and the debtor was not in breach of contract between itself and the secured creditor. At this stage, another creditor of the debtor obtained a judgment against it, ordering the debtor to repay sums due to this creditor. The secured creditor appointed a receiver, with the result that the debtor was unable to deal with its property and pay to the judgment creditor. The court held that since the secured creditor was the

[250] *Hodson v Tea Company* (1880) 14 Ch D 859. See also *Wallace v Universal Automatic Machines Company* [1894] 2 Ch 547; *In Re Crompton & Co Ltd* [1914] 1 Ch 954 for similar results.

[251] *Norton v Yates* [1906] 1 KB 112.

[252] *Campbell v London Pressed Hinge Company, Limited* [1905] 1 Ch D 576.

holder of a proprietary interest in the property of the debtor, it could enforce the security on the ground that such security was in jeopardy. Although Buckley J felt that the outcome of the case was possibly unjust with respect to the judgment creditor, he stated that 'the creditor never had any right as between himself and the debenture-holder [secured creditor] to enforce payment in priority to the debenture-holder'.[253]

Finally, Article 29(6) CTC is also indicative of the proprietary nature of the international interests. According to this provision, 'any priority given by this Article to an interest in an object extends to proceeds'. The ability to follow the object or trace its proceeds in the case of an unauthorised disposition is often considered as another incident of a property interest held in such an object. As a general rule, the owner (or the holder of a lesser proprietary right) is entitled to take its property back from a third party.[254] Article 1(w), however, defines 'proceeds' restrictively, limiting them to monetary or non-monetary proceeds resulting from total or partial loss of the object (such as insurance payments) or total or partial confiscation, condemnation or requisition. For instance, if a debtor sells a train wagon, encumbered by a security, to a third party and retains the proceeds of sale in its bank account, a secured creditor who has a registered international interest in the wagon will not be able to pursue the collateral into the proceeds of sale. If the secured creditor were able to do so, it would broaden the Convention's scope beyond the categories of objects listed in Article 2(3).[255] In contrast, if the charged object is insured against a loss and is later destroyed by collision with another object, the secured creditor's interest in the collateral will extend to the insurance proceeds.[256]

[253] *Ibid* 582, *per* Buckley J.

[254] This general rule may be subjected to exceptions allowing a third party to override the title of the initial owner. See Ali (n 88) 30; A Oakley, 'Proprietary Claims and Their Priority in Insolvency' [1995] *CLJ* 377, 378–81; J Beatson and N Andrews, 'Common Law Tracing: Springboard or Swan Song?' (1997) 113 *LQR* 21.

[255] Another reason why 'proceeds' are narrowly defined by the Convention is to avoid it from covering issues which are already governed by the UN Convention on the Assignment of Receivables in International Trade 2001. See Goode (n 19) 100–01.

[256] *Ibid* 100–01.