

Global Transportation Finance Newsletter

Transferring a Right to Discharge on the International Registry: What You Should Know

One of the significant features of the Cape Town Convention¹ was the creation of an international registry whereby all security interests, leases and similar interests relating to aircraft equipment would be registered and, subject to certain exceptions, accorded priority based on the order of registration. Due to the life expectancy of aircraft objects, and the fact that these aircraft objects often change hands (in some cases several times) and may be subject to financings and subsequent refinancings, it is essential to ensure that registered interests are discharged once they cease to be effective.²

Discharge of an international interest is made solely by the lessor, in the case of a lease, or a secured party, in the case of the security agreement. Failure to properly discharge an interest could create issues in connection with the subsequent sale or financing of the related object as the financier or purchaser would be uncertain as to whether such object was truly free of all competing interests. Until recently, the ability to discharge interests was complicated and it was difficult (particularly in leveraged structures) to be sure the party who controlled the exercise of rights and remedies also possessed the right to discharge all related interests which were reflected at the International Registry. The Regulations

and Procedures for the International Registry (as established under the Cape Town Convention) (the “**Revised Regulations**”) were implemented in the Fall of 2010. Among other changes, the Revised Regulations include updated rules and procedures that govern the transfer of rights to discharge international interests.³ As part of the implementation of the Revised Regulations, the operator of the International Registry, Aviareto,⁴ simultaneously implemented a software change to the International Registry that enables a right to discharge registrant to transfer such right to another transacting user entity.

The International Registry before the Revised Regulations

Prior to the implementation of the Revised Regulations, if an international interest was assigned to a third party, the right to discharge the underlying international interest remained with the assignor and could not be transferred. This inflexible mechanic posed various problems.

³ See Regulations and Procedures for the International Registry, Doc. 9864, International Civil Aviation Organization (4th ed. 2010).

⁴ Aviareto, a joint venture between SITA SC and the Irish Government, has a contract with the International Civil Aviation Authority (the supervisory authority of the International Registry) to establish and operate the International Registry as required by the Cape Town Convention. Aviareto operates the International Registry on a not-for-profit, cost recovery basis, as required by the Cape Town Convention. See <http://www.aviareto.aero/>.

¹ The Convention on International Interests in Mobile Equipment, together with the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, both of which concluded in Cape Town, South Africa, on November 16, 2001.

² A search of the International Registry would highlight all interests which have been registered against an aircraft object, even those that have subsequently been discharged (the discharge itself would be noted on the applicable priority search certificate) and as such a subsequent financier or purchaser would be able to see all registered interests in respect of such object. Contracts of sale (effectively sales of objects) are not subject to discharge.

In this issue...

Transferring a Right to Discharge on the International Registry: What You Should Know 1

Choice of Law After England’s *Blue Sky One* Case 3

D.C. Circuit Limits the DOT’s Authority to Regulate Air Charter Brokers 4

Consider the following example:

Lessor leases an airframe to Lessee and an international interest is registered in respect of such lease. Lessor thereafter grants a security interest in such airframe to Secured Party, and such interest is registered along with an assignment of the associated rights comprised of the lease.

Prior to the Revised Regulations, the Secured Party would be permitted to discharge the assignment of the international interest, but the Lessor would remain the only party authorized to discharge the underlying international interest relating to the lease. This could result in the Secured Party being unable to discharge the interest in respect of the lease without enlisting the assistance of the Lessor (and given the scenario described, such assistance may not be forthcoming). If Secured Party were to successfully repossess the airframe, foreclose on its lien and terminate the lease, the public record at the International Registry would nonetheless still reflect an undischarged interest (in respect of the lease) and the Secured Party would be unable to effect such a discharge.⁵

The International Registry after the Revised Regulations

The Revised Regulations solve the issues illustrated in the previous section by allowing a right to discharge to be transferred from one transacting user entity to another.⁶ Once a right to discharge has been transferred, a notation will be made on the aircraft object's priority search certificate below the interest that is the subject of such transfer. The notation will reflect the date and time the right to discharge transfer was completed, the name of the transferring party and the name of the transferee.

⁵ The Secured Party in this scenario could, however, seek to obtain an order of a court having jurisdiction under the Cape Town Convention requiring the Lessor to effect the discharge. If the Lessor fails to comply with such order, the Secured Party could seek an order of the court of the place in which the Registrar has its centre of administration (currently Ireland) which shall direct the Registrar to take such steps as will give effect to that order. In cases where the Lessor no longer exists or cannot be located for purposes of obtaining an order, the court of the place in which the Registrar has its centre of administration has exclusive jurisdiction to make an order directing the Registrar to discharge the registration. See Article 44 of the Convention on International Interests in Mobile Equipment.

⁶ It should be noted that an assignment of an international interest alone will not, by itself, cause a related assignment of the right to discharge such interest. This allows the parties flexibility to decide who should have the right to discharge.

The transfer can be initiated by the holder of the right to discharge (i.e., the transferring party) or the party requesting the assignment of the right to discharge (i.e., the transferee). In either case, the non-initiating party must consent to the request to transfer the right to discharge within 36 hours of the request, otherwise, the pending transfer will drop off the International Registry and the transfer will need to be reinitiated.

Parties also should keep in mind that a right to discharge transfer may be part of a "registration session" at no additional cost, or it may be performed independently at a later time for a fee of U.S. \$100 per transfer.⁷

Practical Impact

Parties should be mindful that an assignment of an international interest does not automatically transfer the right to discharge the underlying international interest. In addition to international interest and assignment registrations that may be contemplated by a transaction, parties should also be conscious of the transfer of the associated right to discharge. Failure to properly address control over the right to discharge could, in certain scenarios, give rise to situations where undischarged interests remain of record as "clouds" on unencumbered ownership of the underlying aircraft object.

In transactions in which registrations were made prior to the Revised Regulations, parties are also well advised to revisit such registrations to determine whether transfers of the pertinent right to discharge are necessary, and, if so, parties should coordinate to ensure such transfers are promptly completed.

If you have any questions about this article, please contact **Dean N. Gerber** (312-609-7638), or **Jeffrey P. Novota** (312-609-7757).

⁷ International Civil Aviation Organization, *supra* note 3, Appendix, Section 1. The initiator of the transfer is responsible for this additional fee. Further details regarding fees and the right to discharge transfer process can be found on Aviareto's frequently asked questions section of their website by clicking this link.

Choice of Law After England's *Blue Sky One* Case

England's *Blue Sky One* case presents perplexing problems for bankers, aircraft operating lessors, airlines and their lawyers.¹ This note discusses the fallout from *Blue Sky One*, and explains how parties can address these problems in their affected aircraft financing deals.

The Problem

Following the *Blue Sky One* case, there is an issue as to whether an English law mortgage creates a valid security interest in an aircraft in certain situations. A valid security interest is created under English law without additional requirements only when an aircraft is located in England at the time of closing or where the location of an aircraft is unknown.²

In all other situations there are now complicated legal and practical risks to address before parties can be comfortable that an English law mortgage is effective. In summary, the requirements are as follows:

- If an aircraft is outside England at closing, an English mortgage must be valid under the law of the jurisdiction where the aircraft is located in order to be effective.
- If an aircraft is over international waters at closing, best practice is to ensure the mortgage is valid under the law of the jurisdiction where the aircraft is registered to ensure the mortgage is effective.³

These new requirements have cost, risk and timing implications for transactions using an English law mortgage. A best case scenario resolution addressing the new requirements is that local counsel in the jurisdiction where an aircraft is located or registered will

be able to give a clean opinion confirming that the English law mortgage is valid under local law. At worst, local counsel will give an opinion containing assumptions or exclusions that push the risk of a mortgage being invalid back to the parties, or will not be able to give an opinion at all – potentially because the English law mortgage will not, in fact, be effective under local law (as was the case in *Blue Sky One*).

Whichever scenario applies, *Blue Sky One* means that using English law will now result in higher legal costs and potential timing and closing risk. Consequently, lenders, lessors and airlines should question their counsel carefully to understand new risks that may exist, even where a local law opinion has been provided.

The Solutions

The issues with *Blue Sky One* can be side-stepped by having an aircraft mortgage governed by laws other than English law. New York law is an alternative to consider, with a developed body of case law, and courts and a legislature that openly induce commercial contracts to designate New York law.

A choice of New York law in a commercial case will receive nearly absolute respect in New York courts. Section 5-1401 of New York's General Obligations Law provides that:

"The parties to any contract, agreement or undertaking...covering in the aggregate not less than two hundred and fifty thousand dollars... may agree that the law of this state shall govern their rights and duties in whole or in part, whether or not such contract, agreement or undertaking bears a reasonable relation to this state."

The general rule in Section 5-1401 leaves little scope for the type of uncertainty created by *Blue Sky One*. If an aircraft is worth more than \$250,000, a mortgage under New York law will validly create a security interest in it regardless of aircraft location.⁴

A second solution is to rely solely on a mortgage governed by the law of the jurisdiction where the aircraft

¹ *Blue Sky One Limited & O'rs v. Mahan Air & Ano'r* [2010] EWHC 631 (Comm). Here it was held that the validity of an English law mortgage of an aircraft is to be determined by the *lex situs*, the law of the place where the aircraft is situated, at closing. The facts of this case amply demonstrate the importance of the holding. The debtor granted an English law mortgage over several aircraft. One of the aircraft was located in The Netherlands at the time the mortgage was granted. The court found that the mortgage was not effective under Dutch law and consequently the lender was not entitled to enforce its claim against the aircraft.

² This may never be the case in the age of smart phones and free flight tracking apps.

³ Following *Blue Sky One* it is not clear whether English law or the law of the jurisdiction of registration applies, so best practice is to confirm that the mortgage is valid under the law of the jurisdiction of registration.

⁴ New York is not alone in addressing the potential problem by statute. New York's chief domestic jurisdictional competitor, Delaware, introduced Delaware UCC Article 9-111 which provides expressly on-point "If a security agreement is governed by the Laws of the State of Delaware, then those Laws shall govern, among other things... [t]he creation, attachment, validity and enforcement of the security interest."

is located or registered at closing.⁵ This will be less desirable if local rules on enforcement are not as familiar or as effective as the laws of a “moneycenter” jurisdiction like New York. Taking only a local mortgage may also necessitate local counsel and local courts becoming more involved in the enforcement process, potentially reducing certainty and increasing enforcement risk for lenders.

It is worth noting that, if the debtor is located in a country that has adopted the Cape Town Convention, then the parties arguably have a broader choice for the mortgage’s governing law. The Cape Town Convention provides that, so long as the relevant contracting state has made the election under Article XXX(1), the transaction parties are free to choose the governing law of their agreements.⁶ In this case, a New York law mortgage still would be a sensible choice, as this would give the parties the choice of law protections afforded by both The Cape Town Convention and New York law.

Conclusion

Following *Blue Sky One*, lenders taking English law mortgages over aircraft that are not located in England at closing must take additional steps to ensure that they have an effective security interest including confirming that the English law mortgage is valid under the law of the jurisdiction of the location of the aircraft or considering a New York law governed mortgage.

If you have any questions about this article, please contact **Cameron A. Gee** (212-407-6929).

D.C. Circuit Limits the DOT’s Authority to Regulate Air Charter Brokers

On April 1, 2011, the U.S. Court of Appeals for the D.C. Circuit issued an opinion in *CSI Aviation Services, Inc. v. U.S. Department of Transportation*,¹ in which it found that the Department of Transportation (DOT) violated the Administrative Procedure Act (APA) when the DOT failed to justify its authority to issue a cease-and-desist letter to CSI ordering CSI to terminate its business contractual relationships with various federal agencies.²

The CSI case is significant on many levels. First, the case is the first successful challenge of the scope of DOT’s consumer protection regulatory authority and it established the first precedent limiting DOT’s broad interpretation of what constitutes “common carrier” in the context of the definition of “air transportation”. Second, the case involved an inter-agency dispute involving the General Services Administration (GSA), which strongly disagreed with DOT’s position on having the authority to regulate CSI’s ability to enter into government contracts with various federal agencies. Finally, the case is significant because the court held that the DOT does not possess the authority to interfere with business relationships between the federal government and air charter brokers unless and until the DOT provides a reasonable explanation for its actions.

Background

Since 2003, CSI has been under contract with the GSA to broker air charter service for various federal agencies. On March 10, 2009, CSI won a competitive bid to renew its status as a GSA contractor through 2014. A few days prior, on March 6, the DOT sent CSI a letter requesting information to determine whether the company was engaging in “indirect air transportation” without the certificate of authority required by the Federal Aviation Act (FAvA). After the company provided the requested information, the DOT sent another letter, stating that based on the information CSI provided, CSI was acting as an unauthorized indirect air carrier in violation of the FAvA with respect to business transacted via its GSA schedule listing. The DOT also stressed that violations of the FAvA constitute unfair and deceptive practices and unfair methods of competition in violation of 49 U.S.C. § 41712.

⁵ The law of the country of registration is applicable only if the aircraft’s location cannot be determined, most likely because the aircraft is over international waters.

⁶ See Article VIII of the Protocol. In fact, in certain English law transactions the parties currently are using Irish law mortgages, although it is unclear why Irish law would be preferable to New York law.

¹ No. 09-1307 (D.C. Cir. April 1, 2011).

² Vedder Price acted as CSI’s counsel in this case.

Six other companies received similar letters. All six complied by terminating their status as contractors for GSA. Convinced that the DOT was exceeding its statutory authority, CSI alone chose to challenge DOT's determination, asking the DOT to withdraw the cease-and-desist letter on the grounds that the Act requires a certificate of authority only for companies that operate "as a common carrier,"³ and that CSI's charter flights for the federal government are not common carriage.⁴

On November 25, 2009, seeking to avoid shutting down its business, CSI submitted a petition to DOT for an emergency exemption from the certification requirement. GSA supported CSI's petition and in a letter to the DOT GSA explained at length why the Act's certification requirements for common carriage should not apply to government contracts. "Acquisition [of air service] by the Federal Government . . . is distinct in several ways from acquisition in the private sector and does not present the consumer protection related concerns typically at issue in the private sector."⁵ GSA also added that Federal agencies which purchase air charter broker services are protected from unscrupulous contractors in a number of ways.⁶ Although DOT granted CSI a temporary exemption, it indicated that it "remain[ed] of the view that . . . the provision of air services for U.S. Government agencies through the GSA contracting system constitutes an engagement in air transportation, necessitating that brokers conducting such business hold economic authority from the Department to act as indirect air carriers."⁷

The Court's Decision

The primary issue in the case was whether DOT properly concluded that air charter brokers that operate under GSA contract engage in indirect air transportation and therefore require certification from DOT despite the statutory provision that requires certification only for those who provide air transportation "as a common carrier."

Initially, DOT argued that its letter was not a "final order" and that the court did not have jurisdiction. The court, however, rejected the DOT's position and held that the letter was indeed an order because (1) it marked the consummation of the agency's decision making process; (2) it was not merely of a tentative or interlocutory nature;

and (3) the order was an action in which "rights or obligations have been determined" or "from which legal consequences will flow."⁸ The court noted that CSI was faced with a choice between costly compliance and the risk of prosecution. The court also stressed that "an agency may not avoid judicial review merely by choosing the form of a letter to express its definitive position on a general question of statutory interpretation."⁹

The court stressed that "at the very least, the DOT's letter cast a cloud of uncertainty over the viability of CSI's ongoing business. It also put the company to the painful choice between costly compliance and the risk of prosecution at an uncertain point in the future—a conundrum that we described in *Ciba-Geigy* as "the very dilemma [the Supreme Court has found] sufficient to warrant judicial review."¹⁰ The court reasoned that the DOT's action was sufficiently burdensome to make six other GSA contractors terminate their air charter operations for fear of prosecution. The court stressed that "having thus flexed its regulatory muscle, DOT cannot now evade judicial review."¹¹

Next, the court explained why the DOT's actions violate the Administrative Procedure Act. Specifically, the court explained that the fundamental question in reviewing an agency action is whether the agency has acted reasonably and within its statutory authority. The agency must not only adopt a permissible reading of the authorizing statute, but must also avoid acting arbitrarily or capriciously in implementing its interpretation,¹² which requires the agency to "take whatever steps it needs to provide an explanation that will enable the court to evaluate the agency's rationale at the time of decision."¹³ In the CSI case, the DOT simply failed to explain why the Federal Aviation Act requires a certificate of authority for air charter brokers operating under GSA contract.

The court focused on the definition of air transportation under the Federal Aviation Act and stressed that the Act states that "an air carrier may provide air transportation only if the air carrier holds a certificate issued under this chapter [...]. The term "air carrier" means "a citizen of the United States undertaking by any means, directly or indirectly, to provide air transportation."¹⁴ The DOT's

³ 49 U.S.C. § 40102(a)(25).

⁴ *CSI Aviation Services, Inc.*, No. 09-1307, slip op. at 3.

⁵ *Id.* at 4.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.* at 5.

⁹ *Id.* at 6 (citing *Ciba-Geigy Corp. v. EPA*, 801 F.2d 430, 438 n.9 (D.C. Cir. 1986)).

¹⁰ *Id.* at 8 (citing *Ciba-Geigy*, 801 F.2d at 439).

¹¹ *Id.* at 8.

¹² See 5 U.S.C. § 706(2).

¹³ *Id.* at 11-12.

¹⁴ *Id.* at 12 (citing 49 U.S.C. § 41101(a)).

position was that, as a broker of charter flights for the federal government, CSI was engaged in the indirect provision of “air transportation.” But the DOT’s reading failed to engage with the special statutory definition of that term. Under section 40102(a)(5), “‘air transportation’ is defined to include ‘interstate air transportation,’ which in turn means the interstate ‘transportation of passengers or property by aircraft as a common carrier for compensation,’ *id.* § 40102(a)(25) (emphasis added).”¹⁵ “Common carrier” refers to a commercial transportation enterprise that “holds itself out to the public” and is willing to take all comers who are willing to pay the fare, “without refusal.”¹⁶ Some type of holding out to the public is the essential requirement of the act of “provid[ing]” “transportation of passengers or property by aircraft as a common carrier.”¹⁷

The court relied heavily on the fact that CSI performs under its contract with the GSA as a dedicated service provider, not as a common carrier. Under the GSA contract, CSI provides charter service to government agencies only, not to all comers. Thus, within the scope of the contract, CSI does not appear to provide “transportation of passengers or property by aircraft as a common carrier.”¹⁸ If CSI is not a common carrier under its GSA contract, then it does not engage in “air transportation” and its services for GSA do not fall within the certification requirement of the Federal Aviation Act.

The court chastised DOT for failing to address this critical issue both in its cease-and-desist order and in its brief to this court. “This failure is all the more baffling because CSI twice informed DOT that it does not believe it is covered by the “air transportation” portion of the Federal Aviation Act—once in CSI’s letter to DOT dated November 19, 2009, and again in CSI’s brief before this court.”¹⁹ Yet DOT’s brief inexplicably claims, ‘It is undisputed that CSI’s service is indirect air transportation.’²⁰ The court emphasized that “not only is this a disputed point, it is at the very heart of the present controversy.”²¹

In conclusion, the court stressed that “given DOT’s complete failure to explain its reading of the statute, we find it impossible to conclude that the agency’s cease-and-desist order was anything other than arbitrary and

capricious, and hence unlawful. It appears to us that the law cannot support DOT’s interpretation, but we leave open the possibility that the government may reasonably conclude otherwise in the future, after demonstrating a more adequate understanding of the statute.”²²

Impact of the CSI Decision

The immediate impact of the CSI decision is that CSI, along with other air charter brokers, will be able to continue to enter into contracts to arrange air transportation as a principal without the fear of a potential DOT enforcement action. Air charter brokers will continue to perform a valuable service for the federal government. The federal government spends several million dollars annually procuring air transportation services and the use of brokers enables the federal government to obtain the best possible prices and options for air transportation services from FAvA and DOT certificated air carriers. For example, most of the nation’s Immigration and Customs Enforcement deportations and federal interstate prisoner movements are arranged by air charter brokers.

CSI’s position throughout the entire dispute was that DOT’s consumer protection regulations simply don’t apply because the federal government is not the “public,” and the court agreed. Indeed, the protections afforded the federal government under the Federal Acquisition Regulations are much more effective than DOT consumer protection regulations. Unscrupulous contractors may be prosecuted by the U.S. Department of Justice under a wide variety of civil and criminal fraud statutes.

If you have any questions about this article, please contact **David M. Hernandez** (202-312-3340).

¹⁵ *Id.* at 12.

¹⁶ *Id.*

¹⁷ *Id.* at 13 (citing 49 U.S.C. § 40102(a)(25), 41101).

¹⁸ *Id.* (citing § 40102(a)(25)).

¹⁹ *Id.* at 14.

²⁰ *Id.*

²¹ By David Hernandez

²² *Id.*

VEDDER PRICE[®]

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
312-609-7500 | 312-609-5005 • FAX

1633 BROADWAY, 47th FLOOR
NEW YORK, NEW YORK 10019
212-407-7700 | 212-407-7799 • FAX

1401 I STREET NW, SUITE 1100
WASHINGTON, D.C. 20005
202-312-3320 | 202-312-3322 • FAX

www.vedderprice.com

Global Transportation Finance Team

The attorneys in the firm's Global Transportation Finance team represent lessees, lessors, financiers, equity investors and related parties, both domestic and international, in a broad range of equipment finance transactions, including those involving aircraft, railcars, locomotives, vessels, computers, medical equipment, industrial production equipment, satellites, cars and trucks.

About Vedder Price

Vedder Price P.C. is a national business-oriented law firm with offices in Chicago, New York and Washington, D.C. The firm combines broad, diversified legal experience with particular strengths in commercial finance, corporate and business law, financial institutions, labor and employment law, occupational safety and health, general litigation, environmental law, securities, investment management, tax, real estate, intellectual property, estate planning and administration, health care, trade and professional associations and not-for-profit organizations.

Global Transportation Finance Newsletter is published periodically by the law firm of Vedder Price P.C. It is intended to keep our clients and interested parties generally informed about developments in the Equipment Finance industry. It is not a substitute for professional advice. For purposes of the New York State Bar Rules, this Newsletter may be considered ATTORNEY ADVERTISING. Prior results do not guarantee a similar outcome.

© 2011 Vedder Price P.C. Reproduction of materials in the Newsletter is permissible with credit to Vedder Price. For additional copies, an electronic copy of this Newsletter or address changes, please contact us at info@vedderprice.com.

We welcome your suggestions and comments. Please contact Dean N. Gerber in Chicago at 312-609-7638, Ronald Scheinberg in New York at 212-407-7730 or Edward K. Gross in Washington, D.C. at 202-312-3330.