

Regulation Impact Statement

‘Implementation of the Cape Town Convention’

1. Problem

- 1.1 International financiers (creditors) of mobile equipment such as aircraft objects are currently subject to a fractured international legal framework for the protection of their security interests. As aircraft objects frequently move across borders, the rights of and protection available to creditors may be subject to a variety of (including foreign) laws at any given time, which is inherently risky. Where a debtor defaults on their loan or lease, creditors will likely have to undertake an exhaustive legal process to repossess their property, possibly involving a number of different jurisdictions. For this reason, creditors charge a premium for lending to protect themselves against the substantial risks and uncertainty involved.

Creditor security

- 1.2 For financiers, the collapse of Ansett in 2001 demonstrated that Australia’s existing insolvency measures for personal property securities may benefit from the implementation of a more rigorous and uniform securities framework. As a result of this event, international financiers have indicated a lack of confidence in the current system, suggesting it could be more efficient and expeditious.
- 1.3 The mobile and highly depreciative nature of commercial aircraft objects emphasizes the importance of ensuring such assets can be quickly repossessed upon insolvency. The greater the amount of time between debtor default and repossession, the greater the risk exposure of the creditor, which leads to higher costs for airlines (to balance these risks).

Aircraft object financing

- 1.4 The global financial crisis has placed participants in Australia’s aviation industry under significant pressure to find cost savings wherever possible and to reassess their approach to financing the purchase of aircraft objects. This has led Australian-based airlines to increasingly look to international finance as a source of credit.
- 1.5 The need to access alternative funding sources has come at a critical time for the industry. The global aviation sector is predicted to grow significantly over the next 20 years, and demand for new, environmentally friendly airframes is estimated to increase significantly. To allow Australian industry to keep up with this expected growth, Australia needs to ensure its financial infrastructure is consistent with global standards as well as provide Australian airlines access to more sources of finance than currently available. Without these measures, Australia risks losing its competitive edge in the global aviation market as providers of air services.

Cape Town Convention

- 1.6 The *Convention on International Interests in Mobile Equipment* (the Convention) and the *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment* (the Protocol) were established in November 2001 under the auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organization (ICAO). Australia participated in the development of these two instruments (collectively known as the ‘Cape Town Convention’) but did not sign the treaty.
- 1.7 The Convention creates a uniform international legal framework to protect investors in aircraft objects. It provides an International Register for creditors to register their security interests (similar to the land titles system for real property), and creates a set of basic remedies in the event of debtor default. The Protocol complements the Convention and adapts its provisions to meet the particular requirements of financing mobile equipment such as aircraft. For example, it provides additional remedies for creditors, such as the ability to request the deregistration and export of an aircraft object from the national civil aircraft register. These measures increase the security of creditors and reduce their risks, which may lead to cheaper and more accessible financing of aircraft objects for those countries that are party to the Cape Town Convention.
- 1.8 On its own, the Convention will have no impact on Australian business generally. This is because the Convention can only come into effect in relation to a category of objects to which a Protocol applies (aircraft objects in this instance). It follows that the Convention will only apply in accordance with the terms of that Protocol.
- 1.9 The Cape Town Convention entered into force on 1 March 2006. As at 20 December 2010, 34 States and one Regional Organisation (the European Union) had become party to it. Parties to the Convention include the United States, New Zealand, China and Singapore.
- 1.10 In 2007 the Organisation for Economic Co-operation and Development (OECD) developed a new ‘Sector Understanding on Export Credits for Civil Aircraft’ (ASU), to which Australia is a participant. The ASU provides a common framework under which Export Credit Agencies (ECAs) of the EU, the US, Japan, Brazil and Canada can provide export credit finance for the purchase of airframes and engines. It offers a fee discount for airlines from countries that have ratified the Cape Town Convention and have made specified ‘qualifying declarations’ as part of this process.¹
- 1.11 The Convention is expected to complement and go beyond the recently introduced *Personal Property Securities Act 2009* (PPS Act) to protect creditors of aircraft objects.

¹ The ASU is updated periodically and was last updated in 2011.

Main features of the Convention

i. International Framework

- 1.12 Article 7 of the Convention establishes a comprehensive international securities framework by creating an international interest in aircraft objects. This interest is registered on an International Registry and will be prioritised based on a ‘first-to-file’ priority rule. The Registry, based in Ireland, is currently in operation and can be searched by anyone for a small fee.
- 1.13 Article 42 of the Convention allows Contracting States to negotiate which court will have jurisdiction in relation to claims brought under the Convention.

ii. Application

- 1.14 The Cape Town Convention applies to transactions involving an aircraft object where the following three requirements are met:
- a) where the aircraft object meets specified size/power requirements;
 - b) where an ‘international interest’ or prospective international interest is created by the transaction; and
 - c) when the transaction is concluded, the aircraft object is registered in or the debtor is located in a Contracting State.
- 1.15 Article I of the Protocol specifies minimum aircraft object size/power requirements. The Cape Town Convention will apply to:
- a) Airframes that can transport –
 - at least 8 person (including crew); or
 - goods in excess of 2750kgs;
 - b) Helicopters that can transport –
 - at least 5 persons (including crew); or
 - goods in excess of 450 kilograms;
 - c) Aircraft engines that have at least 1750lb of thrust.
- 1.16 Under Article VIII of the Protocol, parties to the Cape Town Convention may agree as to which laws will govern their contractual rights in the event of debtor default. For interim remedies including possession, control and immobilisation, Article 43 of the Convention determines that both the court chosen by the parties and the courts of the Contracting State where the aircraft object is located may make orders in relation to the aircraft object. With regard to the lease and management of the aircraft object, including related income (as an interim remedy), jurisdiction will lie either with the courts agreed by the parties or by the courts of the Contracting State where the debtor is situated.

iii. Qualifying declarations

- 1.17 Annex 1 of the ASU specifies the qualifying declarations Australia must make when acceding to the Convention. Making the correct declarations is critical in order for Australian airlines to qualify for a fee discount from international ECAs in accordance with the ASU. The relevant declarations are as follows:

- a. *Insolvency* – the Contracting State must apply Alternative A under Article XI of the Protocol in the event of insolvency, which requires the debtor to automatically transfer possession of the aircraft object to the creditor after a waiting period of a maximum 60 days; and
- b. *Deregistration* – under Article XIII, the Registry Authority – the Civil Aviation Safety Authority (CASA) in this instance – must record and assist the exercise of a request to deregister and export an aircraft object by the debtor; and
- c. *Choice of Law* – Article VIII provides that the parties to the transaction may agree as to which jurisdiction shall apply to the contract; and
- d. *Exercising remedies without leave of court* – Under Article 54(2), Convention remedies that do not require application to a court may be exercised without leave of the court; or
- e. *Timely interim remedies* – Article X allows for the ‘sale and application of sale proceeds’ as an interim remedy and together with the ASU, establishes a time limit for courts to make decisions in relation to interim remedies (10 days for immobilisation, preservation and possession; and 30 days for lease, sale and proceeds).

1.18 In addition, Alternative A requires Australia not to make a declaration in relation to Article 55 (applicability of interim remedies); Article XXXII (applying Article XXIV - precedence of Rome Convention); and Article 54(1) (preventing lease as a remedy).

iv. *Remedies*

1.19 Quiet possession rights are generally granted to debtors under the Convention. However, in the event of debtor default, a number of remedies are available to creditors under Chapter III. Remedies include re-possession, deregistration and export, the sale of or grant of a lease over an asset and the rights to any proceeds derived from an asset with a security interest attached. Australian courts will be required to observe the ‘self help’ nature of the remedies – particularly if the Article 54(2) declaration (exercise remedies without leave of the court) is made – and may be called upon to ensure these remedies are made available to creditors in the event a debtor becomes insolvent. The remedies must be exercised in a ‘commercially reasonable manner’.

Existing regulation

1.20 The Australian Government recently introduced the PPS Act, which will overhaul the domestic regulation of personal property securities. The PPS Act is expected to commence in 2011.²

1.21 The PPS Act will provide a comprehensive national PPS framework covering all personal property, including aircraft objects. It reconciles over 70 pieces of Commonwealth, State and Territory legislation and will provide:

- a domestic PPS register;
- clear priority rules for security interests; and
- a set of basic remedies in the event of debtor default.

² Since preparation of this RIS, the PPS Act has commenced.

- 1.22 By clarifying the rights and obligations of secured creditors and debtors and creating a single national securities regulatory framework, the PPS Act reduces the costs and risks to financiers, which in turn opens-up the availability of credit for borrowers.
- 1.23 While the PPS Act will cover mobile equipment such as aircraft objects, it has been suggested that the unique requirements associated with financing airframes – particularly large, commercial airframes – cannot be fully met by legislation such as the PPS Act, which is quite broad in its application. More specifically, industry has identified the existing ‘conflict of laws’ provisions in the PPS Act as being inadequate and unsuitable in the aviation context.
- 1.24 This being the case, the aviation industry (including financiers of aircraft objects) has indicated its preference to deal with an overarching securities system tailored to aviation interests, notwithstanding the success and effectiveness of the PPS regime for domestic purposes.
- 1.25 Although the PPS Act and the Cape Town Convention are very similar in their application, concerns exist within the aviation community that the domestic regime cannot adequately support the peculiarities associated with aviation finance law, such as the mobile nature of aircraft assets (which frequently move across jurisdictions), inconsistent regulation and the associated uncertainty around the protections applicable to creditors of aircraft equipment.
- 1.26 One example of the disparity between the two regimes is demonstrated by the relevant governing law provisions of each. Within the PPS Act, the ‘conflict of laws’ section generally considers the location of the collateral as determining the law that governs proprietary rights. An exception to this rule provides that for mobile assets, the applicable law is determined by the jurisdiction in which the grantor is located when the security interest attaches to the asset. Notwithstanding this exception, the Cape Town Convention provides further certainty and flexibility in relation to the laws governing security interests in highly mobile assets which does not depend on national legislation that tends to vary between jurisdictions. As discussed above, parties can agree as to which laws will govern a securities transaction.
- 1.27 Another difference is the ambit of each regime. While the PPS Act applies to all aircraft objects regardless of size and type, the Cape Town Convention is more limited in its application. The Cape Town Convention only applies to airframes that can carry 8 or more passengers or in excess of 2750 kilograms of goods (5 passengers or 450 kilograms for helicopters) and aircraft engines with at least 1760 pounds of thrust. For many smaller, recreational fliers, the targeted scope of the Cape Town Convention is a positive feature as the benefits of the Convention may not necessarily outweigh the costs for this segment of the aviation industry.
- 1.28 In terms of remedies, the PPS Act appears to be broader in its application as it contains a broader definition of ‘proceeds’ when compared to the Cape Town Convention. The PPS Act extends rights over proceeds from the sale of an aircraft object to ‘identifiable or traceable property’ which will allow property to be identified where it is different to the property originally received by the debtor as proceeds.

- 1.29 With regard to sources of finance for the purchase of new aircraft, the Cape Town Convention facilitates increased access to cross-border financing. In addition, the Convention also acts as protection for Australian carriers, in the event locally-based finance becomes interrupted or unsustainable.
- 1.30 Financiers have indicated a trend towards ratification of the Cape Town Convention becoming the ‘rule rather than the exception’, when it comes to aircraft financing. To this end, they have suggested that in the future, financiers may look to provide more favourable terms to airlines of those countries that have ratified the Convention. In addition, ECAs may increase their base fee in the medium to long-term which will further increase pressure on countries to the need to accede to the Cape Town Convention. This global shift towards the Cape Town Convention is something that Australia will inevitably need to confront. By taking action now, the Government will be able to better align accession with the commencement of the PPS Act in 2011.
- 1.31 For industry, a key incentive to accede (and where the treaty differs significantly from the PPS Act) concerns the significant cost savings available to airlines under the Cape Town Convention when purchasing or leasing new aircraft (see paragraph 1.10). This is particularly important for Australian airlines in the current economic environment, which is seeing airlines across the globe invest in new aircraft as the aviation industry recovers from the global financial crisis.

2. Objectives

Objective of government action

- 2.1 The objective is to provide:
- the Australian aviation industry with increased access to cheaper asset financing and sources of finance external to the local market; and
 - financiers with more certainty around Australia’s insolvency laws in relation to aircraft objects.
- 2.2 In 2010, the Hon Anthony Albanese MP and the Hon Robert McClelland MP, Attorney-General, formally agreed for their respective Departments to work together to progress accession to the Cape Town Convention.

3. Options

Option 1: Implement the Cape Town Convention making all qualifications necessary to qualify for the financing discount

- 3.1 This involves acceding to the Convention and making the declarations discussed at paragraph 1.17 to ensure Australian airlines qualify for a fee discount from ECAs in accordance with the ASU.
- 3.2 Without making these declarations, the benefits of accession for Australia would be somewhat limited. More specifically, any gains would be confined to enhancing the protection of security interests of creditors.

Option 2: *Take no action*

- 3.3 This option involves maintaining the status quo and restricting the registration of securities interests in aircraft objects to the domestic PPS register.
- 3.4 As discussed above, the PPS regime provides a domestic securities framework for the protection of creditor interests. While comprehensive and effective for domestic purposes, this framework does not adequately provide for the complexities associated with aviation law and the existing needs of Australia's aviation industry, which requires access to a homogenous securities regime for highly mobile assets. For example, it is less prescriptive in terms of the remedies it can offer for securities interests in highly mobile equipment (the PPS Act is silent in relation to the deregistration and export of aircraft objects whereas the Cape Town Convention specifically provides for this remedy).

Option 3: *Implement the Cape Town Convention without making all declarations necessary to qualify for a financial discount*

- 3.5 Option 3 involves implementing the Cape Town Convention in a way that may prevent the Australian industry from accessing the financial benefits available under the Convention.
- 3.6 By refraining from making the necessary declarations (as specified in the ASU) when acceding to the Cape Town Convention and consequently precluding Australian airlines from receiving any associated financial benefits, one of the primary purposes behind ratification is essentially undermined. The financial benefits available under the Convention are an important and strong consideration for Australia in determining whether or not to accede.

4. Impact analysis

Who will be affected?

- 4.1 The problem affects the Australian aviation industry, including airlines, and manufacturers of aircraft objects, as well as financiers of aircraft equipment.

Option 1: *Implement the Cape Town Convention making all qualifications necessary to qualify for the financing discount*

Benefits

- 4.2 The global financial crisis has prompted industry to reconsider financing beyond traditional domestic sources and to seek cost savings wherever possible.
- 4.3 By reducing the risk associated with asset-based financing and leasing, the Cape Town Convention will increase the availability of and reduce the costs associated with aviation finance. In turn, this will broaden the sources of funding currently available to airlines.
- 4.4 Financiers suggest that in addition to reducing risks to creditors by ensuring creditor access to and the expeditious recovery of assets in the event of default, accession to

the Convention will develop a new global infrastructure to attract capital finance, leading to increased liquidity in aviation markets. This would improve the confidence of international creditors in financing future purchases of aircraft objects by Australian airlines.

- 4.5 Airlines have indicated the Cape Town Convention will greatly assist them in reducing their financing costs in the short-term. In the medium to long-term, the Convention will help airlines in fleet planning by providing more options to source aircraft finance. This may result in increased operating efficiency and profitability, which may flow through to passengers by way of reduced ticket prices and improved serviceability.
- 4.6 An example of the immediate direct benefits of accession can be seen in the context of Qantas and Virgin Blue's future plans. Qantas has announced it has around 65 Boeing 787-8 aircraft on order for delivery from 2013 onwards.
- 4.7 The Virgin Blue Group has announced intentions to purchase 23 Boeing 737 MAX aircraft over a three-year period to facilitate these plans. The new airframes are scheduled for delivery between 2013 and 2016.
- 4.8 Manufacturers will benefit in the long-term through increased sales of new aircraft objects. In turn, this will lead to increased employment, higher output and market expansion.
- 4.9 The OECD ASU allows for participants to the agreement to access fee discounts from ECAs provided the participant-country has ratified the Cape Town Convention and made all requisite 'qualifying declarations'. It currently offers a reduction in the base premium charged by ECAs for export credit financing. Under this arrangement, the base premium established for each risk category would be reduced by 10 per cent.³
- 4.10 As mentioned above in paragraph 1.8, accession to the Convention independent of the Protocol will have no impact on broader business. The Convention can only operate in relation to a category of objects that are covered by a Protocol.

Costs

- 4.11 Airlines that choose to register their interests in accordance with the Convention will be subject to a small administrative fee. For example, a business registering an interest in the International Registry for the first time will be charged a one-off fee of US\$200. Registration and search fees range from US\$35-100. It is expected that these low compliance costs will be offset by the broad benefits available under the Convention.
- 4.12 Registration options and associated costs are being considered by the Attorney-General's Department (AGD), which is also separately examining implementing legislation issues (discussed at paragraph 4.28, below).

³ Conditions and minimum premium rates are updated periodically and published by the OECD. These rates vary according to the risk category of the debtor.

- 4.13 If ‘dual registration’ is applied, airlines will also be subject to registration fees when registering an interest in the domestic PPS register. Advice provided from AGD to date indicates that while this cost is yet to be determined, it is expected to be low.
- 4.14 If ‘deemed registration’ is pursued, airlines may only be subject to the administrative fees associated with the Cape Town Convention (that is, the PPS registration fees may not apply).
- 4.15 For smaller operators, there is a risk the Cape Town Convention may be of little practical use to their operations. For example, smaller operators may not be interested in seeking finance overseas and therefore may have no interest in accessing financial discounts under the Convention or registering their securities interests at a cost. The voluntary nature of the Convention allows for this scenario in that industry participants are not obliged to register their interests on the International Register.
- 4.16 On the other hand, there is a possibility that financiers may begin to mandate registration on the International Register as a prerequisite for the provision of credit in the future. This scenario is largely speculative, however, and largely depends on how the relationship between the aviation industry and financiers evolves over time. Furthermore, the relatively minor registration costs associated with registration mean that small operators should have little incentive not to use the system. For the time being, the securities benefits available under the Convention remain open for the use of all industry participants in considering financing options.
- 4.17 Administrative fees may also apply where a debtor issues an irrevocable de-registration and export request authorisation (IDERA) to CASA (further discussed in paragraph 4.27, below). If costs are deemed applicable, they are not expected to be onerous.
- 4.18 While accession may result in cheaper access to finance, it would also have a corresponding effect on the ability of an airline in financial distress to manage any potential restructure effectively.
- 4.19 It should be noted that upon accession, secured creditors will not obtain any greater preference than they otherwise would – i.e. their order of priority is not changed. If their priority was improved relative to other creditors, the other creditors would be expected to increase risk premiums or to restrict supply of credit.
- 4.20 The impact of the Convention is on the timing of secured creditor’s ability to enforce their claims. Delays in enforcement may negatively impact on rates of recovery. The measure will therefore be expected to reduce risk premiums charged by secured creditors.
- 4.21 By expediting secured creditors’ rights to enforce their security, the period in which a debtor company has to put in place a proposal – such as a Deed of Company Arrangement (Deed) – to rescue a company may be reduced. The extent to which this might be the case is not known; nor is the extent to which losses to unsecured creditors would be expected to increase as a result of any possible reduction in business rescues. Any increases in losses would result in increased costs and reduced access to unsecured credit, with a negative impact on companies. The support of the industry for the measure is indicative that any such negative impact is not expected to

exceed the positive effects of the expected impacts on costs and access to secured credit.

- 4.22 Following accession, a secured creditor would be able to enforce their security after 60 days regardless of whether the company is under voluntary administration and the non-consensual stay of proceedings is continuing. Currently, a secured creditor is prohibited from enforcing its security once a company enters into voluntary administration until a Deed is put in place or a decision is made to wind up the company. While this period is usually only 25 days, the Court is empowered to extend that period, and given the size and complexity of the majority of industry participants this would not be unlikely. Accession to the Convention will put new pressure on creditors to obtain agreement on a potentially extremely complex Deed within the 60 day period.

Effect on existing regulation

- 4.23 Implementation of the Cape Town Convention would likely require amendment of the PPS Act to ensure the international and domestic securities frameworks do not conflict. In this way, effective implementation will enable parties to securities transactions involving aircraft objects to access the protection and benefits available under both systems.
- 4.24 The *Air Navigation Act 1920* (ANA) may need to be amended to give the Cape Town Convention force of law in Australia. Noting the declarations power contained in the Convention, the ANA could be amended to empower the Government to apply relevant provisions of the Convention domestically, including any declarations Australia may make when acceding to the Convention or after accession is complete.
- 4.25 In order to make the required insolvency declarations under the Protocol (known as the ‘Alternative A’ regime) and qualify for corresponding financial discounts from financiers, the Australian courts would be restrained from exercising jurisdiction in relation to securities remedies that are subject to the Convention, in favour of relevant ‘self-help’ provisions. Article XI of the Protocol provides that after a nominated waiting period (60 days), the creditor automatically gains the right to repossess the aircraft object. The courts would have no powers to delay or prevent the enforcement of this remedy, however they would continue to have jurisdiction in relation to other aspects of the securities matter, such as the validity of the claim over a security interest.
- 4.26 To this end, the *Corporations Act 2001* may require amendment to allow for Alternative A to prevail over existing insolvency laws where aircraft objects are concerned.
- 4.27 The Civil Aviation Safety Regulations 1998 (CASRs) would likely require amendment to allow for the deregistration and export of aircraft objects (and/or the cancellation or transfer of ownership in accordance with Article IX and Article XIII of the Protocol). Under Article XIII and in the event of debtor default, where a debtor has provided the registry authority (CASA) with an IDERA, this must be recorded and facilitated by CASA (as discussed at sub-paragraph 1.17(b), above) within the

stipulated time frame. Costs associated with such transactions (if any) would also need to be determined and outlined in the relevant CASA schedule.

Implementation Models

- 4.28 AGD have explored three possible implementation models to implement the Cape Town Convention in Australia (applicable to Options 1 and 3), which include:
- a) giving the Cape Town Convention force of law in Australia, and provide for the Convention to prevail over the PPS Act where inconsistencies arise;
 - b) amending the PPS Act to incorporate the rules of the Cape Town Convention; and
 - c) combining the abovementioned models and enacting parts of the Cape Town Convention, while implementing the rest by amending the PPS Act.
- 4.29 Model (a) (give the Cape Town Convention force of law in Australia, and provide for the Convention to prevail over the PPS Act where inconsistencies arise), may result in simpler legislation and certainty around qualification for a fee discount from ECAs.
- 4.30 This model has been recently been adopted by New Zealand upon acceding to the treaty. Considering that Australia's PPS Act is based on the New Zealand PPS Act, and in light of the both Australia and New Zealand's commitment to regulatory harmonisation and alignment between the two countries,⁴ the adoption of Model (a) is commendable. Additionally, legal and financial practitioners across both jurisdictions would find it easier to work within similar aviation financing regimes.
- 4.31 On the other hand, Model (a) may attract complexities for stakeholders in interpreting legislation and Convention provisions. That is, in practice, Model (a) may make it difficult for stakeholders to understand their rights and obligations in relation to the PPS Act and the Cape Town Convention.
- 4.32 In the first instance, Model (a) will require stakeholders to gain a strong understanding of the operation of both the PPS Act and the Cape Town Convention and identify where inconsistencies arise between the two instruments to determine their rights and obligations. For example, the enforcement provisions of each system differ in some respects, and the responsibility for determining which enforcement mechanisms will apply will lie with the aviation industry and by extension, the courts. As a consequence, and in an effort to circumvent this issue, it follows that the aviation industry may need to engage legal expertise to better understand their rights and obligations. As the main beneficiaries of accession, it would not be unreasonable for industry to incur some of the costs associated with operating under and within the two schemes. Furthermore, parties to aviation finance transactions are quite sophisticated by nature, and would generally seek legal expertise prior to entering into these transactions in any event.
- 4.33 Model (b) (amend the PPS Act to incorporate the rules of the Cape Town Convention) would provide stakeholders with more clarity as to their rights and responsibilities

⁴ See 'Memorandum of Understanding on Coordination of Business Law' at http://www.treasury.gov.au/documents/1073/PDF/Business_law_MOU.pdf

when compared to Model (a). This will be achieved by making detailed amendments to the PPS Act to adapt the Convention rules into the existing legislative framework around PPS interests.

- 4.34 While the detailed analysis and redrafting of the PPS Act required for this option to work will prove challenging for Government, it would mean that industry would only need to be familiar with the PPS Act in relation to their interests in aircraft objects. On the other hand, in the event industry needs to distinguish between Convention and non-Convention issues to determine where their interests sit, they may find themselves subject to the same interpretation complexities that apply to Models (a) and (c).
- 4.35 This issue also extends to the reinterpretation of conceptual differences that exist between the PPS Act and the Cape Town Convention (i.e. differences in the scope of key terms such as ‘security interest’ or ‘proceeds’). The adoption of Model (b) would require major concepts in the PPS Act to be redefined in order for Convention rules to be incorporated. This may have flow on effects for the rest of the PPS Act, which could affect other industries. Such extensive changes would require further rigorous consultation to be undertaken with uncertain benefits to be realised.
- 4.36 In addition, by restating the Cape Town Convention rules in the PPS Act (as opposed to adopting the treaty in its original form), Australia risks failing to qualify for the fee discount in the ASU – a considerable risk and drawback associated with Model (b). This scenario is not uncommon, with countries such as Singapore and Indonesia being required to amend their laws after implementing the treaty to meet strict qualification requirements, causing unnecessary delay and costs. For this reason, stakeholders may prefer to accede to the Cape Town Convention in its original form (Model (a)) to avoid any uncertainty around receiving intended financial benefits from accession.
- 4.37 Model (c) (combination of Models (a) and (b)) balances the two approaches by giving parts of the Cape Town Convention force of law and implementing the balance through amendments to the PPS Act. As with Model (a), stakeholders will be required to navigate the PPS Act and Convention in the first instance. In practice, this complexity is somewhat heightened for Model (c) as it may unclear to stakeholders as to which instrument provides the relevant rule at any given time.
- 4.38 AGD is continuing to explore the benefits and costs of each model in consultation with the Department of Infrastructure and Transport (Infrastructure) and the Office of Parliamentary Counsel (OPC) before deciding on a preferred approach. Advice from OPC to date suggests that legislative complexity issues and the need for industry to take positive action to understand the relationship between and the operation of the PPS Act and the Cape Town Convention will be inevitable. This being the case, the objective of Government in evaluating implementation issues will be to ensure the Convention is implemented in a way that balances the needs of industry and is no more complex than is necessary.

Option 2: Take no action

Benefits

- 4.39 Option 2 involves not implementing the Convention and focussing on preparing industry for the introduction of the domestic PPS reforms. By restricting the protection of securities interests in highly mobile equipment to a purely domestic securities framework, the Australian Courts may have more flexibility to oversee decisions in relation to insolvency remedies, to the extent that the existing PPS framework allows for court intervention in securities insolvency matters.
- 4.40 Under this option, the administrative process for secured creditors would remain relatively straightforward and simple. Interests would only be required to be registered in one Australian-based PPS register, as opposed to two registers which is highly likely if the Convention is implemented and ‘dual registration’ is pursued.
- 4.41 The PPS has been a positive development for holders of securities interests, as it has created a uniform scheme. Its introduction in 2011 will ensure secured creditors of aircraft objects benefit from a centralised and consistent system of registering their interests, which previously did not exist in Australia. In turn, this may reduce the cost and increase the availability of credit available to the Australian airline industry.

Costs

- 4.42 Option 2 could result in the Australian aviation industry becoming more isolated from the rest of the world – and therefore less competitive in the global market – in relation to financing and securities interests. As previously discussed, the PPS reforms, while beneficial for security interests in personal property in general, do not necessarily cater for the specialised nature of the aviation industry when compared to the Cape Town Convention. Distinguishing features of the aviation industry include highly mobile and expensive equipment, complex and sophisticated financing techniques and cross-border regulations.
- 4.43 In addition, a domestic securities framework may over-expose Australian airlines to the risks associated with sourcing export credit finance internally. That is, airlines may continue to rely on local market financing and its associated limitations, with relatively restricted options for contingency finance.

Option 3: Implement the Cape Town Convention without making all declarations necessary to qualify for a financial discount

Benefits

- 4.44 Option 3 would allow Australia to accede to the Cape Town Convention without disrupting its existing securities and insolvency framework. Secured creditors of aircraft objects would receive increased protection in relation to their registered interests (when compared with the PPS system); however, the protection would be less than that afforded under Option 1.
- 4.45 Although legislation will still be required to implement the Convention, the impact on Australian courts, the PPS reforms, the CASRs and the *Corporations Act 2001* will be significantly reduced when compared to Option 1. For example, by not enforcing Alternative A, the Australian courts may have more powers in enforcing remedies under the Convention. It follows that Option 3 would likely be more efficient and less

complex than Option 1, and ratification would ensure Australia remains aware and supportive of international efforts to reduce risk in asset-based financing.

Costs

- 4.46 Under Option 3, airlines would not be eligible to receive a fee discount in accordance with the ASU. As the financial incentives offered under the Convention (as supplemented by the ASU) represent a significant driver for accession, implementation that omits this benefit will be a counter-productive and costly process.
- 4.47 In addition, this form of implementation would be out-of-step with international practice, with 34 countries having already ratified the Cape Town Convention (the majority of which made the required ASU declarations). The long-term benefits to be derived from the Convention for airlines and the broader Australian aviation industry (e.g. access to international financiers, more efficient and cost-effective fleet planning, and remaining competitive in an expanding international market) will be lost if the instrument is not implemented as recommended.
- 4.48 If Australia pursued this option and decided to make subsequent declarations to meet ASU requirements, it would be an expensive, time-consuming and somewhat cumbersome exercise.

5. Consultation

- 5.1 AGD initially consulted industry about whether or not Australia should sign the Cape Town Convention in 2003. This round attracted a limited response, with only three submissions received from stakeholders.
- 5.2 Following the entry into force of the Cape Town Convention in 2006, the Australian Government revived consideration of the treaty. On 27 February 2008, Infrastructure issued a consultation paper to industry, inviting submissions about the implications for Australia if it were to accede to the Cape Town Convention. Infrastructure distributed the consultation paper by writing to stakeholders (including financiers, airlines and industry bodies, as well as the States, Territories and Commonwealth Government agencies) and publishing the paper on its website, where it can still be accessed by the public.
- 5.3 The 2008 consultation paper did not generate significant stakeholder interest, receiving only seven responses. Both industry and Australian Government stakeholders considered that any action to implement the Convention in Australia must be consistent with the PPS reform process which at the time, was yet to be finalised.
- 5.4 The majority of submissions supported accession to the Convention and considered the international register for security interests in aircraft objects a useful and beneficial development. One regional aviation organisation recognised that the benefits of the Convention would extend to regional airlines and would greatly improve borrowing arrangements. Two major law firms stressed the importance of ensuring the Convention and the PPS reforms effectively balanced and complemented

each other and favoured dual registration. Most submissions indicated a preference for the Alternative A insolvency regime and suggested the Convention be implemented around the same time as the PPS reforms.

- 5.5 The only negative response to the consultation paper was received from a non-profit aviation association. The association considered that accession to the Convention would expose the Australian aviation industry to ‘considerable additional costs, unnecessary documentation and delays in the transfer of ownership of aircraft and engines’. Further consultation and analysis of the Convention has countered this argument, indicating that any costs associated with accessing a fee discount under the Convention and registering interests in the international register are minimal and are largely outweighed by the financial benefits and security offered under the Convention. Further, application of the Alternative A insolvency system would provide for the expedited transfer of ownership and possession of highly mobile assets when compared to the existing insolvency remedies system in Australia.
- 5.6 Since this time, the global financial crisis prompted industry to reconsider its options for sourcing finance for the purchase of aircraft objects. In 2009, a number of industry stakeholders approached the Government indicating a renewed interest in the Cape Town Convention. These representations suggested industry had developed a strong desire to progress the Convention in an effort to source available financial discounts. Australian airlines are now looking to international financiers to fund the purchase of new airframes at a time when the industry is trying to recuperate from the effects of the economic downturn and regrow itself.
- 5.7 On 16 December 2009, Infrastructure wrote to industry following the release of the National Aviation White Paper, advising about the Government’s consideration of the Convention. Infrastructure indicated it would be working with AGD to examine options for implementation of the Convention in a manner that would complement the new PPS reforms in an administratively sound manner.
- 5.8 Over the course of 2009 and 2010, the Government continued consultations with a number of major airlines, law firms, a major airframe manufacturer and international financing companies about accession. The Tourism and Transport Forum, a peak industry body, has been actively involved in a number of meetings with aviation industry stakeholders, to keep abreast of the interactions and outcomes between industry and the Government. This has also ensured continuous engagement between government and stakeholders and in turn, ongoing progression of consideration of the Convention.
- 5.9 The Government also wrote to small air operators to gauge their views about implementation and the possible impact of the Convention on their operations. This letter generated minimal interest from this sector of the industry, with one response received from a general aviation body, indicating its in-principle support for accession.
- 5.10 The Hon Anthony Albanese MP, Minister for Infrastructure and Transport, formally wrote to the Hon Robert McClelland, Attorney-General, on 10 March 2010 to advise about a proposed way forward. The Attorney-General responded on 19 April 2010

supporting Australia's accession to the Convention and agreeing to the proposal. To this end, AGD will continue to provide advice about the interaction between the Convention and the PPS reforms and possible implementation options.

- 5.11 On 22 November 2010, Infrastructure released a new consultation paper for stakeholder consideration, seeking advice about technical accession issues that require further consideration by industry. It is intended that stakeholder input to this paper will assist the Government in resolving complexities associated with relevant 'declarations' Australia may make if it decides to accede to the Convention.
- 5.12 In addition, AGD presented a paper entitled 'Australian Personal Property Securities Reform and Secured Finance in the Aviation Industry' at an Aviation Law Association of Australia and New Zealand (ALAANZ) conference on 12 March 2009. Infrastructure also outlined the Government's consideration of the Convention at an ALAANZ event held in Melbourne on 29 April 2010, as part of a presentation detailing changes to existing carriers' liability and insurance arrangements.

6. Conclusion and recommended option

- 6.1 In the current economic climate, Australian airlines are conscious of the need to update their fleets with more efficient and environmentally-friendly aircraft objects and balance this with corporate requirements to monitor and control capital spending.
- 6.2 For international financiers, the ability to offer export credit finance to a fast-expanding aviation market demands more certainty and security in relation to their rights and the enforcement of default remedies.
- 6.3 This scenario affects and involves various other stakeholders in the aviation industry including airlines, manufacturers of airframes and lawyers, making the Cape Town Convention relevant for the majority of participants in the Australian aviation industry.
- 6.4 Option 1 (accede to the Convention by making all declarations specified in the ASU) attempts to address the various demands associated with cross-border aircraft financing to create a more stable environment for the financing of aircraft objects. The provisions of the Cape Town Convention have proven appealing to ECAs to the extent that a number of financiers have offered a fee reduction for countries that ratify the Convention in a manner that will provide creditors with strong and robust remedies in the event of debtor default. In this way, Option 1 affords financiers with the enhanced security they seek while providing airlines with an opportunity to significantly reduce their financing costs. In the longer term, it is expected this approach to aircraft financing will underpin a healthy and sustainable global aviation industry.
- 6.5 Option 2 (take no action) retains the status quo. While this scenario – upon the commencement of the PPS Act – will provide for an improved domestic environment for the protection of securities interests, airlines may continue to struggle for finance in a limited local market. In turn, this could continue to restrain Australian airlines

from accessing international financing opportunities available to other international airlines, impacting on their competitiveness in the market.

- 6.6 Option 3 (accede to the Convention without making all declarations necessary to qualify for a financial discount), while positive in that it will demonstrate that Australia is supportive of international efforts to improve certainty around aircraft object financing, will have little impact on the Australian industry. Omitting to make critical declarations will be seen by ECAs as failing to ensure enhanced security for financiers of aircraft objects and will result in no fee reduction being passed onto Australian airlines. Ultimately, this form of ratification will preclude the availability of the possible benefits under the Cape Town Convention for all parties, making ratification a futile and costly exercise.
- 6.7 For these reasons, Option 1 – namely, accession to the Convention by making all declarations specified in the ASU – is the recommended option. This option will produce the most benefits to all industry stakeholders with little cost and is therefore the most effective option to remedy an otherwise fractured international legal framework governing the rights of international financiers of aircraft objects and the costly lending premiums airlines have become subject to as a result. The ongoing ratification effort by the rest of the international community is indicative of the increasing influence of the Convention over the international financing of aircraft objects. If Australia wishes to remain on par with the global aviation industry and reap the economic and securities benefits of the Cape Town Convention, it must accede to, and implement the treaty in accordance with Alternative A.

7. Implementation and review

- 7.1 Infrastructure, together with AGD, will have responsibility for progressing accession to the Cape Town Convention and administering related legislation and amendments. To assist in determining which implementation option to adopt, AGD have commenced analysis of the Cape Town Convention to identify convergence and divergence between the Convention and PPS Act rules and concepts. Legal practitioners involved in aviation financing would have the necessary expertise and would be aware of the vagaries of such transactions, and it is possible that comments and input from these stakeholders will be sought.

20 December 2010

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