

ASSIGNMENTS OF INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND RELATED RECEIVABLES UNDER THE UNIDROIT CONVENTION: WHEN SHOULD THE TAIL WAG THE DOG?

CHARLES W. MOONEY, JR.*

1. INTRODUCTION

The International Institute for the Unification of Private Law ("UNIDROIT")¹ and the International Civil Aviation Organization ("ICAO")² are collaborating in the sponsorship of the proposed UNIDROIT Convention on International Interests in Mobile Equipment³ and a protocol that deals with aircraft

* Interim Dean and Professor of Law, University of Pennsylvania Law School. I served as a member of the UNIDROIT Study Group (1993-1998), and I now serve on the United States delegation for the UNIDROIT Convention on International Interests in Mobile Equipment. The views expressed in this paper, however, are not necessarily those of the United States government or of other members of the United States delegation.

¹ UNIDROIT is an intergovernmental organization based in Rome. Its work focuses on the harmonization of private law.

² ICAO, an inter-governmental organization based in Montreal, addresses a wide variety of matters concerning civil aviation, including the harmonization of civil aviation-related private law.

³ A UNIDROIT Study Group and a subcommittee of the Study Group, meeting from 1992 to 1998, produced a draft convention for consideration at the first meeting of governmental experts, held in Rome in February 1999. The UNIDROIT Committee of governmental experts and a Subcommittee of the ICAO Legal Committee met in joint session for the first reading of the *Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment*, UNIDROIT 1998 Study LXXII - Doc. 42, ICAO Ref. LSC/ME-WP/3 (July 1998), and the *Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*, UNIDROIT 1998 Study LXXIID - Doc. 3, ICAO Ref. LSC/ME-WP/4 (July 1998). A drafting committee elected by joint session produced revisions of each document. See *Text of the Preliminary Draft, UNIDROIT Convention on International Interests in Mobile Equipment as Reviewed by the Drafting Committee, in First Joint Session Report*, Unidroit CGE/Int.Int./WP/16, ICAO Ref. LSC/ME-WP/27 app I (Feb. 12, 1999) [hereinafter Base Convention]; *Text of the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment as Reviewed by the Drafting Committee, in First Joint Session Report*, Unidroit CGE/Int.Int./WP/16, ICAO Ref. LSC/ME-WP/27 app II (Feb. 12, 1999) [hereinafter Air-

equipment.⁴ The Convention principally focuses on equipment financing pursuant to security agreements, leases, and title reservation agreements.⁵ Certain provisions of the Convention also address assignments of payment streams associated with the equipment, such as the obligations secured under a security agreement, the obligations owed by a lessee under a lease, and the obligations of a buyer under a title reservation agreement. More often than not, the assignment and financing of these payment streams are integral elements of the equipment financing transaction itself.⁶ Financing these equipment-related receivables is both representative and important in the context of large commercial aircraft financings to be covered by the Convention.⁷

This essay addresses certain aspects of the Convention's treatment of assignments involving international interests and related receivables. The Convention's treatment differs from the

craft Protocol]. Subsequent references to the "Convention" encompass both the Base Convention and the Aircraft Protocol, unless otherwise specified.

⁴ See Aircraft Protocol, *supra* note 3.

⁵ See Base Convention, *supra* note 3, art. 2 (explaining the scope of "international interest").

⁶ Consider, for example, the treatment of chattel paper, writings that evidence both a monetary obligation and a security interest in the lease of specific goods, under Article 9 of the Uniform Commercial Code ("UCC"), a version of which is in effect in each state of the United States. The importance of facilitating a market for assignments of chattel paper justifies a special priority rule for certain purchasers who take possession. See U.C.C. § 9-105(1)(b) (1995) (defining "chattel paper"); U.C.C. § 9-308 (1995) (explaining the special priority rule). Under a revision of Article 9 that is currently being considered by the states, but is not yet effective in any state, similar treatment is provided for chattel paper and is extended to "electronic chattel paper" that is not evidenced by writings. See U.C.C. § 9-102(a)(11) (1998) (defining "chattel paper"); U.C.C. § 9-102(a)(31) (1998) (defining "electronic chattel paper"); U.C.C. § 9-330 (1998) (stating the special priority rule).

⁷ The Aircraft Protocol defines "aircraft" to mean "airframes with aircraft engines installed thereon or helicopters." Aircraft Protocol, *supra* note 3, ch. 1, art. I(2)(a). It defines "airframes" as:

airframes, (other than those used in military, customs and police services) that, when appropriate aircraft engines are installed thereon, are type certified by the competent aviation authority to transport:

(a) at least eight (8) persons including crew; or

(b) goods in excess of 2750 kilograms,

together with all installed, incorporated or attached accessories, parts and equipment (other than aircraft engines), and all data, manuals and records relating thereto.

treatment under other modern legal structures for financing receivables, in particular under Article 9 of the UCC in the United States and the proposed Draft Convention on Assignment in Receivables Financing being developed by the United Nations Commission on International Trade Law (“UNCITRAL”).⁸ I conclude that the general approach taken in the current version of the Base Convention, which provides that an assignment of an international interest carries with it an assignment of the associated receivable, appears to be satisfactory in the context of aircraft financing, provided that the related priority rule is appropriately circumscribed. This conclusion depends on empirical assumptions that should be rigorously examined and tested.

2. THE UNIDROIT CONVENTION’S APPROACH TO ASSIGNMENTS OF INTERNATIONAL INTERESTS AND ASSOCIATED RECEIVABLES

The principal substantive provision of the Base Convention of interest is Article 30(1), which provides that “an assignment of an international interest in an object made in conformity with the preceding Article transfers to the assignee, to the extent agreed by the parties to the assignment: (a) all the interests and priorities of the assignor under this Convention; and (b) all associated rights.”⁹ Paragraph 1(a) is straightforward: the assignee of an international interest receives what the assignor assigned, including the priority of the assigned interest. Paragraph 1(b) must be read with the definition of “associated rights,” defined in Article 1 as “all rights to payment or other performance by the obligor under an agreement or a contract of sale secured by or associated with the object.”¹⁰ Article 30(1) establishes the baseline scheme. An assign-

⁸ See *Report of the Working Group on International Contract Practices on the Work of Its Thirtieth Session*, U.N. Convention on International Trade Law, 32d Sess. Annex, U.N. Doc. A/CN.9/456 (1999) [hereinafter *UNCITRAL First Draft*]; *Draft Convention on Assignment in Receivables Financing* (visited Oct. 2, 1999) <http://www.uncitral.org/english/sessions/wg_icip/drftcon99.htm> (unofficial document compiled on the basis of documents A/CN.9/447, A/CN.9/455, A/CN.9/WG.II/WP.96, A/CN.9/WG.II/WP.98, and A/CN.9/WG.II/WP.102) [hereinafter *UNCITRAL Second Draft*]. References herein to the Articles 1-26 of the “UNCITRAL Convention” are to the *UNCITRAL First Draft* and references to all other articles are to the *UNCITRAL Second Draft*.

⁹ See Base Convention, *supra* note 3, art. 30(1).

¹⁰ *Id.* art. 1. Article 1 also defines “agreement” as a “security agreement, a title reservation agreement or a leasing agreement.” *Id.*

ment of an international interest carries with it, automatically, the related payment receivables ("associated rights").

At first blush, the Convention's approach appears to turn on its head the commonly understood relationship, at least as interpreted in the United States, between an obligation and the property that secures the obligation. Normally, the *security* follows an assignment of the *obligation*.¹¹ The draft UNCITRAL Convention also adopts the conventional security-follows-obligation approach.¹² The UNIDROIT Convention reverses the order of security and obligation by providing that the obligation follows the security. There is a good reason for this reversal. These apparently conflicting approaches are indistinguishable because, in reality, each formulation produces exactly the same results. Absent agreement otherwise, an assignment of either the obligation or the interest carries the other with it. Once one knows the applicable baseline rule (i.e., whether the Convention or other law applies), it is easy to ensure that both the obligation and the security are assigned.¹³

The reason for the Convention's receivable-follows-international interest framework is simple. The Convention provides for an international registration system for international interests that will be indexed by and searchable against a description

¹¹ See, e.g., U.C.C. § 9-203(g) (1998) (explaining that the attachment of a security interest in right to payment is also attachment of a security interest in lien securing right to payment); U.C.C. § 9-203(g) cmt. 9 (1998) ("Subsection (g) codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal property is also a transfer the security interest or lien."); U.C.C. § 9-308(e) (1998) (explaining the perfection of security interest in right to payment is also perfection of security interest in lien securing right to payment).

¹² See *UNCITRAL First Draft*, *supra* note 8, art. 11(1):

A personal or property right securing payment of the assigned receivable is transferred to the assignee without a new act of transfer, unless, it is by law [independent] [transferable only with a new act of transfer]. If such a right is by law [independent] [transferable only with a new act of transfer], the assignor is obliged to transfer this right and any proceeds to the assignee.

¹³ If the Convention applies, the parties will know how to provide that an interest is assigned and, therefore, carries with it the obligation, and vice versa if other law applies. In the real world, of course, documentation can be expected to provide for the assignment of both the obligation and the interest, as is common today.

of the aircraft object.¹⁴ The Convention's approach toward assignments of receivables allows those assignments to be registered in the international register.¹⁵ This system would provide certainty inasmuch as an assignee will be able to search against a specific aircraft description and ascertain that it has the first-in-time assignment of receivables related to that aircraft. Thus, the Convention solves what is a substantial problem under current law in many jurisdictions that contain no adequate registration system for receivables.¹⁶ Assignments of receivables also benefit from the Convention's priority rules.¹⁷ In sum, by tying the assignment of receivables to the international registry for the aircraft to which the receivables relate, the Convention achieves a modern registration system for *both* aircraft and related receivables.

This brief overview of the Convention's approach to assignments of receivables summarizes the state of the receivables-related provisions found in the first preliminary draft of these provisions presented to the UNIDROIT Study Committee in January 1997. As I pointed out to the Study Committee at that time, however, this approach harbors a problem. The next part of this essay identifies that problem and proposes a possible solution.

¹⁴ See Base Convention, *supra* note 3, ch. IV (The International Registration System), ch. V (Modalities of Registration); Aircraft Protocol, *supra* note 3, ch. III (Registry Provisions Relating to International Interests in Aircraft Objects).

¹⁵ See Base Convention, *supra* note 3, arts. 31-33.

¹⁶ Under both the 1995 and 1998 UCC in the United States, filing a financing statement (the equivalent of "registration" as that term is used here) is the normal method of perfecting a security interest (i.e., ensuring priority over third parties). See U.C.C. § 9-302(1) (1995); U.C.C. § 9-310 (1998). Although the UNCITRAL Convention contains provisions for registration, they are optional, with priority being governed by the law of the state in which the assignor is located. See *UNCITRAL Second Draft*, *supra* note 8, art. 31(a) - (c); Base Convention, Annex, arts. 1-7. For a critique of this approach, see Steven L. Schwarcz, *Towards a Centralized Perfection System for Cross-Border Receivables Financing*, 20 U. PA. J. INT'L ECON. L. 455 (1999).

¹⁷ See Base Convention, *supra* note 3, art. 33 ("Where there are competing assignments of international interests and at least one of the assignments is registered, the provisions of Article 27 [the basic priority rules] apply as if the references to an international interest were references to an assignment of an international interest.").

3. THE PROBLEM AND THE PROPOSED SOLUTION

The problem arises because, in a secured transaction (not a title reservation agreement or a leasing agreement), the obligation that is secured has no necessary relationship to the object that secures it. For example, the obligation secured may be to repay a loan made for general business purposes although it may be secured by several objects under several different security agreements. Consider a single promissory note evidencing a loan that is secured by objects A, B, and C under three separate security agreements. None of the security agreements make reference to the others. Consider, also, an assignee who receives an assignment of the note and an assignment of the international interest in object A. Under the Convention's straightforward approach, described above, by registering the assignment of the international interest in object A, the assignee would also have a valid and effective assignment of the right to payment under the note. On the other hand, the assignee would have no way to determine that any additional collateral security existed (objects B and C) or whether the international interests in B and/or C had previously been assigned. Similarly, if a prospective assignee wishes to take an assignment of the note under local law, it would have no way to determine that the note was secured by one or more international interests. The crux of the problem, then, is that the circumstances may or may not alert a prospective assignee to the need to search the international registry and to register an assignment of a relevant international interest.¹⁸

Note that problems do not exist to the same extent in the cases of title reservation agreements and leasing agreements. In those cases, the right to payment that is to be assigned necessarily relates to the purchase or lease of a specific object. Based on the assumption that a prospective assignee will be aware of the underlying nature of the receivable that is to be assigned, it then would be in a position to search the international registry to determine if there has been a previous assignment relating to the international interest in that object. The assignee then could ensure that the international interest arising out of the title reservation agreement or lease is assigned to it in the international registry.

¹⁸ Another potentially misleading situation could involve an assignment of one or more of a large number of receivables secured by a single object in a transaction subject to the Convention.

This insight—that prospective assignees will become informed as to the nature of a receivable to be assigned—is the basis for the solution to the problem reflected in Article 34 of the Base Convention. Article 34 provides:

Where the assignment of an international interest has been registered, the assignee shall, in relation to the associated rights transferred by virtue of the assignment, have priority over the holder of associated rights not held with an international interest to the extent that the first-mentioned associated rights relate to: (a) a sum advanced and utilised [sic] for the purchase of the object; (b) the price payable for the object; or (c) the rentals payable in respect of the object; and the reasonable costs referred to in Article 9(5).¹⁹

Article 34 limits the priority in the associated rights that follow assignment of an international interest in an object to the monetary portion of the receivable that relates directly to the international interest itself—purchase-money obligations and rentals under leases. To the extent that the international interest secures other obligations, the Convention would confer no priority over other assignees of those obligations. Presumably, that priority contest would be resolved under non-Convention applicable law.

4. TESTING THE SOLUTION

The wisdom of the Article 34 solution depends on the assumption that a prospective assignee of a receivable normally would be aware that the receivable is a purchase-money or lease-rental obligation relating to an aircraft object. Examination by the assignee of the underlying documentation or the representations and warranties of the assignor should bring this fact to the assignee's attention. Because of the high value of the commercial aircraft covered by the Convention, it is unlikely that purchase-money or lease-rental obligations relating to an aircraft object would be "buried" in a large pool of seemingly fungible receivables that might be assigned without the assignee's awareness or reliance on the aircraft. Could the same be said of other equip-

¹⁹ Base Convention, *supra* note 3, art. 34.

ment that might become subject to the Convention under another protocol, such as a protocol covering rail cars or containers? No. It would then be appropriate to move the assignment provisions from the Base Convention to the Aircraft Protocol, recognizing that they are best considered on an object-type-by-object-type basis.

Article 34 of the current draft of the Aircraft Protocol contains square brackets around the language that would limit the priority in receivables covered by registered assignments to purchase-money and lease-rental obligations.²⁰ As the brackets indicate, the appropriateness of the limitation for aircraft-related receivables remains unresolved. However, the drafting committee recognized the potential impact of the resolution of this issue on receivables financing in general.²¹ As discussed in Part 3, the problem consists of whether a prospective assignee will know that it needs to check the international registry with respect to a particular aircraft. Consider the following paradigm, discussed by the UNIDROIT Study Committee. An obligee proposes to assign one or more receivables arising out of a series of general business loans or sales of goods and services to an obligor. The obligor then acquires one container (assuming containers were covered by a protocol to the Convention) and creates, in favor of the obligee, an international interest in the container to secure all of its obligations to the obligee. Because the container secures all of the obligations, registering the assignments of international interest in the international registry would (except as otherwise agreed) carry with it the valid assignment of all of those obligations. The priority limitation in Article 34 would ameliorate this problem as long as the obligations secured by the container in this example are not purchase-money or lease-rental obligations.

²⁰ See Aircraft Protocol, *supra* note 3, art. XV(4). If the language in square brackets were deleted, Article 34 would read (for purposes of the Aircraft Protocol) as follows: "Where the assignment of an international interest has been registered, the assignee shall, in relation to the associated rights transferred by virtue of the assignment, have priority over the holder of associated rights not held with an international interest."

²¹ See *id.* art. XV(3) ("Article 34 of the preliminary draft convention, as may be modified by this preliminary draft protocol, will have important implications for the competing rights of a receivables financier and an asset-based financier. Consideration should be given to the appropriate rule in the context of aviation financing.").

The container paradigm is striking because containers are relatively inexpensive. The creation and assignment of an international interest in a container could provide a strategic mechanism to bootstrap the assignment of receivables into the international registry, and thereby into the Convention's priority rules, even though the container might be superfluous to the transaction in all other respects.²² Ironically, for contextual reasons similar to those that would make the Article 34 priority limitation effective and plausible, the limitation may not be necessary in the commercial aircraft context. More directly, if it is obvious to any prospective assignee that the receivable to be assigned is secured by a commercial aircraft (given the value, the nature of obligors that would have an interest in the aircraft, etc.), *whether or not the receivable to be assigned is a purchase-money or lease-rental obligation*, then the limitation may be unnecessary. While I am open to persuasion, I remain dubious about the factual assumptions that underlie the argument that the Article 34 priority limitation is unnecessary in the commercial aircraft context. Moreover, any doubt should be resolved in favor of the limitation, given the importance of receivables financing in general. Here, as with most other contentious issues, resolving the legal issue requires an investigation and analysis of the facts. However, the issue ultimately must be resolved with imperfect and incomplete information.

5. ASSIGNMENTS IN PERSPECTIVE: THE LOCAL LAW CONUNDRUM REVISITED

In a 1996 article dealing with the UNIDROIT Convention, I addressed what I referred to as the "local law conundrum."²³ The local law conundrum confronts the United States, Canada, and other states or subdivisions of states with modern, successful systems for personal property security. These states may be reluctant to expose important domestic transactions to a very different, and possibly less successful, regime under an international convention. On the other hand, one of the purposes of the

²² This might suggest that in the context of containers it would be unwise to have *any* provisions for assignment of receivables in the relevant protocol. At a minimum, it is clear that a priority limitation along the lines of Article 34 would be necessary and important.

²³ Charles W. Mooney, Jr., *Exporting UCC Article 9 to an International Convention: The Local Law Conundrum*, 27 CAN. BUS. L. J. 278 (1996).

UNIDROIT Convention is to provide a framework to displace local law in jurisdictions whose regimes are not friendly to personal property secured transactions. My article offered some principles that, if adopted in the Convention, would overcome the local law conundrum. For the most part, the current draft of the Convention adopts these principles.

One of the principles addresses the local law conundrum in the context of assignments of receivables:

A security interest that is valid and enforceable against a debtor's creditors and trustee in bankruptcy under applicable local law is not rendered ineffective or subordinate by noncompliance with international registration.²⁴

Under this principle, embraced by Article 28(3) of the Base Convention, the Convention would validate interests but would not invalidate interests that otherwise would be valid under applicable local law.²⁵ As explained above, imperfections may exist in the scheme for including assignments of equipment-related receivables within the scope of the Convention, and the risk that an assignee could be unaware of the need to search and register in the international registry still remains. Insofar as that risk would exist under the Convention's regime, the validating-but-not-invalidating principle would lower the stakes for an assignee that took the relevant steps under the applicable local law to validate its position vis-a-vis the assignor's trustee in bankruptcy.

6. CONCLUSION

The Convention's scheme for the assignment of an international interest to carry with it the related receivables is an innovative and ambitious effort to add certainty and safety to an important aspect of aircraft financing. The aptness of the pejorative metaphor of the international interest "tail" wagging the receivables "dog" depends on the circumstances. At least in the context of financing the large commercial aircraft to be covered by the

²⁴ *Id.* at 284.

²⁵ See Base Convention, *supra* note 3, art. 28(3) ("Nothing in this Article affects the validity of an international interest against the trustee in bankruptcy where that interest is valid against the trustee in bankruptcy under the applicable law.").

Convention and the associated payment streams, the approach seems sound. However, the importance of receivables financing in general and the potential for creating a trap for the unwary dictate caution. At a minimum, the approach ultimately followed should be fully vetted with and examined by a wide variety of interested participants in the financial markets.

* * * * *