

Financing Rolling Stock: Luxembourg Rail Protocol Steams Ahead

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Cross-border trade and international law regimes were central themes of this column in February when we discussed the Hague Securities Convention. We continue that theme this month with a preview of another international trade convention: the Luxembourg Rail Protocol to the Cape Town Convention.

The Cape Town Convention (the Cape Town Convention on International Interests in Mobile Equipment (the Convention)) is well known to those experienced in aircraft financing. Like the Hague Securities Convention, the Cape Town Convention was sponsored by UNIDROIT (the International Institute for the Unification of Private Law), an intergovernmental organization whose mission is to harmonize international laws.

The Convention was completed in Cape Town, South Africa in 2001. It applies to specific assets through a "protocol" and its first such protocol, adopted contemporaneously with the Convention, covers aircraft assets (specifically airframes, aircraft engines and helicopters). The "Protocol on Matters Specific to Aircraft" (Aircraft Protocol) came into force in March 2006 when ratified by the minimum 8 countries (including the United States).¹ The Aircraft Protocol has been a clear success. It's effective in close to 70 countries and the international asset registry created under that protocol, located in Dublin, Ireland, has handled over 600,000 registrations.

In February 2007, representatives from 42 nations meeting in Luxembourg adopted a second protocol to the Convention, extending it to another group of mobile assets: rolling stock.² Although not yet in force, the expectation is it will become operational towards the end of 2018 when ratified by at least four countries. The Luxembourg Rail Protocol (the Rail Protocol),

officially the "2007 Luxembourg Protocol on Matters Specific to Railway Rolling Stock," has been ratified by Luxembourg and the European Union in respect of its areas of competence (such as jurisdiction and choice of law), and signed by the United Kingdom, Switzerland, Italy, France, Germany, Gabon and Mozambique. These latter countries, together with Sweden, are now working towards ratification. The registrar has been appointed and the initial regulations for the international registry, which is to be located in Luxembourg, have been drafted.

Today we discuss briefly the Rail Protocol, how it compares to the Aircraft Protocol and its relevance to the United States.

The Convention

The Convention aims to establish enforceable rights in mobile equipment that can be applied consistently across different legal systems. To do this, it creates an internationally recognized security interest, the "international interest," covering the rights of secured creditors, lessors under leasing agreements and equipment vendors under title reservation agreements (such as a conditional sale agreement). It also establishes an Internet-accessible international asset registry for filing of such international interests that not only provides notice to third parties but gives creditors priority against unregistered and subsequently registered creditors, as well as against a debtor's insolvency administrator.

Unlike the Hague Securities Convention, the Cape Town Convention is not a set of choice of law rules (in fact the Aircraft and Rail Protocols defer to the parties' choice of law) and can apply to purely domestic transactions. Instead, much like the Uniform Commercial Code (UCC), it provides for the creation of an interest recognized by all contracting states, provides creditors with a range of basic default remedies, establishes the priorities of creditors' rights, and provides rights and remedies on default or insolvency of the debtor. But it also, unlike the UCC, establishes a means of obtaining speedy interim relief. Most of these rights and remedies can be varied by agreement among the parties.

Railcar vs. Aircraft Protocols

The Rail Protocol applies to railway rolling stock, broadly defined to include vehicles that move on a track or guideway, whether directly on, above or below, and all their components. It therefore covers not just "conventional" rolling stock, such as passenger and freight locomotives and railcars, but also light rail and metro trains, trolleys, monorail vehicles, airport people movers and even cable cars.

Like the Aircraft Protocol, the Rail Protocol establishes a publicly and continuously accessible registry where certain interests in rolling stock may be registered and searched, and, as noted above, respects parties' choice of law and allows interim remedies for creditors (see Article VIII). However, the Rail Protocol does contain some special features. Notably, the Protocol will require that each item of rolling stock be uniquely and permanently identified. Such an identifier, known as the URVIS (Unique Rail Vehicle Identification System) number, will be issued by the registrar on demand. (In certain circumstances, a contracting state may designate an alternative regional or national number with consent of the supervisor which must nevertheless be a unique identifier.) This is particularly significant, because while the aircraft sector was blessed with a uniformly accepted system for identifying airframes and engines, relying on manufacturer and model and serial number, the rail industry was not so fortunate. A uniform numbering system

will not only enable a worldwide registry system for security interests, it will provide other benefits when dealing with rolling stock. For example, it can facilitate location and status tracking, insurers will know which asset is covered by their policies and maintenance programs can be customized according to utilization.³

Unlike the Aircraft Protocol, international interests cannot be created separately over an engine or other traction equipment. Also, contracts of sale are recordable interests under the Aircraft Protocol. They are not under the Rail Protocol, although the Protocol allows notices of sale of rolling stock to be filed but without creating any incremental rights or remedies (although the registered notice may well create rights under domestic law).

Another unique feature of the Rail Protocol is that a contracting state, by prior declaration, can protect the need for public transit (described as rolling stock "habitually used for the purpose of providing services of a public importance"). In certain circumstances, this enables the state to prevent creditors from asserting various creditor rights provided that the party retaining control compensates the creditor by paying it the greater of market lease rental and the amount it would be required to pay under national law. On the other hand, Article VII(5) of the Protocol requires a contracting state to ensure that the relevant authorities expeditiously cooperate with and assist the creditor (subject to safety laws and regulations) to the extent necessary for the exercise of remedies.

Finally, a critical set of protections for creditors of mobile equipment is contained in Article XI and IX of the Aircraft and Rail Protocols, respectively. Article IX provides certain rights in connection with a debtor insolvency but applies only if selected by the contracting state, in this case the state of the debtor's statutory seat (i.e., its registered office or, if there is none, its place of organization). Otherwise, the contracting state's insolvency laws will apply. Under the Aircraft Protocol a contracting state can choose between two alternatives (A and B). The Rail Protocol adds an Alternative C.

Under Alternative A (the "hard rule"), the debtor must within a specified period either cure all defaults or return the equipment. If neither occurs the creditor may exercise all of its rights and remedies. Alternative B (the "soft rule") requires the creditor to specify a period within which the debtor must cure all defaults or allow return of the equipment. However, if the debtor fails to do either within that period, the creditor must seek court authorization to obtain possession. Alternative C is a modified version of Alternative A and gives the debtor or the insolvency administrator the right to apply to court for relief from creditor repossession of the equipment, subject to payment to the creditor of what would be contractually owed during the period of relief and compliance by the debtor with its other obligations.

Is It Beneficial?

For the United States, the key benefit and the one most likely to lower rail financing costs is Alternative A in Article IX, which is modelled after U.S. Bankruptcy Code §1168.

Section 1168 (similar to U.S. Bankruptcy Code §1110 for aircraft) allows secured creditors to exercise rights against a bankrupt debtor free of the bankruptcy automatic stay if such debtor fails to cure its defaults within 60 days of its bankruptcy filing. But 1168 only applies to debtors that are railroads (as defined under Bankruptcy Code §101(44)) and only to "rolling stock

equipment" (used without definition). Moreover, a railroad run by an eligible chapter 9 municipality, such as a transit authority, could be free of the constraints of §1168 altogether. The Rail Protocol, through adoption of Alternative A, will broaden this reach to non-railroad debtors, and, as noted above, encompass a potentially much broader scope of assets.

Under Article 4 of the Convention, the Rail Protocol applies to transactions based on their "connecting factors." Jurisdiction of organization, principal place of business or statutory seat or registered office of the debtor are all sufficient connecting factors to justify application of the Protocol. Financings of U.S.-based manufacturers, banks, operators and lessors will be covered by the Protocol even if the rolling stock is operating outside the United States. In addition, the proposed Luxembourg registry will provide several advantages over the existing filing system for rolling stock maintained at the U.S. Surface Transportation Board (STB). The STB records are currently available only in limited respects after regular business hours and there is no capacity to search specific assets in the STB registry. The conventional rolling stock identifier (either the UMLER (Universal Machine Language Equipment Register) number issued by the AAR or a local operator number) can, and often does, change. On the other hand, as noted above, the Luxembourg registry will be available at all times and searchable against assets based on a unique, uniform non-changeable identifier.

Conclusion

Unlike the Aircraft Protocol, the Rail Protocol is expected to gain sufficient economic momentum from EU and African states' participation to become rapidly a major factor in railcar financing globally. Although the need in the United States for the Protocol is perhaps not as acute as in Europe, the Rail Protocol is beneficial for U.S. manufacturers, lessors and financiers, as well as passenger and freight operators. U.S. manufacturers are major rail equipment exporters and U.S. financiers and lessors have a significant potential market outside the United States. The Rail Protocol will create a common system to protect creditors, both within and outside of each jurisdiction. Participation by the United States will encourage joinder by Canada and Mexico, providing benefits to all three. As international commerce continues to grow, further uniformity of laws across countries will advantage all players in the industry.⁴

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¹ See Alan M. Christenfeld and Shephard W. Melzer, "'Cape Town' sets Framework for International Aircraft Deals," 235 NYLJ __ (June 1, 2006).

² In 2012, the Convention adopted a third protocol extending its coverage to "Space Assets."

³ For further discussion on this, see [Comparative analysis of aircraft, rail and space international registries and their regulatory provisions](#), Rory McPhillips, Howard Rosen, Souichirou Kozuka & Stuart Kennedy, 5 Cape Town Convention Journal, Feb. 7, 2017.

⁴ For more information about the Rail Protocol, see www.railworkinggroup.org