The Luxembourg Rail Protocol : a Major Advance for the Railway Industry

Howard Rosen *

I. – INTRODUCTION

Leasing of movables in its modern form began in the mid-nineteenth century in Britain with the leasing of rolling stock. The world's first registered limited liability leasing company, *Birmingham Wagon Company*, was established in March 1855 and leased rail wagons to British mine owners. By the mid-twentieth century, however, outside of North America, both the infrastructure and the operator typically were State-owned and sometimes run as a government department. Rolling stock was financed either directly through government subsidies, grants or loans or through multinational organisations such as Eurofima, underwritten by governments. Private sector finance was relatively unimportant and international agreements and treaties concentrated on regulating the relationships between the railways, how they operated and how they carried passengers and goods between States.

In some parts of the world, the rail sector is already going through a renaissance; in other regions this development is on the way. The revitalisation of the railway sector is coming in part from the transformation of both State and private rail operators into dynamic competitive undertakings. This, in turn, is changing the way that these companies operate, both in terms of involvement in other parts

* Principal of *Howard Rosen Solicitors*, an English law firm based in Zug (Switzerland); expert consultant on international rail finance matters to the UNIDROIT Study Group for the preparation of uniform rules on international interests in mobile equipment; Chairman of the Rail Working Group responsible for the preparation and implementation of the Luxembourg Rail Protocol. <www.railworkinggroup.org>.

of the transportation sector, as well as investing in rolling stock based on need rather than available (government) funding. Once again, operators are turning to private sector funders to facilitate capital investment through loan and lease finance. In part also the revitalisation is coming by default as governments cease or reduce their direct control and finance of railways, driven by budgetary constraints.

Since 1996, when serious work began on what has now become the Luxembourg Rail Protocol, the market conditions have changed significantly. Whilst few governments have adopted the British privatisation model, there has been a general trend towards commercialisation of the rail sector. In Europe, EU Directive 440/91 (now as amended) [1] has required railway undertakings to account transparently and many have been transformed into corporations, even where the shares have remained in State ownership. Many of these companies are now acting more independently and entrepreneurially than they have in the past. In the intervening years also, markets have been opened to competition, particularly in the freight sector, and other rail operators have taken a more holistic approach to freight transportation incorporating road freight services into what has become a logistics solution. In addition, significant work is being done on harmonisation of technical standards, both at a public level, with the detailed involvements of the *Union Internationale des Chemins de Fer*, and through manufacturers improving their designs of rolling stock so that they can operate in different environments.

In response, banks and lessors in the private sector are increasingly focused on financing railway equipment. New markets are potentially opening up and old ones expanding in relation to assets which are generally stable over an economic cycle. Railway undertakings are also, at times, acting as lessors of their surplus rolling stock.

Historically, there has been no dedicated international legal regime for the financing of rolling stock and, in particular, the

[1] *Directive 2001/12/EC of the European Parliament and of the Council of 26 February 2001 amending Council Directive 91/440/EEC on the development of the Community's railways.*

securing of creditors. Unlike the aviation and shipping sectors, with few exceptions, there are no material registers registering title and security interests. The Luxembourg Rail Protocol,[2] adopted at a Diplomatic Conference in Luxembourg in February 2007, has therefore created a new, sophisticated international legal framework which should dramatically affect the availability and cost of private sector funding for the rail industry in the coming years.

II. – REVISITING THE ARCHITECTURE

As some readers will already know, the Cape Town Convention [3] incorporates an unusual structure whereby the basic objectives are established in the main treaty to which there are then to be protocols for each industry sector. In 2001, both the Cape Town Convention and the Aviation Protocol [4] were adopted and are now in force. In the text of the Convention [5] and the Final Act of the Diplomatic Conference, two further protocols were envisaged, namely for railway rolling stock and space property.

2 *Luxembourg Protocol to the Convention of International Interests in Mobile Equipment on Matters specific to Railway Rolling Stock* (hereinafter: "the Luxembourg Protocol" or "Rail Protocol"), signed at a diplomatic Conference to adopt a Rail Protocol to the Convention on International Interests in Mobile Equipment held, under the joint auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the Intergovernmental Organisation for International Carriage by Rail (OTIF), at the invitation of the Government of the Grand-Duchy of Luxembourg, from 12 to 23 February 2007. See elsewhere in this issue for the text of the Luxembourg Protocol in English, French and German.

3 *Convention on International Interests in Mobile Equipment* (hereinafter: "the Convention"), signed in Cape Town (South Africa) on 16 November 2001 at a diplomatic Conference to adopt a Mobile Equipment Convention and an Aircraft Protocol held, under the joint auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organization (ICAO), at the invitation of the Government of South Africa, in Cape Town from 29 October to 16 November 2001; entry into force: 1 April 2004; text at: <www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf>.

4 *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment* (hereinafter: "the Aviation Protocol"), signed at a diplomatic Conference in Cape Town (South Africa) on 16 November 2001 (see *supra* note 3); entry into force: 1 March 2006; text at <www.unidroit.org/english/conventions/mobile-equipment/aircraftprotocol.pdf>.

5 Art. 2(2).

The Convention creates the status of an "international interest", being a security interest in relation to the secured positions of a vendor under a conditional sale agreement, a lender taking security in an asset under a finance agreement and a lessor in relation to the equipment leased.[6] It creates a system of priorities in relation to these interests which are usually driven by the fact and timing of their registration in an international registry operating "24/7", 365 days a year, and accessible through the Internet. The Convention then goes on to provide basic default and insolvency-related remedies for the creditors including even remedies for interim relief pending final determination of claims. Lastly, the Convention introduces a specific regime for the construction of the international registry, directing the establishment of a Supervisory Authority and a Registrar, their respective liabilities and setting out modalities of registration.

Another important part of the Cape Town Convention's architecture was to establish a detailed system of opt-ins, opt-outs and reservations, which system has been continued into the protocols, giving various areas of flexibility for Contracting States to adapt the protocol to their local circumstances, but on the other hand relying on market – and hopefully political – forces to ensure that the whole project does not become a "*treaty à la carte*".[7]

So, the Cape Town Convention provides the platform to be modified as dictated by industry constraints and requirements by the individual protocol for the respective industry. The Luxembourg Protocol, therefore, was not simply to be an application of the Cape Town Convention to the rail industry, but is a detailed mechanism for modifying and adapting the Cape Town Convention and, as already discussed in previous articles,[8] the Luxembourg Protocol had to face and find solutions for some difficult legal issues, some of which are reviewed in detail below.

6 Each of these parties is hereinafter referred to as a "creditor" and respectively the purchaser, borrower and lessee are hereinafter referred to as a "debtor".

7 See also Part IV below.

8 See H. ROSEN, "Creating an International Security Structure for Railway Rolling Stock: an Idea Ahead of its Time", *Unif. L. Rev. / Rev. dr. unif.* (1999), 313; *idem*, "Building a Railway to the Future – Progress on the draft UNIDROIT/OTIF Rail Protocol", *Unif. L. Rev. / Rev. dr. unif.* (2001), 50.

III. – CONFRONTING THE KEY ISSUES

1. Defining rolling stock

"Railway rolling stock" was defined as

> "vehicles movable on a fixed railway track or directly on, above or below a guideway, together with traction systems, engines, brakes, axles, bogies, pantographs, accessories and other components, equipment and parts, in each case installed on or incorporated in the vehicles, and together with all data, manuals and records relating thereto." [9]

This description masked a significant discussion both before and during the Diplomatic Conference. In principle, the intention has always been to define such equipment as broadly as possible to make the Protocol as inclusive as possible. So there is no doubt that included in the definition are not just conventional trains, *i.e.*, locomotives and either passenger or freight wagons, but also trams and mountain railways as well as maglev and monorail transportation equipment – technically not rolling at all, but either hovering above or suspended below a guideway. On the other hand, equipment running on rubber tyres, generally considered to be rolling stock in the industry (for example, metro trains in Paris or in Montreal), or inter terminal shuttles at many airports, are not vehicles with flanged wheels running on tracks but do qualify since they are either running on or beside guideways. Certainly there is still room for ambiguity. A case could be made for including in the definition cable cars suspended under a fixed cable or, perhaps in the future, ordinary motorised vehicles where they are guided by subterranean or GPS-type guidance systems, and it could also be argued that the definition applies to toy trains, but this is clearly not the intention.

More fundamental is the inclusive nature of the definition. As in the aviation sector, a driver in the whole project from the outset has been the exceptional risk for funders financing movable assets which by their nature cross borders, but it was recognised early on in the drafting process that it was impossible to differentiate between equipment types which *did* cross borders and which potentially *could*

[9] Art. 1(e) of the Luxembourg Protocol.

cross borders. There are even examples of tram systems crossing borders (*e.g.* the Tijuana trolley between San Diego and Tijuana).

There remains a safety valve. Article 50(1) of the Convention retains the concept of an internal transaction. This empowers a ratifying State to disapply the Convention (subject to the exceptions in Article 50(2)) to an "*internal transaction in relation to that State with regard to all types of objects or some of them*". Article XXIX(2) of the Luxembourg Protocol then stipulates that for the purposes of the Protocol, in respect of an internal transaction, exclusion is only possible

> "where the relevant railway rolling stock is only capable, in its normal course of use, of being operated on a single railway system within the Contracting State concerned, because of track gauge or other elements of the design of such railway rolling stock."

This provision is somewhat awkwardly drafted because the concept itself is somewhat clumsy. The problem is that one can only exclude the application of the Convention by reference to the *type* of rolling stock and not to its *assignment*. The use of the term "transaction" implies that the application of the Convention can be excluded by reference to a particular use or user of the rolling stock. But this is hopelessly impractical since any Registry will have to track all rolling stock of a particular type. In other words, the only sensible exclusion is by reference to the type of rolling stock itself and not by reference to its mission, as there can be no other intention behind Article XXIX(2) other than to empower a ratifying State to exclude certain *types* of rolling stock (for example, rollercoaster trains at fair grounds).

2. Identification of rolling stock

There are actually two identification points. Article V introduces a liberal regime for identification of rolling stock for the purposes of complying with the formal requirements under Article 7 of the Convention for the constitution of the international interest and for the applicability of Article XVIII of the Luxembourg Protocol, relating to waiver of sovereign immunity. So, for these purposes, it is sufficient to describe the rolling stock either by item or by type or by reference to any general statement relating to assets being pledged by a

debtor. So, for example, rolling stock covered, with other assets, under a floating charge, even though not identified specifically by item, would be sufficient to permit the creation thereon of an international interest. Again, the intention is to make the Protocol as inclusive as possible.

Having constituted the international interest, however, that interest has to be registered and here there is a heavier identification requirement, quite naturally, since the Registrar has to note what is being registered with precision.

Article XIV(1) of the Luxembourg Protocol provides that there has to be a unique identifier of the rolling stock. The identification number will be allocated by the registrar and shall be either:

> "(a) affixed to the item of railway rolling stock;
>
> (b) associated in the International Registry with the manufacturer's name and the manufacturer's identification number for the item so affixed; or
>
> (c) associated in the International Registry with a national or regional identification number so affixed."

In the Aviation Protocol, identification was never a problem. There are a limited number of manufacturers and each allocates a unique serial number to each aircraft produced. By combining the manufacturer, model and serial number, there is clearly a unique identifier. Unfortunately, this is not so easy in the railway industry. It is, hopefully, reasonably obvious why a unique identifier has to be allocated to an asset. The Registrar is noting specific security interests in relation to a specific asset. If the identification of the asset changes, there is then a risk that other parties will claim security interests in the same asset with its changed identification. There is even, however, some discussion as to what "unique" means. Is it an identifier which at the time of registration is unique or an identifier which at all times is unique and cannot be replicated? It must be the latter. If a number may be recycled, even in ten years' time, this in itself would undermine the integrity of the registration system.

Ideally, there should be no reason not to adopt the same approach as the Aviation Protocol and now the International Registry for Aviation Equipment, namely always focusing on the manufacturer and the serial number and the model. Unfortunately,

this does not necessarily work in the railway industry for various reasons. Models can change and there is a question as to how uniform the model description system is worldwide. In addition, some older rolling stock apparently does not have a manufacturer's serial number and even in more modern rolling stock, the serial number is not always immediately apparent for the purposes of any inspection. If, for example, it is stamped on the chassis and is not otherwise locatable, this would cause significant problems in being able to identify the specific asset covered by any registration. The diversity of manufacturers in the rail sector with different numbering systems also creates a problem of uniformity as well as practicality.[10] Industry practice has, in some parts of the world, traditionally focused on identifying rolling stock by reference to numbers generated through an international or national agency or under its rules (for example, the RIV/RIC numbers in Europe and the UMLER numbering system in North America, where there is a potential for these numbers to change). This all presented a significant dilemma to the drafters of the Luxembourg Protocol.

The solution reflected a binary approach to the problem. In principle, clearly, a unique identification system driven by manufacturer (non-recyclable) serial numbers, which are visible on physical or electronic inspection, is the ideal approach. This does, however, require more coordination between manufacturers to create a broadly common system with, possibly, manufacturers agreeing collectively to allocate specific identifications to specific manufacturers and an agreed discipline within each manufacturer to ensure that no single serial number is allocated to two different types of rolling stock it produces.

All of this is logical. A manufacturer needs to identify specifically items of rolling stock which it produces in case of any complaint or even accident which could result in contractual or public liability. Further, the opening up of the rail sector requires there to be an independent system for ensuring that the rolling stock is fit to run on the railway system, administered separately from the railway undertaking. In the past, where this was only a State undertaking, this

10 For example, if part of a manufacturer's serial number included Cyrillic script which the Registry would not be able to process.

was regulated simply by agreement between the railways themselves. Today that is no longer possible and the new system established, for example, by the European Union for controlling the "immatriculation" of rolling stock will need to have a consistent record of exactly what maintenance or problems have affected a specific item of rolling stock.

If this is the ideal scenario, the industry has to accept that as of the date the Protocol will probably come into force, a universal unique numbering system based on non-recyclable manufacturers' serial numbers may not be possible. An interim solution, therefore, has to be found for at least some jurisdictions and this is the background to Article XIV(1)(b) and (c). Here, the unique number has to be generated within the Registry and then associated with the non-unique number on the rolling stock. This is, of course, a more complex system as it requires the Registry to keep a library, hopefully noting where numbers have changed on the rolling stock. It will be up to the creditor to ensure that all changes of numbers are properly registered with the International Registry, with the risk of conflicting claims if this is not done properly. This will certainly be one of the tougher problems for the Registrar as the Protocol is implemented. Also the Supervisory Authority will need to be firm on how it accepts alternative unique identification systems and not be tempted to compromise on inadequate systems.

3. Insolvency

The Luxembourg Protocol does not entirely follow the model of the Aviation Protocol in relation to the way that it deals with creditors' rights on the insolvency of a debtor. In the Aviation Protocol, the Contracting State which is the primary insolvency jurisdiction has the option of either disapplying the specific remedies contained in Article XI of the Aviation Protocol or adopting one of two alternatives, with Alternative A being a strong pro-creditor provision, and Alternative B being a much weaker provision making it significantly more difficult for the creditor to repossess assets following an insolvency. In particular, it requires the creditor to work through a court, which means a significant delay before an asset may be repossessed.

Whilst not rejecting the two possible alternatives which could be adopted, Article IX of the Luxembourg Protocol introduces an Alternative C which in many respects adopts the same system as Alternative A but provides a fallback position for the debtor to apply to the court under certain circumstances and therefore may be viewed by certain States as being more balanced. In particular, under Alternative C in paragraph 4, it stipulates that before the end of a cure period,[11]

> "the insolvency administrator or the debtor, as applicable, may apply to the court for an order suspending its obligation under sub-paragraph (b) of the preceding paragraph for a period commencing from the end of the cure period and ending no later than the expiration of the agreement or any renewal thereof, and on such terms as the court considers just (the "suspension period")."

The logic behind Alternative C is to give the debtor recourse to the courts for protection if necessary but only on the basis that the creditor's financial position is not materially damaged. So, the second sentence of paragraph 4 states that any court order

> "shall require that all sums accruing to the creditor during the suspension period be paid from the insolvency estate or by the debtor as they become due and that the insolvency administrator or the debtor, as applicable, perform all other obligations arising during the suspension period."

Paragraph 8 of Alternative C also provides for the court order to cease to have effect and generally restores the position prior to the insolvency if the insolvency administrator or, if it is in possession still, the debtor, agrees to cure all defaults (obviously other than the default caused by the insolvency proceedings themselves) and agrees to perform all future obligations under the relevant agreements. As with Alternative A, there is no second bite of the cherry. If things go wrong again, the debtor or insolvency administrator, as appropriate, will have no further right under the Protocol to require a court to intervene to suspend the repossession of the asset.

11 Paragraph 15 stipulates that the exact cure period will be specified in a declaration of the Contracting State which is the primary insolvency jurisdiction.

4. Liability of the Registrar

Article 28 of the Convention provides very clearly that the registrar should be liable for compensatory damages for loss suffered directly resulting from an error or omission of the Registrar, its officers or employees or from a malfunction of the Registry (subject to certain caveats). Article 28(4) requires the Registrar to obtain suitable insurance cover to the extent determined by the Supervisory Authority. The thinking behind this provision was certainly that, although the Supervisory Authority has absolute immunity as an international organisation,[12] this should not apply to the Registrar since it will not be a public agency. Moreover, it will be providing services on an economic basis and creditors need to have the security of recourse to the Registrar if there is a failure at the Registry level.

Prior to, and at, the Luxembourg Diplomatic Conference there was detailed discussion on this provision driven by two factors. It was a guiding principle of the drafters (and certainly of the Rail Working Group) that the cost of registration should be kept as low as possible. The Rail Working Group was strongly opposed to creating a cost structure which would discourage registration or otherwise make it a heavy burden on operators (who either directly or indirectly would carry the registration costs). By the time the Aviation Protocol came into force, it became clear that the insurance required to cover the liability of the registrar was surprisingly expensive and at the same time was limited to an annual amount. On the other side, the assets of the International Registry, being the proprietary rights in the databases and archives, belong to the Supervisory Authority [13] and in any event these are immune from seizure or other legal or administrative process.[14] As a result, whilst the Registrar theoretically had unlimited liability, it had no assets other than rights under an insurance policy, a limited initial capital and retained profits, with which to discharge any liability. The argument therefore was that by ascribing unlimited liability to the Registrar, the Convention gives the impression to creditors that such liability could be discharged,

12 Art. 27 of the Convention.

13 Art. 17(4) of the Convention.

14 Art. 27(4) of the Convention.

whereas practice subsequent to the adoption of the Convention and the Aviation Protocol showed that it is impossible to insure for an unlimited liability. This analysis produced a somewhat unusual, and counterintuitive, conclusion that whereas normally insurance follows the liability, in reality, liability levels would be dictated by the level of insurance available on the assumption that there would be few additional assets to satisfy any claims. Moreover, even the level of liability insured for the International Registry registering interests in accordance with the Aviation Protocol threatened to impose an unacceptable cost burden on the proposed analogous registry under the Rail Protocol.

A number of delegations at the Diplomatic Conference stated that constitutionally, they could not accept a position where it was left to the Supervisory Authority to determine the level of liability of the Registrar without constraint. These States were comfortable with the Supervisory Authority increasing the level of liability but not with its reducing it. Article XV(5) of the Protocol therefore establishes a base liability of 5 million Special Drawing Rights (SDRs) in any calendar year but empowers the increase of the liability to "*such greater amount, computed in such manner, as the Supervisory Authority may from time to time determine by regulations.*" The minimum level of liability specified there is rather low by industry standards and the clear understanding was that the liability would be increased by the Supervisory Authority as long as insurance cover was available at an acceptable cost. This intention was reinforced by Resolution 6 of the Final Act of the Luxembourg Diplomatic Conference which resolved to "*invite the Supervisory Authority to consider the desirability of reviewing the liability limit provided for …… at the earliest possible opportunity, subject to the finding of the necessary insurance cover.*"

In fact, this process is already running and with the experience of the Aviation Protocol, to date there having been no reported claims during nearly two years of operation of the International Aviation Registry, it is anticipated that insurance cover will become cheaper and would be available for a higher amount than the level prescribed in Article XV(5) and, in particular, based on a per incident claim as well as an annual limit. There is an interesting question as to whether, having set a higher liability level, the Supervisory Authority

may, by regulations, reduce the level of liability as long as the liability level is at least 5 million SDRs. It is argued that this is possible, but only prospectively for subsequent registrations and in relation to existing registrations where the event on which any claim is based occurs after the effective date of the reduced liability level.[15] It may be argued that there is a contract between the registering party and the Registrar which precludes the registrar or the Supervisory Authority unilaterally changing the level of liability for an existing registration. Although this has the force of equity, the problem is that if there is no insurance cover, as a matter of fact the higher liability level is meaningless. In this case again, both the Registrar in any terms and conditions and the Supervisory Authority in regulations will need to make it clear that even in relation to existing registrations, any change of the liability level applies equally to existing registrations as long as the event causing the claim takes place after the change.

A further interesting question is whether the per incident liability can be set at below 5 million SDRs. The logical interpretation of Article XV(5) is that it cannot, because there is only scope for the Supervisory Authority to set a liability level if it exceeds 5 million SDRs. This, it is submitted, must apply both to the annual liability or the per incident liability. So, for example, it would be perfectly proper for the Supervisory Authority to set a per incident liability level at 6 million SDRs and the annual aggregate liability at 30 million SDRs, but it could not set the per incident liability at 5 million SDRs or less, even if the annual aggregate annual liability figure was higher.[16]

15 Probably the Supervisory Authority will be well advised to introduce a cut-off period in its regulations so there is a limited "overhang" of any historical claims at a level above that for which the registrar is subsequently insured.

16 Of course, there also remains the difficult problem as to what happens if the registrar's annual liability is exceeded by the value of the claims on it in any particular year. Is there then a pro rata allocation for all the claims and, if so, must the registrar wait until the end of a specific year to evaluate the level of potential claims before paying out on any of them? It will be essential that the aggregate level of liability is set at a sufficiently high level to ensure that these questions, in practice, remain theoretical ones.

5. Public service exemption

The Luxembourg Protocol will provide more secure, and therefore cheaper and more readily obtainable finance, facilitating more capital investment, lower operating costs and an expansion of the choice of finance available. This must be in the public interest. However, an essential element of the "Luxembourg regime" is the provision of a clear universal system for creditor (re)possession of rolling stock on default by the operator under the financing contracts or due to its insolvency and there is also a public interest in keeping the trains running. Reconciling these two objectives has been one of the most difficult challenges facing the drafters of the Luxembourg Protocol. The response has been an unusual one, resulting in a key provision of the Protocol which deals with the problem with some subtlety.

Chapter III of the Convention sets out in detail the remedies available to a creditor, which has registered its international interest, on the occurrence of a default by a debtor. In particular, it provides that in principle, such a creditor may, on a default, subject only to superior registered international interests, take possession or control of the asset and/or sell or grant a lease in such asset and/or collect or receive income or profits from the management or use of such asset. There is provision for application to the court if necessary in order to exercise remedies as well as for interim relief including for orders preserving and maintaining the rolling stock, for possession, control or custody thereof and its lease or management until any dispute is fully resolved.

This would all seem to be perfectly logical, but in the case of the railway sector, the economic effect of repossession could be disproportionate to the damage suffered by the creditor if repossession does not take place. A creditor taking possession of commuter rolling stock could mean many thousands of passengers stranded on station platforms, not being able to get to work, with consequent huge loss of productivity for the community. Not just because commuters are voters (but this is certainly a factor), governments are understandably reluctant to contemplate such a situation without certain safeguards.

In his commentary on the Cape Town Convention, Professor Sir Roy GOODE QC states that the Convention is governed by "five underlying principles": Practicality, Party autonomy in contractual relationships, Predictability in the application of the Convention, Transparency and Sensitivity to national legal cultures "in allowing a Contracting State to weigh economic benefits against established rules of national law to which it attaches importance." The discussions on the "conflict of public interests", guided by these principles, resulted in a formula set out in Article XXV of the Luxembourg Protocol which elaborates the so-called "public service exemption". This groundbreaking provision does not occur in the parallel Aviation Protocol and it represents a carefully engineered solution balancing the public interest for competitive finance with the public interest to keep rolling stock rolling even after a debtor default or insolvency. Article XXV however has more facets to it than is immediately apparent, as will become clear.

Article XXV(1) provides that:

> "A Contracting State may, at any time, declare that it will continue to apply, to the extent specified in its declaration, rules of its law in force at that time which preclude, suspend or govern the exercise within its territory of any of the remedies specified in Chapter III of the Convention and Articles VII to IX of this Protocol in relation to railway rolling stock habitually used for the purpose of providing a service of public importance ('public service railway rolling stock') as specified in that declaration notified to the Depositary."

At first glance, this is a disaster for the secured creditors. It appears to abrogate the most important provisions of the Protocol by giving a Contracting State the ability to override the Protocol's default and insolvency remedies. But two points should be immediately noted. Firstly, the Contracting State must make a declaration, on or subsequent to ratification, specifying which rules of law will apply in these cases. Such declaration will be public record and available to all creditors. So, in principle, the creditor will know what it is getting itself into if it provides finance for rolling stock operating in a country making such a reservation.[17] Because the

[17] It is clear that any reservation cannot have retrospective effect (Art. XXV(5)).

creditor's risks will rise, so will the risk premium it will add on to its funding costs in calculating payments to be made by the debtor. A State proposing to make such a declaration can expect to come under pressure from rail operators because it will put them in an adverse competitive position both compared to other international rail operators and to transportation companies in the rival aviation and road sectors.

Secondly, the declaration can only be made in relation to *"railway rolling stock habitually used for the purpose of providing a service of public importance."* It will be for the Contracting State making a declaration to determine exactly what comes within this category, but the intention of the drafters is clear. Whilst it can be argued that there is a general public interest in every item of rolling stock operating as there is in every car or aircraft running to maximum efficiency, the focus of this provision is on rolling stock which is used *habitually* for this purpose (and not occasionally) and the criterion is "public importance" (and not just "public interest"). We can expect therefore that it will apply principally in the passenger rail sector (and not definitively apply to the whole of the sector) and then subsidiarily in the freight sector to the extent that a wagon qualifies – for example if it transports nuclear or other materials relating to public security (where the use will be habitual since it is unlikely to be used for much else). It should be noted that the public service exemption was only reluctantly extended to freight rolling stock and the extension should be construed narrowly. It is an open question to what extent the public service exemption can apply to locomotives, since many can be swapped in and out and technically are providing locomotion to the rolling stock providing the public service. Probably, however, dedicated locomotives which are part of train sets will come within the category if a ratifying State so determines.

Nonetheless, Article XXV(1) on its own is an unsatisfactory solution even with the caveats mentioned above. But this is not necessarily an insuperable problem. The creditor's position should be that it is entitled to the benefit of its bargain. If it can continue to receive the monies for which it contracted, then it will be no worse off if it does not repossess the assets notwithstanding the debtor default or insolvency. The starting expectation, therefore, was (and remains)

that a State wishing to freeze or suspend the (re)possession of rolling stock by a secured creditor, notwithstanding a debtor default or insolvency, will have to pay the amounts to the creditor to which the creditor was entitled assuming that a default or insolvency had occurred, with such obligation commencing from the date the government, or an agency appointed by it or another party, would take possession of the assets. Moreover, any party taking this secondary possession would have to have an obligation to maintain the assets from the time of possession until the time they were restored to the creditor. The British government broadly has adopted this "step in" approach through statute [18] and contract as part of its privatisation of the British railway system in 1996.[19]

Accordingly, Article XXV(2) and (3) specifically provides for this:

> "2. Any person, including a governmental or other public authority, that, under rules of law of a Contracting State making a declaration under the preceding paragraph, exercises a power to take or procure possession, use or control of any public service railway rolling stock, shall preserve and maintain such railway rolling stock from the time of exercise of such power until possession, use or control is restored to the creditor.
>
> 3. During the period of time specified in the preceding paragraph, the person referred to in that paragraph shall also make or procure payment to the creditor of an amount equal to the greater of:
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> (a) such amount as that person shall be required to pay under the rules of law of the Contracting State making the declaration; and
>
> (b) the market lease rental in respect of such railway rolling stock …….."

Do note the delicate phrasing in paragraph 3(b). The secondary possessor, either a government, a government agency or another party appointed by a government, is not required to underwrite the rental or debt payments contracted to be paid by the debtor. If it steps in, it will have to pay the greater of the amount required to paid under local law or the market lease rental. This is because this is

18 S. 30 Railways Act 1993.

19 But note that this applies only to carriage of passengers and then does not impose an obligation to step in if and to the extent that "*adequate alternative railway passenger services are available*".

part of the bargain. The creditor still takes a credit risk on the debtor but its remedy of being able to recycle the asset, with the revenue that would be generated after such recycling, is what it is entitled to when the secondary possessor steps in, not the contractually agreed rent or repayment. In other words, the creditor is restored to the position it would have had had it repossessed, not to the position that it would have if there was no default. There is no debtor guarantee. If a creditor backloads lease rentals so that the payments are delayed and in later years exceed the market lease rental, this still represents a risk for the creditor.

Unfortunately, this is not the end of the story either. Some States represented at the Diplomatic Conference had constitutional constraints on agreeing in advance the protections for the creditor mentioned above. Effectively, they needed to reserve the possibility of the government or an agency thereof blocking the (re)possession of rolling stock by a creditor without compensation. This does not mean that those delegations were unaware of the effect of such a caveat. On the contrary, they were acutely sensitive to the fact that to preserve such a right, which to some would appear to be confiscation, would fundamentally undermine the possibility of financing rolling stock in their country through the private sector. So Article XXV(4) provides that where a Contracting State wanted to disapply the maintenance and compensation obligations in paragraphs (2) and (3), it would have to make a separate declaration specifically stating this.

Article XXV(4) is not a provision generally permitting governments to exclude repossession rights without any measure of compensation or corresponding obligations from the party assuming the assets or stepping in to operate them. It is merely a facility whereby a Contracting State could, in theory, make such a reservation knowing well that this would demolish a key pillar of the Protocol with the corresponding negative effect on the local rail industry. Such States are reminded that in making any declaration under Article XXV, they must

> "take into consideration the protection of the interests of creditors and the effect of the declaration on the availability of credit." [20]

20 Art. XX (6).

Just as importantly, the structure of Article XXV gives a State the flexibility to change its position [21] after ratification by modifying or withdrawing declarations once any "offending" local legislation is removed. In other words, it is up to the industry – manufacturers, operators and financiers – to work together to ensure that governments realise the effect of making such reservations and hopefully to ensure that they do not do so.

6. Non-financed equipment

In the Aviation Protocol, it was clear from an early point in its drafting that it would apply also to sales and, in particular, treat a contract of sale in the same way as an agreement creating or providing for an international interest with the various follow-on consequences.[22] The treatment of sales as if effectively they were types of international interests, subject to the exceptions stated in Article III of the Aircraft Protocol, was probably unavoidable due to the fact that national aircraft registries record both title and, usually, charges on aircraft. With the lack of national rail registries in most parts of the world, this was not an automatic requirement in relation to the Rail Protocol and the initial view had always been that the Cape Town Convention was intended to deal with security interests and not absolute title interests or documentation evidencing such.

Relatively late, the rail industry perspective changed and it was considered that creating a mechanism which would also deal with sales was desirable. The principal reason for this change was the objective of making the Protocol as inclusive as possible. There was concern that, due to a significant part of currently operating rolling stock being owned absolutely by State or private railways using finance not directly secured on the rolling stock, these assets would be excluded from any benefits of the Protocol and there would be no way for a potential purchaser or financier of an item of rolling stock to verify if another party had an interest in the asset. Perversely, it put owners who had not financed rolling stock, nominally probably a better credit, in a worse position than those who had already done so because there was no ability for the creditor to verify competing

21 In relation to future financings – Art. XXV(5).

22 Art. III of the Aviation Protocol.

claims. It was, however, also decided that it was not necessary to incorporate the (notice of contract of) sale itself into the Cape Town regime in the same way that the Aviation Protocol had done and the compromise may be found in Article XVII of the Protocol. This Article establishes an informational register to run alongside the registry of international interests at the International Registry. The consensus was that by facilitating owners placing into the public domain effectively a notice of their interest [23] in the asset, on a practical basis all creditors would check this Registry to ensure that there was no rival claim and this would go a long way to preclude any fraudulent financing.

In the Aviation Protocol, there is a distinction made between a prospective sale and an actual sale. The prospective sale is derived from an agreement to sell, whereas the actual sale involves the transfer of ownership. It is submitted that, taking this into account, the only reasonable interpretation of Article XVII of the Rail Protocol is that it creates the ability to register a notice of the transfer of title itself. What the Registry is *not* providing is a registration of title interests; it is registering the transfer of title interests. Accordingly, the Registrar will need, in due course, to accumulate details of the transfer and not simply that a particular party owns an item of rolling stock. The consequence of this will be, of course, that a manufacturer will not be able to register its title as such and in fact only the second owner will be able to register due to the fact of the sale from the manufacturer to it in accordance with Article XVII.[24]

Lastly, it is important to note that this is not an optional facility in relation to the Registrar. Article XVII is mandatory on the Supervisory Authority to set out regulations authorising the registration of notices of sale.

7. Legacy issues

Once such a powerful instrument as the Luxembourg Protocol is in place, there will be pressure to apply it also to interests arising under transactions in existence prior to the Protocol coming into force. As a

23 Technically a notice of sale.

24 The manufacturer certainly will be able to register a notice of sale if it transfers the assets from its production company to a sales company.

legal principle, however, this is untenable, since it could retrospectively reset the priorities of security interests already in existence without the consent of the concerned parties.

The general principle, as stated in Article 60 of the Convention, is that unless otherwise declared by a Contracting State at any time, the Protocol does not apply to a pre-existing right or interest and in this context this does not just cover the priorities but all the remedies. This can be the only conclusion applying Article 3 of the Convention which provides that it applies if the debtor is situated in a Contracting State "*at the time of the conclusion of the agreement creating or providing for the international interest.*" Unlike the Aviation Protocol, the Rail Protocol provides a specifically revised mechanism for a Contracting State to apply, by declaration, the Protocol's priorities to pre-existing interests created in the Contracting State prior to the date of the Protocol coming into force in that State. The declaration will set out a transitional period ending no earlier than three years and not later than ten years after the effective date of the declaration during which pre-existing interests may be registered and retain their pre-existing priority.[25] This follows a general principle of making the Protocol as inclusive as possible. It is surely undesirable to leave a two-tier security recognition system in place for any prolonged period. What the revised Article 60(3) does not do is extend applicability of the Protocol to a pre-existing interest created at a time when the debtor was not situated in the declaring State, even though it may be situated there at the time of the declaration, nor does the Protocol extend the remedies or the other rights to creditors in relation to pre-existing interests which can be brought within the scope of the Protocol. It only gives them the ability to perfect their priority position but they will then need to rely on local law to enforce it, for example, on a default by the debtor.

It could be argued that these distinctions offend against the principle of inclusiveness. The first exclusion is surely correct in that, if a debtor was situated in another Contracting State also making a declaration under the revised Article 60(3), there would be a conflict as to when the Protocol's priorities would become applicable. The

25 Art. XXVI, providing for a revised Art. 60(3) of the Convention as it is applied by the Rail Protocol.

second exclusion is more troubling. If the priority protections of the Convention can be extended to pre-existing interests, why should they not also have the concomitant remedies set out in the Convention to enforce their rights? Certainly there is nothing preventing a Contracting State importing those remedies into local law at the same time as making a declaration (and it is submitted that this would be a logical course of action), but Article 60 of the Convention only deals with priorities and perhaps it was felt that it was a step too far to provide for the automatic allocation of the Convention's remedies to holders of pre-existing rights once the Convention's system of priorities was applicable. The primary intention of Article 60 was to create a cut-off date beyond which pre-existing priorities would lapse (without registration), not to extend the Convention as such to pre-existing interests. Moreover, an automatic variation of the pre-existing contractual remedies with retrospective effect may not be without precedent, but it is a step not to be taken lightly.[26]

The inescapable conclusion will be that if a creditor wishes to ensure that it has all of the Convention rights in relation to its secured position arising under an agreement concluded prior to the entry into force of the Protocol in the location where the debtor was then situated, assuming of course that the debtor remains in the jurisdiction which has now adopted the Protocol, the best option would appear to be to execute an additional agreement creating a new security interest, thereby effectively side-stepping the effect of

[26] The registrar may, in practice, be tempted to accept registrations without verifying whether the debtor was situated in a Contracting State at the time the (asserted) international interest was created. It is submitted, however, that this would be a mistake since not only does it cut across the intention of the revised terms of Art. 60(3) specifically dealing with pre-existing rights but it can ultimately affect the reputational integrity of the registry if there is uncertainty as to whether the registered interest in fact qualifies to be registered. This may be resolved by the registrar requiring the registrant simply to state the country in which the debtor was situated (pursuant to Art. 4 of the Convention) at the time the interest was created and the date the interest was created. By cross-checking against the date the Protocol comes into force in that Contracting State, the registry should be able, automatically, to ascertain whether the interest which is sought to be registered in fact was an international interest at the time it was created and, therefore, is registrable either as an international interest or as a registrable pre-existing interest pursuant to the declaration by the relevant Contracting State under Art. 60(3).

Article 60. But there is also a trap here. The normal approach would be to re-execute a document restating the existing security interest. Either expressly or impliedly, this would supersede and replace the original security interest created. The difficulty with this approach is that this could result in the loss of the priority position on the pre-existing interest since other creditors' pre-existing interests which are subordinate to the creditor's pre-existing interest will then take priority, under the revised terms of Article 60(3), over the newly created security interest. The only watertight solution to preserve the priorities and the remedies for the first creditor is to leave the first creditor's pre-existing security interest in place, register it and then create a *second* security agreement with an effective date on or after the date that the Protocol comes into force in the relevant Contracting State.

IV. – THE WAY AHEAD

The train has left the station and it is picking up speed but certainly it is nowhere near its destination. The Final Act of the Diplomatic Conference passed two important resolutions in relation to the implementation of the Luxembourg Protocol. Resolution 1 established a preparatory commission to act effectively as a provisional Supervisory Authority. The resolution sets out in detail the constitution of the preparatory commission and directs the commission to prepare regulations and procedures for the international registry as well as initiate the selection process for the Registrar. Both of these duties are significant tasks. Draft regulations have been prepared but are subject to continuous discussion. The intention is that they will be published in draft form before coming into force but work is still proceeding on establishing not just which areas they cover but also how issues such as registrar liability will be dealt with in the regulations. The request for proposals from parties wishing to tender to operate the registry has been completed but the selection process has yet to begin. For various reasons, not least because of the significantly higher quantities of rolling stock compared to aircraft, it will not be possible just to extrapolate the system operated currently by Aviareto, the International Registrar under the Aviation Protocol.

A further duty of the preparatory commission, which arises from the Protocol itself rather than the resolutions mentioned above, will be to review and validate rolling stock identification systems to the extent that identifiers are proposed other than manufacturer's serial numbers. This will involve not just ascertaining whether a system works as a unique identifier but also ensuring that the registry is able to cope with the layer of complexity that such a system will create.

The second major work to be completed before the Protocol moves forward is the official Commentary which was mandated in Resolution 4 of the Final Act. Professor Sir Roy GOODE, the rapporteur of the Diplomatic Conference, is preparing this and, as with the Aviation Protocol, there is no doubt that his Commentary will be the Bible for every practitioner dealing with issues arising from the Luxembourg Protocol.

Seminars are beginning to mention the Luxembourg Protocol. Articles are being written and the railway community is beginning to understand both the potential of, as well as the necessary procedures which will be required following, the adoption of this Protocol. There will need to be pro-active work within the rail industry, co-operating within the private sector and with government agencies to create a visible, secure and unique asset identifier. We need to stimulate governments to adopt the Protocol and to excite them about the way it can open up highly cost-effective private finance structures both in the developed and developing world as well as in the countries recently described by Professor Collier as the "Bottom Billion", as an alternative to aid payments.[27]

We need to demonstrate to governments, when ratifying, the need to avoid the temptation of reserving rights to block creditor repossession on default or insolvency. Most importantly, contiguous States should be encouraged to adopt the Protocol as much as possible in the same way with the same reservations and options. Here a *treaty à la carte* becomes a real practical danger. The more divergences there are in a contiguous geographical area (for example Europe or North America), the more difficult it will be for practitioners to operate under the Protocol efficiently and

[27] P. COLLIER, *The Bottom Billion – Why the Poorest Countries are Failing and What Can Be Done About It*, Oxford University Press (2007).

effectively. Inevitably, with different national priorities within such geographical areas, this also will be a challenge.

V. – CONCLUSION

It has taken about twelve years to move from the germ of an idea to an effective international legal instrument providing a new level of security for the private sector financing rolling stock across the world. The Luxembourg Protocol has had to confront a number of difficult legal issues as part of its adoption process. Generally, it has dealt with those issues in accordance with Professor Goode's five underlying principles of Practicality, Party autonomy in contractual relationships, Predictability, Transparency and Sensitivity to national legal cultures. It has not always been easy and there are difficult discussions ahead in relation to the way that the Luxembourg Protocol can be implemented in practice. Unique identifiers remain a problem; unrestricted repossession on default is another; registrar liability is still an open issue. It is clear, however, that the Protocol as now adopted on 23 February 2007 in Luxembourg clears the way for a greater role for efficient private sector finance of rolling stock and as such will play a significant role in the renaissance of the railway industry around the world in the 21st century. The directors of the Birmingham Wagon Company would have approved.

* * *

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