

Feature

KEY POINTS

- ▶ The Luxembourg Rail Protocol is part of the regime established by the 2001 Cape Town Convention on International Interests in Mobile Equipment to provide for an internationally recognised interest in railway rolling stock.
- ▶ It applies equally to rolling stock moving across country/jurisdictional border and stock operating on local closed, eg tram, systems.
- ▶ There are options available for each country to decide on the insolvency provisions that will apply in that country.
- ▶ Special provisions to require lessors and financiers to make rolling stock available where a service is a service of public importance.

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All tracks lead to Luxembourg: the Luxembourg Rail Protocol

On 23 February 2007, a Diplomatic Conference attended by government delegations from 42 countries agreed on a declaration bringing into being the Rail Protocol to the 2001 Cape Town Convention on International Interests in Mobile Equipment. This final version of the text has been designated the Luxembourg Rail Protocol and forms part of the Cape Town Convention agreed in 2001 which set out the framework for an internationally accepted registration of rights in mobile equipment, which, by their very nature are able to cross borders and thereby change the legal systems that apply to them. It should be noted, however, that the Convention is quite specific regarding the mobile equipment that it covers, namely aircraft and aircraft engines, railway rolling stock (locomotives, carriages and wagons) and satellites.

The Cape Town Convention takes account of three types of creditor in a transaction:

- ▶ a vendor under a conditional sale agreement;
- ▶ a lessor under a lease; and
- ▶ a bank or other financier taking security over assets as part of a loan or other credit facility agreement.

The Convention sets out a framework under which internationally recognised interests can be created and which are to take precedence over those created purely by local laws. A creditor is to have rights to recover the assets in the event of a default by the debtor (most notably in the case of the debtor's insolvency) and it is the Rail Protocol which specifies what these rights are.

The Convention also provides the basis for creditors to register their interest in a

The Luxembourg Rail Protocol is designed to give a significant boost to financing rolling stock transactions by the private sector. The Rail Protocol creates a new international system for recognising and registering the security interests of banks and lessors financing or leasing rolling stock.

particular asset. Here the general principle is that priority is given to the party being the first in time to register. It is therefore important that the relevant registry is easily searchable and accessible on a 24/7 basis and for registration to be quick and relatively straightforward. In addition, charges for searches and registration need to be kept at a reasonable level so that cost does not become a barrier either. This is particularly important when a financing deal could cover hundreds of items of mobile equipment.

A BROTHER TO THE AVIATION PROTOCOL

The Luxembourg Rail Protocol is the second of three protocols. The first protocol was the Aviation Protocol which was signed at the same time as the Cape Town Convention and came into force in a number of countries in 2006. The Rail Protocol is similar to the Aircraft Protocol in a number of areas, but for various reasons, it was decided not to follow it in all respects. As a result, lessors and financiers who are familiar with the Aviation Protocol need to take care to ensure that they do not overlook any of the differences between the two protocols.

Examples of this are an additional alternative for the insolvency regime and special provisions for the continued availability of rolling stock required for services of public importance (both of which are discussed later). The registration of conditional sale agreements is different too,

with the Rail Protocol simply creating the ability to set up a notification system allowing for an informal registration of any sale, without creating any priority. This is intended to allow the owners of fleets of rolling stock that do not have any financing attached to them, such as the existing fleets of many state-owned operators, to place other parties on notice of their interest in that stock.

ROLLING STOCK COVERED BY THE PROTOCOL

The Rail Protocol is not restricted to rolling stock used in cross-border traffic. It applies to all types of rolling stock, whether used on a city centre tram system, a narrow-gauge mountain railway, a high-speed rail route or a short-haul freight route. The main reason behind this is that assets can be moved between systems, either by the debtor or the creditor. For example a debtor may want to bolster the trams in a certain city by moving some trams from one system to another. Another reason is that not all countries have a public registry for recording security titles in rolling stock. By having the ability to record such details even for a domestic financing, the Rail Protocol will make even pure domestic financing safer.

THE LUXEMBOURG REGISTRY

It was agreed at the Diplomatic Conference that the international registry which is to record the interests would be based in Luxembourg. The Rail Protocol provides for a

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supervising authority to be set up to agree a set of guidelines on how the registry will work. The operation of the registry itself is to be put out to tender, with the successful bidder operating the registry for a number of years, most likely to be for an initial ten-year period.

Each item of rolling stock is required to have a unique identification number, which will then be recorded at the international registry. Currently different railways have different methods of identifying vehicles, some based on the manufacturers' serial number and others based on the job that the vehicle does on the railway. The main rolling stock registries are working together to agree a system which can be used throughout the world. It is likely that the final form will be based around manufacturers' serial numbers, with special provisions being introduced for older wagons so that railway companies can alter running number in order that stock can also be identified for operational reasons.

INSOLVENCY OPTIONS

Under the Aviation Protocol, on accession, states were given the choice of adopting one of two alternatives for remedies available on insolvency. One alternative, Alternative A, was pro-creditor, giving the creditor the power to take possession of the asset once an agreed 'waiting period' had elapsed unless the default had been made good. The waiting period is specified by the state so all creditors are able to easily understand the risk they are taking. The other alternative, Alternative B, was pro-debtor, with a creditor having to comply with the provisions of the local law before it could take possession of the asset.

The Rail Protocol provides a third option, Alternative C. It was introduced to provide a more palatable option in the middle ground. Under Alternative C the debtor or an insolvency administrator has a cure period within which to cure the defaults and within that time period can apply to the local court for an order suspending the right of creditors to take possession of the rolling stock. If the suspension order is granted, the debtor or insolvency administrator is required to preserve the rolling stock and maintain it and its value and to pay the creditor any amounts

that would otherwise be paid to it had the default not occurred.

PUBLIC SERVICE PROVISION

One of the more interesting issues raised by the Rail Protocol's protection of a creditor's interest has been the effect that it could have on general rail services. While a lessor or financier may be entitled to take possession of its rolling stock there is a political fallout if Mr Jones or Herr Schmidt finds that as a result the 7:42 does not run so he cannot get to work. Trains are used for mass transportation in a way that aircraft are not. In certain countries, preventing a public rail service from operating presents constitutional problems. This does not only apply to passenger services. There may be a need for freight services to continue, eg to bring coal to a power station, to keep a country fully functioning. Governments have strategic priorities and cannot always let market forces act uninterrupted.

The Rail Protocol has, therefore, developed a pragmatic solution to manage this problem. If a state has in place laws which, by their nature, would prevent a creditor from repossessing rolling stock that state can make a declaration on acceding to the Rail Protocol in respect of rolling stock that is 'habitually used for the purpose of providing services of a public importance'. This gives the state the right to require the creditor to allow the rolling stock to continue to be used in exchange for the state providing the creditor with an amount of compensation. Generally the compensation would be equivalent to the rental payments for such rolling stock. If local laws provide that no compensation is payable, the state can make a further declaration at the time of accession putting all creditors on notice that no compensation would be paid. This would, of course, affect the risk profile of the financing, but it ensures that all lessors and other financiers are aware of the position which may affect them.

It should be noted that the public service provision is not designed to be a catch all, allowing a state to decide whether all of its services fall within such a category. The discussions at the Diplomatic Conference made it clear that the expectation under the

Rail Protocol was that in the normal course, creditors have a full range of remedies to recover rolling stock in which they have an interest.

CONCLUSIONS

Although the form of the Luxembourg Rail Protocol has now been agreed, there is still much work to be done to bring it into force. A preparatory commission is currently being constituted, after which it will set up its supervisory authority, decide on the form of IT system to be used, and finalise the rules for the international registry. In order to come into force, the Rail Protocol itself needs to be ratified by a minimum of four countries and OTIF is required to certify that the international rail registry is fully operational.

An issue which remains is how to deal with the position if only certain countries adopting the Rail Protocol. With the Aviation Protocol, an aircraft is able to fly between two states that have adopted the Aviation Protocol, avoiding countries which have not adopted it. This is not so easy for rail transport, where rolling stock operates cross border and may pass (albeit briefly) through a state which has not adopted the Rail Protocol. Financiers and lessors will need to take into account the risk of a default affecting the rolling stock while it is in such a country which may result in an additional risk margin. With this in mind, there is likely to be more pressure on blocks of neighbouring countries to adopt the Rail Protocol than there has been with the Aviation Protocol, which could result in a faster adoption of the Rail Protocol.

The Rail Protocol should make it easier for banks and lessors to obtain credit approval for financing rolling stock that is to move through legal jurisdictions which previously provided stronger rights to those in actual possession of the stock. With more financiers on board it is hoped that there will be greater competition allowing for easier and cheaper cross-border financing and operating leases. This is particularly important in parts of the developing world that need to improve their rail systems with the use of private sector finance but until now have faced either high risk margins or a lack of interest due to the potential risks involved. ■