THE LUXEMBOURG RAIL PROTOCOL. AN ESSENTIAL ELEMENT OF INTERNATIONAL TRANSPORT BY RAIL

With increasing cross-border rail traffic, encouraged by the development of the Belt and Road Initiative, and more private financing of rolling stock, particularly in the freight area, issues concerning legal claims to title to rolling stock are becoming more critical in the absence of international rules. Fortunately, there is a solution on the way: the Luxembourg Rail Protocol, which provides the first ever detailed legal framework to protect owners and financiers of rolling stock as it moves across jurisdictional boundaries

A piece of the jigsaw is missing. International transportation of goods and people by rail is expanding. At the same time, liberalisation is taking place in the rail sector, as diverse operators and users enter the rail market. Inevitably, there must be rules for the operation of railway equipment across national boundaries. In Europe, the EU is not just legislating for a Single European Rail Area but is also, through the European Union Agency for Railways (ERA), gradually taking over responsibility for the admission of rolling stock. OSJD and OTIF administer international treaties regulating the transport of goods and passengers and the admission of vehicles on the international rail network. OTIF's CUV gives a legal basis to a multilateral agreement dealing with the use of rolling stock by parties that are not owners. But at the moment, issues concerning title to and security interests in the rolling stock actually moving goods and people across borders are covered by solely by national law.

As long as all the operators were state entities the implications of this lacuna were not so significant. Rolling stock was largely owned either directly or indirectly by the state, and even if rail equipment was financed by third parties, the financing was underwritten by the state or a state agency. Accordingly, any disputes on ownership of rolling stock could be covered at either intergovernmental level or through agreements between state-owned enterprises. But this is now changing. The 4th EU Rail Package, creating the Single European Rail Area, with open access for both freight and passenger services, has set Europe on a course towards liberalisation of the rail market. Other rail markets around the world are moving in the same direction. In two recent studies commissioned by the Rail Working Group, consultants Roland Berger identified that there is a direct correlation between liberalisation and the need for private capital. The reports also showed that there is a clear trend whereby the private sector is gradually financing more procurements by both state and private operators.

More cross-border operations and more investment

With rail strategies focused on developing regional, cross-border networks, and increasing passenger numbers and freight moving across jurisdictional boundaries, the need for settled law in this area has become acute. Projects such as the Belt and Road Initiative promise significant growth in rail traffic between Europe and Asia, thus raising difficult questions in relation to title interests in rolling stock crossing borders. A recent Roland Berger survey for the UIC predicts compound annual growth of 15%+ on these "silk routes", which will mean not just a higher number of locomotives and wagons crossing borders, but rising demand for new wagons and more private finance. Moreover, if these developments make variable gauge rolling stock economically viable, this will exacerbate the problem with freight wagons moving from Western Europe to the Chinese pacific coast without the need for transhipment.

All this will require significant ongoing investment in rolling stock. State-owned operators are looking for third-party debt without state underwriting, where the recourse of the lenders is to the rolling stock. Private operators do not necessarily have sufficient capital to carry all the costs of procuring railway equipment. They will borrow money from banks secured on railway equipment, or they will lease rolling stock from specialist lessors or even from other operators, often publicly owned, looking to monetise excess rolling stock or as part of franchises or joint ventures with the private sector.

In each case the creditor needs to be clear that it has the right to repossess the asset financed in the event of debtor insolvency, default, or simply at the end of the financing. Even when operators finance their equipment through equity, they need to be

secure that their ownership interests in the locomotives and wagons cannot be overridden, as a matter of national law, when it is operating in a jurisdiction other than their home state. This is particularly problematic since there are no public national rail registries for registering title security interests in rail equipment, and there is no common unique system for identifying rolling stock. In addition, even if a repossessing creditor knows where its assets are (which is often not the case), it has to depend on local court procedures to recover the equipment, which can take years, and there is no system whereby a state will assist with the redelivery of the equipment repossessed in a case of debtor insolvency.

If these potential conflict of law issues cannot be resolved to ensure that the transnational movement of rolling stock does not undermine the ownership and security interests of operators and financiers, it will place severe constraints on private finance for procurement of new rolling stock at a time when this is most urgently needed. At worst the credit simply will not be available. At best, when funds are available, financing rates will stay high if the debtor is a poor credit risk, since risk and reward go together, in turn potentially adversely impacting the competitiveness of public and private rail operators and creating a financial disincentive for new potential entrants into the rail market.

A new solution to a growing problem

To modify the old saying, "cometh the hour, cometh the treaty". The Luxembourg Protocol to the Cape Town Convention on International Interests in Mobile Equipment (the Luxembourg Rail Protocol) is a ground-breaking global treaty on the recognition and prioritisation of security interests held by creditors on railway equipment. It will create a new type of global security interest (the “international interest”) for the benefit of creditors either taking a pledge of rolling stock as part of a financing, or leasing railway rolling stock under a lease, and it will also apply to a vendor’s rights under a conditional sale (where title is retained).

The Protocol will apply to leases and security created on a broad range of rail equipment: any vehicle that is “movable on a fixed railway track or directly on, above or below a guideway”. So the benefits of the Protocol will apply not just to freight and passenger locomotives and wagons, but also to trams and metro/subway trains, people movers at airports, and gantries and cranes running on rails at ports.

Although the Protocol does not apply to sales and is not intended to be a record of ownership, only of security interests created over rolling stock, there is a separate provision in the Protocol for notices of sale (Article XVII). This will permit vendors to register sales at the international registry, thereby giving notice of the transaction even though neither the vendor nor the purchaser acquire rights under the Protocol. However, virtually all contracts for sale of rolling stock will qualify as conditional sale agreements, so the contract of sale will create an international interest that will be registrable (and extinguished once the sale takes place).

Critically, the Luxembourg Rail Protocol will apply when the debtor has its principal place of business in a ratifying state. This must be the case, since it has to be clear that the creditor rights apply regardless of where the rolling stock is physically at any point in time. However, it is acknowledged that it may be difficult for a creditor to exercise its rights in relation to the financed equipment if, at the time, the rolling stock is located in a state that has not yet ratified the Protocol. This exposure for creditors should only be temporary, and eliminated as more states ratify the Protocol. It demonstrates the need for states to act regionally in adopting the Protocol. Moreover, registration of an international interest may have a legal impact in non-ratifying states under domestic law, and there is also evidence from the operation of the parallel Aircraft Protocol to the Cape Town Convention that creditors are registering security interests in the international registry even when the debtor is located in a non-ratifying state (or in the case of the Aircraft Protocol, the aircraft is registered in a non-ratifying state) because the benefit of the registry is to give public notice of ownership or security interests. This will be particularly relevant in the rail sector due to the absence of national registries showing such interests.

Rights of repossession

The Luxembourg Rail Protocol grants holders of international interests in rolling stock clear rights as creditors, including rights of repossession on debtor default or insolvency, the overriding concern of every secured creditor.

Article 8of the Cape Town Convention, as modified by Article VII of the Protocol, sets out detailed rules on the rights of the creditor on a debtor default. Essentially, unless a contracting state has by declaration required that a court is to be involved, the creditor may, if this is provided for in the finance agreement, take possession of the asset on the occurrence of a default and sell or grant a new lease over it.

But there is an important constraint on the creditor’s exercise of its repossession rights where there is a strong public policy reason to block this. It was acknowledged by the drafters of the Protocol that there could be situations where the loss to the community resulting from repossession of rolling stock could be significantly in excess of the gain to the creditor in effecting such repossession. The classic case would be commuter rail transport, where the failure of many thousands to get to work in the morning could create economic chaos and major losses to the economy as a whole.

The Protocol therefore contains what is known as the “Public Service Exemption”, under Article XXV of the Protocol. This allows a contracting state to continue to apply existing law that precludes, suspends, or governs the repossession remedies in relation to "railway rolling stock habitually used for the purpose of providing a service of public importance". This type of equipment has to be identified in a declaration, and for the period while repossession is blocked, the government or other party that has taken over possession must preserve and maintain the railway rolling stock until it is redelivered to the creditor, and must also pay compensation to the creditor, which will be the higher of the amount required by local law or the market lease rental.

Theoretically a state may also make a second declaration stating that it will not pay compensation if this is not required under local law. But this is most unlikely, since any published intention to block a creditor’s repossession on a debtor's default, with no compensation to the creditor, would inevitably mean that no creditor would be prepared to take the risk of lending on the category of rolling stock concerned. What is also important to note here is that such a modification of creditor rights can only be made by reference to a specific class of railway equipment that is habitually used to provide a service of public importance. The exclusion of repossession rights cannot be made by reference to the mission of the rolling stock. Creditors have to be clear which types of equipment are covered by such a declaration.

Another delicate area confronted by the Protocol is where the creditor looks to repossess the financed equipment due to a debtor insolvency. Article IX of the Protocol gives the ratifying state four options. It can either remain with existing law or make a declaration that it will apply one of three different alternatives. Alternative A is a strong pro-creditor provision that allows creditor repossession without the need for a court order. Alternative B, by contrast, is very favourable to the debtor, such that a court order is necessary before a repossession can take place. Although this may be a tempting option for some states wishing to protect local operators, the outcome of selecting this option would be to significantly reduce the availability of private capital – since ultimately, the creditor's position would be too weak. A third option is a modified version of Alternative A, where repossession may be blocked by a court - but only if the creditor is given the benefit of its bargain during the period when repossession is blocked. This third position (Alternative C) may be more suitable in states where there are constitutional restraints on self-help repossession. As and when there is repossession, the contracting state in which the debtor is located has a duty (assuming it has made the requisite declaration) under Article X to “co-operate to the maximum extent possible with foreign courts and foreign insolvency administrators in carrying out the provisions of Article IX”.

The registration system

International interests will be registered in a new international registry located in Luxembourg, which will be searchable by the public through the internet 24/7. Unless the parties agree otherwise, the priorities of the international interests will be dictated by the time of registration. In other words, earlier registrations will have priority against later registrations. If the international interest is assigned, it will retain its priority. There are specific provisions in the Protocol for what are known as "pre-existing interests", security interests created before the Protocol entered into force in the state where the debtor is located. So the priorities of the previous interest will be protected for a given number of years, depending on the period nominated by a contracting state, although a better solution would be for the parties to execute additional documents, to ensure not just the priorities of the security interest but also that the other creditor rights under the Protocol will apply.

All this necessarily requires that all rolling stock covered by the Protocol is uniquely identifiable; that once allocated, the identification number cannot be duplicated or recycled; and that the item of rolling stock concerned will never change its number. This means that the number for the Protocol will run alongside, and not replace, the (immatriculation) running number allocated to rolling stock.

Technically, the Protocol permits three types of identifiers: a unique identifier stipulated by the international registry, a manufacturer's serial number, or a national or regional numbering system stipulated by a contracting state. In each case, the number must be demonstrably unique. In fact, the only practical solution will be the number issued by the international registry. Not only will this ensure consistency, it also avoids the immense complications, and therefore costs of running a registry operating up to three different types of identifiers that may themselves be different (for example, one manufacturer’s identification system may be alphanumeric, others simply numeric, and there may be different systems for different types of rolling stock).

The identifier issued by the registry is known as the URVIS (Unique Rail Vehicle Identification System) number. This 20-digit number will be allocated by the registrar to a specific item of rolling stock and will be permanently fixed to the item. It will include RFID chips and other systems that use GPS or other technology to track the equipment in real time. Once allocated, the number will never be recycled or duplicated. The system will be the same regardless of the asset type and guaranteed to be unique, not just at the time of allocation but also on an ongoing basis.

The registrar of the international registry has already been appointed (Regulis SA, a subsidiary of SITA) and

the registry will be regulated by an intergovernmental Supervisory Authority, formally constituted as the Protocol enters into force. OTIF will play an important role as the secretariat to the Supervisory Authority, and will be assisted by a committee of experts. The first set of regulations and operational procedures will be issued as the Protocol enters into force.

When will it start?

The Luxembourg Rail Protocol requires ratification by four states and confirmation by OTIF, as the secretariat, that the international registry is operational. It is expected to enter into force in ratifying states during 2019. By the end of May 2018, it had been ratified by the European Union (in respect of its competences), Gabon and Luxembourg; Sweden is due to ratify very shortly. It has also been signed by France, Germany, Italy, Mozambique, Switzerland and the United Kingdom – which are all moving towards ratification. Many other countries are also working actively on the adoption of the Protocol.

This is a tried and trusted system. The Cape Town Convention and the Aircraft Protocol have now been adopted by 71 states, for which adoption of the Luxembourg Rail Protocol should be very straightforward. The corresponding international registry for Aircraft, in Dublin, has been operating smoothly since 2006, registering over 850,000 international interests in aircraft with an estimated value of over USD500 billion. The designated registrar for the international registry in Luxembourg is an affiliate of the registrar in Dublin.

When it comes into force, the Protocol will make it easier and cheaper for the private sector to finance railway rolling stock. According to a recent survey prepared for the Rail Working Group by the economic consultancy Oxera, the Protocol will deliver direct micro-economic benefits of EUR19.4 billion to 20 selected states in Europe. A second study, covering many states in the ex-USSR “1520” region, will be published shortly and will demonstrate benefits in this area that are just short of EUR14 billion. This does not even try to quantify the macro-economic benefits.

Reconciling the Luxembourg Rail Protocol with local law

As with any international treaty designed to harmonise applicable legal rules, the Protocol will modify national law in some states, and have the effect of improving the position of creditors.

In some states, the change to insolvency law may be a problem and may need to be adopted over a period of time, perhaps as part of a general insolvency law reform.

Another issue will be the tension between local laws on asset security, particularly when there is a local personal property registry, and a security system that could be at odds with the rules in the Protocol. Some states may need to work this through, although the end result, the overriding position of the rules in the Protocol, cannot be avoided.

Since the unique numbering system will operate in parallel with the immatriculation numbers, this need not be an obvious conflict. Governments, manufacturers and operators can use this as an opportunity to consolidate the way they identify rolling stock, which they need to regulate anyway, by reference to the URVIS numbering system. Moreover, the creation of a single identification system that applies to all types of rolling stock will be a major step forward for many governments, making it easier for them to adopt a common system to regulate and control all types of rolling stock. It will help in many areas, not just facilitating the tracking of all types of rolling stock, but also opening the way to customised maintenance programmes and more efficient insurance protocols.

A more relaxed area is the issue of party autonomy in relation to the choice of law applicable to any security agreement or lease. Assuming that the declaration is made by the relevant contracting states, Article VI empowers the parties to decide the law applicable to the agreement creating the security. This is a helpful provision in that it is regardless of the location of the debtor, which will make it easier to create standardised finance agreements and at the same time exclude obvious conflict of law risks.

Completed jigsaw

The Luxembourg Rail Protocol coming into force will be an essential element of the new international rail regime, becoming part of a uniform rail law that ensures not just regulation of the goods carried by rolling stock across borders and the admissibility and operation of rolling stock, but that title claims on the rolling stock itself are adequately protected in a common system, removing one more barrier to seamless cross-border operation of the railways. And the Protocol delivers even more. It creates a mechanism by which new rolling stock can be procured and brought into the system using private finance at a reasonable price. This will liberate operators from the need to obtain state finance or state guarantees for rolling stock procurement (and relieve governments of the burden) as they work to transform international rail transport of passengers and freight into a competitive, cost-effective and environmentally sustainable service for the logistics community and the traveling public. States should move quickly to adopt the Protocol and to put the last piece of the jigsaw in place.

Howard Rosen
Chairman of the Rail Working Group