

The Rail Protocol to the Cape Town convention – is this the way to rail investment?

The world needs railways and railways need investment - investment in track, other infrastructure and rolling stock. Government funding is scarce. So private financiers of rolling stock, manufacturers who provide vendor finance for their own rolling stock, and train operators worldwide, may benefit from a diplomatic conference Luxembourg will host in February 2007. The conference will consider adoption of the Rail Protocol to the Cape Town Convention. A key aim of the Rail Protocol is to clear the way to cheaper private funding for rolling stock. Alexander Hewitt explains.

Uniform creditor-friendly rules

One risk blocking private investment, or increasing its cost, is that the legal system in a country where rolling stock will be used may not protect financiers on a debtor default. In some countries, for example, you cannot enforce a mortgage without lengthy court proceedings. In others, you must sell the rolling stock at a much-delayed, local public auction that has little hope of clearing the mortgage debt. Some countries do not recognise mortgages. Some prevent lenders from getting their equipment back for social, economic or political reasons. Good reasons may lie behind these aspects of a country's legal system. But they are not features that fill investors with confidence.

Another issue for financiers considering cross-border deals, or financing rolling stock that may move across borders, is the conflict of laws. These are the rules that decide such questions as:

- which of several potentially relevant systems of law should govern the parties' contracts, property rights or remedies
- can the parties choose the system of law that decides those questions or will the law of the place in which the rolling stock is located at the relevant time prevail and
- which countries' courts should have the sole or shared right to settle the parties' disputes?

Behind the Rail Protocol is a vision of (partly) uniform rules on financiers' interests in rolling stock and against other parties to finance transactions. The hope is that this regime will be sufficiently:

- uniform to reduce the costs and uncertainty generated by the conflict of laws and
- pro-creditor as to encourage investment in rolling stock that will be used in, or may travel through, countries whose legal systems might otherwise cause concern.

What is the Cape Town Convention?

The Cape Town Convention (Cape Town) is an international treaty that creates a legal framework for the type of uniform rules mentioned above. Signed in November 2001, it deals with the creation, registration, priority, protection and enforcement of international interests in certain types of mobile equipment. International interests are the interests given to: a lessor under a lease; a chargee under a security agreement (such as a mortgage or charge); or the seller under a conditional sale or hire purchase agreement. International interests are assignable and their priority can be varied by agreement.

Cape Town and the draft Rail Protocol give financiers various remedies on default. These include repossession and sale of the equipment, and leasing it to others. Hardly groundbreaking options, but in some circumstances the

parties can exercise them without going to court. In many civil law countries (e.g. on mainland Europe, in parts of Africa or South America) that is revolutionary. Where the parties must go to court, the courts can be given power to order the preservation or leasing of the rolling stock before the trial.

Insolvency regimes

Even more important than default remedies are a financier's remedies in an insolvency. The Rail Protocol sets out three possible sets of remedies. The basic scheme of each is that within a specified time the financier must have either got its wagons back, or the debtor (or the insolvency practitioner running its affairs) must have cured all the debtor's defaults and committed to performing its remaining obligations. Alternative A is the first of the three possible regimes. It is based on Chapter 11, US Bankruptcy Code and is the choice most likely to attract private investment.

The operator perspective

Cheaper funding apart, a legal regime that protects the rights of lessors and sub-lessors may benefit operators. The International Institute for the Unification of Private Law (or UNIDROIT for short) is the Rail Protocol's main sponsor. As the chairman of its Rail Working Group writes:

Operators ... constantly lease or sub-lease rolling stock to other operators as they cross borders. In the former case, registration of the lessor interest will allow the asset to cross borders without the lessor operator worrying that its title or lease interest could be overridden by local operators or their creditors. In the latter case, if the owner's interest under the lease is already registered, that would already put any foreign innocent third-party on notice of the prior rights of the lessor.

The UK perspective

In the UK, the current draft Rail Protocol offers most potential benefit to rail lessors who finance rolling stock in mainland Europe. Such rolling stock is more likely to cross borders than UK equipment. And, tending to be

more debtor-friendly than the UK, other European legal systems would become more attractive to financiers if they incorporated the Rail Protocol. This is good news, then, for UK rail leasing companies now that there are more and more opportunities opening up in Europe as a result of EU expansion and competition for railways - both in the passenger and freight sectors.

Benefits to the rail industry within the UK (except to the freight sector) are harder to find. The UK is already a creditor-friendly jurisdiction - more creditor-friendly in some ways than Cape Town and the Rail Protocol. Another factor is that most UK passenger rolling stock stays this side of the Channel, and is funded by (specialist, well capitalised) UK leasing companies. So the conflict of laws is not an issue for most UK rolling stock financings.

The main reason, however, why the Rail Protocol may do little to boost rail financings within the UK is that, if adopted, the current draft would not necessarily remove a particular concern in UK rail financings. This is that a lessor cannot simply repossess its equipment on a default. Instead, it must give the Department for Transport the chance to, among other things, organise another lessee to step into the defaulting lessee's shoes. This is a complex issue, and one which the draft Rail Protocol gives countries the option of resolving themselves rather than applying the Rail Protocol's remedies regime.

Will the Rail Protocol promote private investment in rolling stock?

This will depend on the details of each country's ratification. For when countries ratify (and sometimes after ratification) they can choose between rules they want to adopt, provisions where they prefer diluted versions of Cape Town or the Rail Protocol and (sometimes) keeping their own laws. Key choices include: whether default remedies can be exercised without court proceedings; whether those remedies can be exercised against public service rolling stock and which of the Rail Protocol's insolvency regimes to adopt. Reaping the benefits of the Rail Protocol will mean making choices that favour financiers. Decisions at this stage that favour the status quo may severely limit any chance of stimulating private investment.

Making the Rail Protocol happen

Even if the Rail Protocol will not necessarily deliver a perfect legal environment for private finance in every participating state, there is no denying its adoption in many countries (in Europe or Africa, for example) would be a huge step forward.

How might that adoption come about? Cape Town itself does not come into full force until enough states have signed and ratified it. But that only brings the framework into force. For that framework to bite on a type of mobile equipment, enough states must sign and ratify a protocol for a type of asset. Hence the draft Rail Protocol. Protocols also supplement the Cape Town framework with rules suited to their type of equipment.

The proposal is that only three states will need to sign and ratify the Rail Protocol. Those states will need to have signed and ratified Cape Town as well. So far, Burundi, Canada, Chile, China, Congo, Cuba, France, Germany, Ghana, Italy, Jamaica, Jordan, Kenya, Lesotho, Saudi Arabia, Sudan, Switzerland, Tanzania, Tonga, Turkey, Ukraine and the United Kingdom have signed but not ratified.

The USA, Malaysia, Ireland, Oman, Pakistan, Ethiopia, Nigeria, Panama, Angola, Senegal and Afghanistan have signed and ratified. These ratifications have been inspired by Cape Town's Aircraft Equipment Protocol. This has been in force since March 2006 in the USA, Malaysia, Ireland, Oman, Pakistan, Ethiopia, Nigeria and Panama.

The implication for the rail industry of these signatures and ratifications of Cape Town, is that if the Luxembourg conference goes well, the Rail Protocol could be in force in at least three countries by the middle of 2007. And the fact that the aviation industry has already done a lot of spadework on legal and practical issues, plus work done by UNIDROIT's Rail Working Group and the Intergovernmental Organisation for International Carriage by Rail, should help the rail industry make its protocol a reality.

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