

## **Creating an international security structure for railway rolling stock : an idea ahead of its time ?**

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### **I. – INTRODUCTION**

The railways were there at the beginning. The industrial revolution owed much to the development of the rail network, initially in England and then in other parts of the world. Decades before the motor car and the truck, railways were the key mechanical means, to move manufactured goods from factory to market or ports, and to move coal from the mines to the factories. The railways were at the beginning of mass passenger transportation over land. The London Underground system is over 150 years old in parts. Mass passenger traffic by rail was the basis of modern tourism for the general population. Railways were also at the beginning of modern-day asset finance. From the 1830s onwards, railway operators in England saw that they needed not just to provide the track but also to actually run the trains. Shortage of capital persuaded both them and the colliery owners who needed coal transportation wagons, to look to small private investors for funding through leasing. Thus the first established leasing companies were set up in the 1850s to deal with leasing of rolling stock. At that time, railway companies were not State owned and had to look to the market for funding. Leasing provided an ideal method of financing long-term investment in rolling stock.

The railways did not always prosper, but their social and political importance required either government intervention or government ownership at the local or national level. Even in the United States of America, the bastion of free enterprise, the rail system had to be rescued by the government in the 1970s, although unlike in Europe and other parts of the world, government intervention was temporary and today the US has a thriving private rail sector. An essential element of State involvement has been the provision of the finance but once involved, governments have generally proven very reluctant to give up control. As a result railways have become dependent on direct or indirect State financial support. When no funds have been available, capital investment has suffered.

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The dynamism of the railways and their independence were, and are, clearly linked. There is much talk in Europe of a renaissance of the railways. World-wide, this could – and should – happen in the next century. The rail system offers environmentally acceptable means of transportation of goods and people at a time when distribution is ever more important and at a time when the other means of distribution (particularly by road and air) are becoming increasingly overloaded. It is no surprise that the European Union decided at the beginning of the 1990s to begin a process – still unfinished – of forcing more accountability and transparency in the railways, and, gradually, of introducing more competition.

## **II. – IS SECURITY AN ISSUE ?**

In terms of pure economics, governments can no longer afford just to pump vast amounts of resources into the railways. Politically, governments realise that they can control the operation of a strategically important industry through regulation rather than “hands on” ownership. But it is also becoming clear that commercial and financial independence will be a key element in the revival of the railways. This revival will only achieve its true potential if the operators can access the substantial resources available to them from the capital markets. This paper will argue that, in the coming years, the demand for private finance will only be satisfied if we can also provide funders, in a clear and considered way, with acceptable security for their investment in the railways. And although today proper security is just an “optional extra” when there is an explicit or implicit State guarantee, tomorrow it will be essential and, indeed, a key element in the reinvigoration of the rail sector in the new millennium. As a result, we must anticipate that need and, in so doing, underwrite the future stability and dynamism of the railways.

The rail operator generally has three sources of finance (outside its own cash flow) for the acquisition of rolling stock. Debt or equity from a State or an agency thereof; leasing or debt finance from the private sector; or grants or loans from supranational organisations such as (for example, in Europe) the European Union, the European Investment Bank or Eurofima. Every lender will evaluate the security it requires to ensure that the investment is repaid. In the rail sector, a lender must also be concerned with the ability of the borrower to maintain properly the assets financed. The perception amongst borrowers and lenders alike is often that security is not an issue. Only a look into the near future will show what a dangerous – and, it is submitted, undesirable – assumption that is.

The credit of the borrower/lessee may be today a quasi sovereign risk but one cannot rely on that for the duration of the contract (which could be 18-20 years). Outside North America (where it is already the case), railway operators are likely to be required in the coming years to stand on their own feet without government guarantees for debt, or even be privatised. Moreover, as competition increases in the sector (a crucial element in its development), increasingly funders will have to finance private operators who will in turn complain to cartel authorities if their competition

enjoys State guarantees on its debt. On the other hand, increasing sophistication of financing techniques (for example, securitisation) will deliver financial benefits to operators, as well as lower the costs of entry into the market, as long as the financial markets are comfortable that there is real security over assets financed.

Increasing pressure on governments to eliminate, partially or even completely, the current funding of operator deficits (billions of dollars a year in Europe alone), will force operators into looking at the private finance sector as its source of funding. States will then inject cash solely where subsidies are required on social or environmental grounds. At the same time, more rolling stock will be leased under operating leases, transferring asset and other risks to the private sector. We will also gradually see more types of wet-leasing in rolling stock (where the lessor provides crews and/or maintenance). The markets will only carry those risks at an acceptable cost however if the assets are fungible (i.e. they can be repossessed and placed elsewhere – without local government interference to the disadvantage of the funder). Again security will become a key issue.

For manufacturers, providing finance to a customer is an excellent means of maintaining a business relationship as well as being, at times, a condition for being considered as a supplier. It offers a “one-stop shop” solution. Manufacturers will also, in certain circumstances, lease rolling stock to customers on a short or long term basis. On the other hand, a manufacturer usually cannot carry financed assets on its own books since this will have adverse balance sheet and cash flow implications. The solution is often finance from third parties, with recourse only to the assets financed. Enabling funders to secure its loans or leases will encourage them into the market to support the manufacturer. If the manufacturer does carry risk on its balance sheet, protection of its interests in leased assets will be crucial, thereby allowing it to give more comfort to banks providing their working capital credit lines, and to demand more flexibility in using owned assets for such purposes (where they are possibly pledged as security for the credit line).

By increasing considerably the resources available to buy new rolling stock, capital investment should rise and the manufacturing sector should emerge from its current often depressed state, creating more employment and improving social and environmental conditions. In this context, it is interesting to note the example of the United Kingdom. Years of minimal rolling stock investment has given way, post privatisation, to unprecedented levels of new equipment orders, with funding almost exclusively coming from the private markets.

As soon as security is acknowledged to be an issue, there is a problem. In many jurisdictions, there is no watertight security system since in the past, State funding of railways has rendered it unnecessary. Moreover often rolling stock can migrate, temporarily or permanently, across borders. As a result, even if security can be perfected in a specific jurisdiction, the financier remains exposed if the asset moves across a border. Even in North America, this can be an issue. Both Canada and the United States have excellent personal property security systems as well as a Federal

asset based registry, but what happens if a wagon moves into Mexico? In Europe, wagons can travel easily from the Spanish border through to the eastern edge of Poland (and even further with modifications). The same is true in South America, Africa and potentially in the Middle East. Today a wagon can move from a Civil law jurisdiction to a Common law jurisdiction in seconds. Those jurisdictions may have significantly different perceptions of how title, priorities of charges, repossession and bankruptcy issues should be regulated. Already today, financing of rolling stock which can move across borders results in a hill of a loan agreement, a cliff of legal opinions and a mountain of security agreements – and even then it is not clear that the agreements would be effective in practice. Similarly, cross-border leases present no problem theoretically, but once the lessee is less than a top credit, enforcement becomes a critical issue. The lessor will often borrow and wish to provide security to its lender – so back to the mountain of documents. Creating unimpeachable security for these transactions will open the market for more capital investment and also lower the cost of capital – even for State credits.

In Europe, this is an issue that is about to confront operators. The tendency is to wait for the problem to manifest itself. This would be a mistake. In other parts of the world, it is already a significant brake on investment in the railways. In Eastern Europe, South America and Africa, an international security system for rolling stock would materially increase its attractiveness as an investment target. Even from a European perspective, the future has to be anticipated and planned for proactively. Establishing an international security system is complex and time consuming. The time to move is now.

### **III. – DOES THE PROPOSED UNIDROIT CONVENTION PROVIDE AN ANSWER ?<sup>1</sup>**

The preliminary draft Convention on International Interests in Mobile Equipment, prepared by the International Institute for the Unification of Private Law (UNIDROIT) now being discussed by governmental experts, is the best chance the rail industry has to provide an international (and indeed in many cases a domestic) security system for the next millennium. Failure to grasp this opportunity could not only hamper the

<sup>1</sup> A working draft (July 1999) of a preliminary draft Protocol to the preliminary draft UNIDROIT Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock is reproduced in Appendix V to this volume. Like the working draft itself, this paper is based on the texts of the preliminary draft Convention and, where appropriate, of the preliminary draft Aircraft Protocol as contained in the working documents of the First Joint Session (Rome, 1-12 February 1999) of the UNIDROIT Committee of governmental experts for the preparation of a draft Convention on international interests in mobile equipment and a draft Protocol thereto on matters specific to aircraft equipment and the Sub-Committee of the ICAO Legal Committee on the study of international interests in mobile equipment (aircraft equipment), in particular the Report by the Drafting Committee (UNIDROIT CGE/Int.Int/WP/16 / ICAO Ref. LSC/ME-WP/27, 12/02/99), containing Appendix I ("Text of the preliminary draft Convention on international interests in mobile equipment as reviewed by the Drafting Committee") and Appendix II ("Text of the preliminary draft Protocol to the preliminary draft Convention on international interests in mobile equipment on matters specific to aircraft equipment as reviewed by the Drafting Committee"), which are reproduced as Appendices I and II to this volume.

development of private sector rail finance for many years, but also actually result in the worsening of the position of the rail sector if other modes of transportation competing with rail (such as the aircraft industry) are able to take advantage of the new security system. The preliminary draft Convention also raises some difficult issues for the rail sector, which need to be confronted. These can be divided into two separate discussions. How should a Convention be best structured to apply to the industry? And how are the special circumstances of rail transportation to be dealt with? Let us examine each in turn.

The future Convention will recognise as an international security interest the property rights of a secured lender under a loan, a vendor selling with reservation of title and a lessor under a lease. The interest will be assignable. It will also be possible to create a prospective interest. The preliminary draft Convention also provides that there will be a world-wide asset registry for each type of asset, accessible 24 hours a day, where any funder can check if any other party claims a right in the equipment to be financed. The funder will be able to register its interest which will then, in most cases, take precedence over any other unregistered security interest and over any subsequently registered interest. It will also take priority over any third party rights asserted in a bankruptcy of the possessor. The Registry will be operated by an international organisation and will be overseen by a Regulator, an independent international (possibly inter-governmental) body, appointed under the individual protocols.

### 1. The architecture

These are all basic principles. In the preliminary draft Convention there are other principles which also have general application. These include the definition of a default; the type of remedies of the secured party (including the right to interim relief) or the position and liabilities of the proposed registry under international law. They can apply to the aviation and the space property sectors as well as to the rail sector. Creating a Convention is however a delicate process. The objective is to create a degree of uniformity which will be commercially acceptable whilst reconciling this with legitimate differing policy approaches of various jurisdictions. The drafters working on the preliminary draft of the proposed Convention have recognised that there were two levels of concern. The general principles need to be universally applicable but there will necessarily be differences in approach because of the divergent characteristics of the assets concerned. The resulting "architecture" of a base convention plus industry specific protocols must make sense. But there are also certain dangers.

First, there is the reserve system where certain principles are opted-out of by signatory States or, even worse, where certain principles require an opt-in system to be adopted in a specific State. Then there is the "throw down technique". Anything on which agreement cannot be reached is then relegated to industry protocols. These are difficult areas because there are no absolute answers. In practice, the various legal systems of signing States mean that one cannot force every signatory to adopt exactly

the same Convention. There will be times when delegation of detailed issues to particular industry protocols makes sense. But there must surely be a limit if we are not to lose sight of the overall objective. What the proposed Convention attempts to provide is a set of principles that, as a matter of private international law, will gradually apply to all types of movable property which, by their nature, may move across national boundaries. This is a brave and ambitious objective, and the goal is very worthwhile – even if it requires much patient discussion. If reservations are too fundamental or if States have the right to decide if some basic elements are applicable or not, the certainty that commerce requires will be lost, especially since a lender does not know in advance if the financed asset will enter into a State which has not fully applied the basic principles.

Equally, the “throw down technique” can also be abused. As will be discussed in detail shortly, different industry sectors face different commercial problems. National aircraft registries exist virtually world-wide; national rail registries are the exception. The techniques to recover rolling stock will have to differ from those for space property. But if general principles migrate into the protocols to avoid disagreement on the text of the Convention, not only does this simply postpone the discussion on key issues, it also risks the integrity of the Convention as a whole. Ultimately the protocols become conventions themselves, the Convention becomes a mere preamble and the desired objective, of creating a system of international law applicable to all movables, is lost. Moreover, the probable result will be to hinder the adoption of protocols – such as the proposed Rail Protocol – which will probably follow after the adoption of the base Convention and the Aircraft Protocol (the first in line) because each Protocol will effectively be a complete review of many of the applicable principles, not just industry-specific adaptations of a standard set of ideas. Paradoxically, that would create an even worse economic position for the rail sector than pertains today, giving one of its main competitors, the aircraft sector, an even greater edge when the public interest would probably argue for its elimination. Despite these reservations however, the current architecture of the Convention must be the way forward.

## 2. Designing the Rail Protocol

At the beginning of this decade, when rail finance was very much in a development stage in Europe, many asset finance lawyers tended to apply the standard financing documents for commercial aircraft with only minor modifications. Trains were too often regarded as planes without wings. That has already changed. Further, in drafting the prospective Rail Protocol, one cannot fail to take into account that the industry is going through a transition and, as a result, the future has to be anticipated. For example, the growing operational transparency imposed by governments, leading gradually to separate, actual or virtual, track authorities (even if State-owned), means that consideration must be given to the rights of track authorities to demand payment of track fees from an insolvent or unwilling lessee/operator and perhaps to take a lien on the asset to secure payment of such fees. Other instances of where special considerations pertain for the rail sector are set out below.

*(i) Asset identification*

There are a handful of commercial aircraft manufacturers in an industry dominated by two giants. In the rail sector, there are over a hundred manufacturing companies in Europe alone. Therefore relying on common manufacturer identification systems is not practicable. Moreover, self-propelled rolling stock (locomotives) have to be accommodated together with wagons that have no independent means of propulsion. Even identification marks allocated by international organisations may be changeable. The Protocol will have to extend its description of covered assets to ensure that there is always a clear identification of the asset concerned.

*(ii) Applicability*

Once the means to identify assets have been established, the question then arises whether they should be covered by the Convention and the Protocol. Are underground/metro commuter trains and trams excluded? Probably they should be but does the exclusion extend to light rail (and how is that defined)? What about rolling stock that can only operate on a closed circuit which will never cross a national border (but which could be relocated onto an open circuit which could cross a border)? The Rail Working Group has tended here towards an inclusive approach tinged with pragmatism.

*(iii) Repossession*

It must be accepted that court approvals will often be required before an asset may be repossessed and this is anticipated in the preliminary draft Convention. But even if an order is given, this does not itself facilitate repossession. The defaulting obligor will often be the only mechanism for repossession. Unlike an aircraft repossession, a creditor cannot send in a "hit squad" to fly the asset out. It may have to run on tracks provided by the obligor under locomotion also provided by the obligor. Even if there is open access, there could be problems with the local railway authority who may not want such action to take place or who may insist on a level of competence or a licence for the repossession crew. There may be substantial opposition from non-governmental organisations, such as trade unions, objecting to non-union labour moving the railway wagons. If rolling stock is perceived as a strategic asset, there may be local legislation (or judicial precedents) prohibiting repossession. Voters tend to be somewhat aggravated when trains do not turn up on time. What happens if they do not turn up at all? Political pressure may be applied to stop the 'heartless banks' enforcing their legal rights. Or, as in the United Kingdom, statute may permit a government agency to take over or reallocate the obligations of the defaulting obligor and to retain the rolling stock. These are all difficult issues which have already resulted in much debate. In principle, the Rail Working Group sees little alternative but to insist on the rights of repossession for the obligee subject only to contractual constraints agreed by both parties from the outset.

(iv) *Insolvency*

The insolvency aspects of the preliminary draft Convention itself are still being grappled with. In the context of the rail industry, consideration has to be given to the fact that obligors may be State-owned entities or government agencies, or otherwise governed by public law. Or even that they can be given, *ex post facto*, a privileged position or protection against creditors. National bankruptcy law, in most countries, has its idiosyncrasies. A court is constantly juggling with two desirable but mutually exclusive objectives: to recognise valid and not fraudulent security and to deal equitably with all creditors without discrimination. In the rail sector this is compounded by public policy issues and the interests of the shareholder, especially if the obligor is publicly owned. Strange results are always possible. When the assets of the insolvent party are crossing borders they are virtually assured. What should be clear however is that a registered interest must overreach domestic law stipulating a "reputed ownership" principle as a defence to otherwise valid security, but on the other hand the Convention should not unduly interfere with the local bankruptcy rules, and especially the law on fraudulent preference.

(v) *Registration*

The operation of the registry and the supervision of the registrar are both issues under discussion. The conclusions so far have been that the registry should stand alone with few or no satellite operations. There is also a consensus that there should be a distinction between the regulator and the registrar, who have different, and at times even conflicting, roles. The rail sector also has to cope with current, and widely divergent, registration systems in place where there is no treaty-imposed common, albeit limited, system. In the aircraft industry, the new registry can work with the national aircraft registries. In the rail sector there are at times formal or informal national registration systems or international systems (such as that operated by Eurofima) which are neither inclusive nor always naturally compatible with the scheme of the proposed Convention. Furthermore some jurisdictions have their own personal property security or charges' registries with procedures and objectives not fully reconcilable with those of the proposed international registry. As a result, care must be taken in the Protocol to legislate for this.

Our guiding principles in drafting the preliminary draft Rail Protocol have been to keep the text as simple as possible, as fair as possible and to replicate, where relevant, the approach of the Aircraft Protocol, not just because of the enormous and impressive effort that has been invested into that document, but so as to facilitate easy adoption of the Rail Protocol once the Aircraft Protocol has been accepted by governments. These three principles are not always compatible.

**V. – CONCLUSION**

An internationally recognised security system for rolling stock should have a fundamental effect on the development of the rail industry in the coming decades. At

a time when business and its financing is increasingly international and capital investment in the rail sector generally remains poor, the proposed Convention and the Rail Protocol will open the door to more sophisticated cross-border financing of moveable assets where otherwise, banks and other financiers funding assets not in their possession would risk losing their security position in an asset, particularly once it moved across a national border. The proposed UNIDROIT Convention provides a mechanism for both private and public sector rail operators to utilise the private capital markets cost-effectively and on similar terms to the aircraft sector, facilitating, in turn, a better service for the customer and a vital means of recovering market share from the road and air sectors in freight and passenger transportation. Even for State-owned railways, the Convention will bring considerable benefits by increasing the sources of capital available for investment in new rolling stock without the need for State support (financed by borrowing or taxation) or guarantees. This will occur due to the reduction of risk that a funder will be required to take. It will also give railways more independence as to how they develop their equipment requirements and facilitate future capital investment – and protect State-owned operators – as governments gradually withdraw from the sector, either through partial or full privatisation or just by refusing to guarantee future debt incurred by the railways. For the private operator, access to the capital markets, directly or through banks and leasing companies, will be essential to their entry into the market and this in turn will be a key element in the renaissance of the rail industry in the next century. In each case, the more private sector capital there is available and the lower the risk a funder is required to take, the cheaper that capital will be.

The Convention will bring more flexibility in the use of financed rolling stock and encourage the development of both finance and operating leases (due to the new protection afforded to the lessor) and a secondary market, significantly reducing the capital commitments required by the operator (or permitting it to offer more new and efficient rolling stock without increasing its equity). The availability of operating leasing for aircraft has been a key factor in the development of the aircraft sector. Investors and lessors will be prepared to take more residual value risk due to the increased certainty that can be given to a lessor or investor that it will retain its interest in the asset against local legal challenges.

Lastly, debt financing for rolling stock at present means voluminous documentation – especially in relation to security issues, extensive legal opinions and still legal uncertainty for all parties. The future Convention should also result in much simpler security documentation, more modest legal opinions and considerably reduced transaction costs.

Unlike the aircraft sector, there are usually not even national registry systems in place to give funders (limited) protection. Further, the prevalence of State support for significant operators has discouraged funders from entering into the business due to fine margins and the risk of governments changing the rules when it suits them. Accordingly it has encouraged current lenders to ignore the security due to the quality of the credit. In the aircraft sector, that has already changed and we can expect a

similar change in the rail sector in the next 10 years. We must anticipate that change now so that the legislative framework is in place when it is needed.

The architecture of the proposed Convention, with a basic set of principles set out in the Convention itself and detailed industry rules in the respective protocols, must be the correct way forward. Care should be taken, however, to ensure that the base Convention is not undermined through multiple opt-outs or opt-ins to key principles. Similarly, throwing down key elements into the industry protocols as a way of avoiding confrontations on particular issues will possibly threaten the integrity of the Convention as well as simply postponing, but not eliminating, the issue. A quick fix now might be a very slow one later.

In the rail sector much has already been accomplished and a coherent draft of the Protocol is already available. It is recognised, however, that there are many issues in the Rail Protocol which are industry-specific. These need to be discussed as widely as possible; we should resist the urge to over-elaborate and over-complicate. The Protocol should be quickly made ready for review by government experts. The railways were there at the beginning of modern day asset finance. In the next century, competitive social and financial pressures will make efficient private sector finance for the railways essential if they are to prosper. Security for rail finance is not an idea ahead of its time. Its time is about to come (again).

