

## Building a Railway to the Future – Progress on the Draft UNIDROIT / OTIF Rail Protocol

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### I. – SIGNIFICANT STEPS FORWARD

One major distinction between the proposed Aviation Protocol to the draft UNIDROIT Convention on International Security Interests in Mobile Equipment and its counterpart for the railway sector is that the Aviation Protocol seeks to improve an established system of security registration. The Rail Protocol<sup>1</sup> is arguably more revolutionary, since it is attempting to *create* such a model in order to secure lenders in the railway sector. Members of the Rail Working Group<sup>2</sup> have sometimes felt that they are trying to anticipate a certain future need rather than respond to a current one. This is not a recipe for an easy life, so the first meeting of Governmental experts in Berne (Switzerland) on 15-16 March 2001, jointly hosted by OTIF<sup>3</sup> and UNIDROIT and expertly chaired by Professor Karl KREUZER, represented a significant, and far from automatic, step forward.

In many respects, the fact that the meeting took place at all and was attended by 20 actively engaged national delegations as well as a number of international organisations was as important as the detailed and highly constructive comments that followed. There is a growing recognition at Governmental level that creating a facility to enable railways to stand on their own feet financially is something that is not just politically desirable, and a budgetary benefit, but also an essential part of any revitalisation of the railway sector

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<sup>1</sup> The draft Protocol to the draft Convention on International Interests in Mobile Equipment on matters specific to Railway Rolling Stock.

<sup>2</sup> This comprises representatives from manufacturers of rolling stock, funding banks, lessors, rail operators, lawyers, rail industry associations and international organisations.

<sup>3</sup> The Intergovernmental Organisation of International Carriage by Rail (OTIF).

in the 21<sup>st</sup> century.<sup>4</sup> Further, perhaps this reflects a growing recognition, at least in Europe, that the interests of the State are not necessarily identical to that of the State Railways and that, although privatisation is not necessarily the ideal remedy for every railway system, private capital should be a key component. To source this capital efficiently, an international security interest is essential if Governments are to withdraw explicit or implicit credit support.<sup>5</sup>

During the course of any major project such as the Convention now under discussion and the Industry Protocols, there is inevitably a considerable gestation period between conception and birth. What we are doing is proposing international law, which can have a considerable effect on multinational trade for decades to come. Naturally, there needs to be a diligent and regular examination of the proposed new child. The group responsible for the project, in this case the Rail Working Group, subjects the policy assumption and drafting to continuous criticism and re-examination. Nonetheless, Governmental Experts' reviews are essential to ensure that the correct political, as well as legal, result is achieved. In the case of the Rail Protocol, as with the Aviation Protocol, we can expect two and probably three detailed examinations of the Protocol. The first, which took place last March, was a major step forward, but this is still very much work in progress.

One of the unique problems that we face with the proposed Rail Protocol is the fact that it operates by reference to a Convention which remains in draft form and is not yet agreed. The current draft will almost certainly undergo some changes before it is finally adopted later this year at a diplomatic Conference in Cape Town. Indeed, the Rail Working Group is proud of the fact that some of the changes derive from suggestions coming from the Group itself or from Governmental Experts at the Berne meeting. Other changes will be required due to the fact that from their different industry perspectives, the rail and aviation sectors both regard certain provisions, currently in their respective Protocols, as essential and that they had therefore probably best be incorporated in the Convention itself. It is naturally a particular challenge to take the process forward when the ground is shifting, but nonetheless considerable progress has in fact been made on the working draft Protocol, even though it may be difficult to assess exactly how much remains to do. Moreover, the process is clearly an iterative one. In a situation where participants are trying to anticipate what can be needed, ideas and text proposals are reviewed and comments are made in the knowledge that consequences have to be worked through and then the proposal is reappraised.

## II. – THE KEY ISSUES

Aside from the detailed technical matters that were dealt with at the meeting, three significant issues were addressed. Firstly, there is a general acceptance of the fact that in many countries, Railways form not just an element of the economic development of the community but are also part of its social fabric. Indeed, it is most likely one of the main reasons why in many countries privatisation has been rejected as a solution to the problem of how to reinvigorate the rail sector. This is a problem of considerable import for any Protocol

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<sup>4</sup> For a detailed discussion on the design and objectives of the Rail Protocol, see the author's article in *Uniform Law Review / Revue de droit uniforme*, 1999, 313.

<sup>5</sup> Indeed, even as the experts met in Berne, there was a tense and surprisingly public dispute developing between Deutsche Bahn and the German Government over the future structure and financing of the German railways.

regulating security interests in rolling stock since it is designed specifically to permit the secured party to repossess assets (and therefore potentially take them out of public circulation) if payment obligations are not met. On the other hand, public policy considerations may, particularly in relation to passenger traffic, dictate that this eventuality has to be avoided due to its disproportionate effects on the public as well as on the economy as a whole. At first glance, these objectives are conflicting, but a more detailed consideration shows that this is not necessarily the case. Governments are concerned that rolling stock will operate regardless of compliance by a debtor in connection with its funding obligations. On the other hand, the financier has no inherent interest in preventing the rolling stock forming part of its collateral being utilised, even if there is a default, as long as the funder is being properly compensated. During the course of the meeting in Berne, a basic idea has now changed into a concrete proposal which is being drafted into the next version of the Protocol. We call this the “Public Service Exemption”. Firstly, the area of applicability is closely defined by restricting it to passenger rolling stock. A public service agency then has the right effectively to lock the rolling stock concerned in place and require its continued operation by applying to a court, but subject in turn to that agency giving an undertaking that the financing party will be properly compensated within a reasonable period of time.

The second major concern that was confronted at the meeting was the interaction between local insolvency law and the operation of the Protocol. This is certainly an extremely sensitive issue, particularly where insolvency law is at times radically different in various countries. At the moment, the Aviation Protocol still provides two alternatives, which we expect will be discussed in detail at the diplomatic Conference next October. The easy route then is to allow Contracting States to choose whether they want a system which will override local insolvency rules, or one which will basically reserve some discretion to the local courts. Indeed, the Aviation Protocol at the moment also contemplates Contracting States actually contracting in to this provision (rather than contracting out). Hopefully, then, this is not over-ambitious, but the Governmental Experts approved in principle the approach taken by the Rail Working Group whereby it seeks to reconcile the various positions in one article, giving some flexibility to a local court and incorporating the Public Service Exemption (which logically must apply equally to insolvency situations as it does to defaults), and subject thereto applying a common system to each Contracting State, guaranteeing the secured party's right to possession.

The third substantive issue considered at the March meeting in Berne was the position of the Supervisory Authority. At the moment this is still anticipated to be OTIF, although it is expected that ultimately this is a decision for Contracting States collectively. Having said this, there is no obvious alternative as an intergovernmental organisation. It has been decided, however, to leave the choice of the Registrar to the Supervisory Authority rather than to try to legislate for this in the terms of the Protocol.

### **III. – TOUGH PROBLEMS**

If these principles can be sustained as Governments review the detailed wording in the next draft of the Protocol, then indeed serious progress has been made. There do, however, remain some significant issues that need to be confronted. Perhaps the most difficult one is the reconciliation of the overall aims of the Protocol with the existing North-American registration system, which currently operates a debtor- (as opposed to asset-) based system for registration of security interests in rolling stock. We still have to consider whether in fact

geographical areas covered by such a system should be fully excluded from the application of the Protocol or whether these should be recognised as functioning economic areas where the legal consequences of the Protocol will apply but the system of implementation through registration will be modified to take into account local circumstances and facilities. A third option, of imposing the rules in the Protocol and the international registry and jettisoning current structures, has probably been excluded, since it is clearly unrealistic and it makes sense to utilise local facilities where they are available and where they can perform a role in the system proposed by the Protocol.

This problem is exacerbated by the fact that there are no universally accepted descriptions of rolling stock world-wide (a major departure from the aviation sector). A uniform or even modified system of registration can only apply if it is clear which criteria are utilised for the purposes of registration to make rolling stock uniquely identifiable as well as traceable. Both in Europe and in North America, the current commonly used identification systems are changeable if and when rolling stock is moved between different operators, whereas security demands that the description of the equipment is immutable (what the Protocol refers to as the "Unique Identification Criteria"). There are both technical and legal solutions to this problem, but these require investment in time and money and a readiness to accept that current systems need to be modified.

In order to assist Governments in evaluating these matters, the meeting established a registry task force, jointly chaired by the Governments of the United States and Italy, to examine the various options. It will consider the conclusions of our colleagues on the International Registry task force working with the Aviation Working Group on the operation of the Aviation Registry and assess where these could be applied to the operation of the railway rolling stock registry. It will further analyse existing or potential railway rolling stock regional registration systems, look at the various advantages and disadvantages of making special provisions for registration systems in unified transnational railway networks as well as examine the Unique Identification Criteria and how they are registered. Once the task force reports, further discussions and compromises will be needed at Governmental Expert level if the goal of an inclusive Protocol is to be achieved. These discussions will not be easy.

A second issue, technically outside the scope of the Rail Protocol itself, is how the Protocol will be adopted under the architecture of the Convention. Will each Industry Protocol require a separate diplomatic Conference or can an acceptable "fast track" system be facilitated within the Convention itself, so that this considerable expense and delay may be avoided without depriving Contracting States of their ability not just to oversee, but also to influence the development of the Industry Protocols? While the Governmental Experts' meeting could not itself resolve this matter, there was considerable sympathy for the view from the Rail Working Group that a "fast track" solution is desirable and should be possible.

Another challenge to the design of the Protocol comes from outside. The UN Commission on International Trade Law (UNCITRAL) is currently in the late stages of refining an international Convention on Assignment in Receivables Financing. Potentially there is a conflict here, since receivables are often pledged as part of the security created by a borrower. If that security includes real property covered by the UNIDROIT Convention, this

would create a legal nightmare by having one part of the security governed by one Convention and the other part by a second Convention, probably stipulating different law and jurisdiction in relation to the respective security. This makes little sense and the Rail Working Group, in common with the position taken in relation to Aircraft and Space Property, considers that the *in personam* security has to follow the *in rem* security and the Rail Protocol reflects this view. Nonetheless, it would clearly be preferable to exclude from the proposed UNCITRAL Convention receivables covered by the UNIDROIT Convention as implemented by the relevant equipment-specific Protocols.

#### IV. — THE TRACK AHEAD

Thanks to the tireless efforts of OTIF, UNIDROIT, Prof. Sir Roy GOODE as well as the Rail Working Group, not only has a strong foundation now been laid for an international security system relating to Railway Rolling Stock but the Governmental Experts' meeting in Berne last March represented considerable progress in building an effective and workable structure. The philosophy and objectives of the Protocol appear to be broadly acceptable to Governments and significant issues arising from the detailed review have already been confronted in a positive and constructive manner. However, much work still remains to be done. Principles need to be converted into acceptable detail and substantive problems still remain to be resolved.

The next Governmental Experts' meeting will probably not take place until April 2002. Although this seems a distant date, there is good logic for this timing. To fix much more in place before the diplomatic Conference called to discuss, and hopefully adopt, the Convention in October/November this year, will be very difficult due to the considerable inter-relationship between the Industry Protocols and the Convention (and indeed the close co-operation and exchange of ideas going on between the Rail Working Group and the Aviation Working Group). Once the discussions are concluded in November, the Governmental Experts' drafting group will have only a very short period of time in which to prepare a new working draft of the Protocol and have it translated into the appropriate languages in order to give Governments sufficient time to review this draft and to take industry soundings before the next planned review meeting. In the meantime, however, the registry task force will continue its deliberations, the current working draft of the Protocol will be updated taking into account the decisions made in Berne, work will proceed on an Economic Impact Assessment, and members of the Rail Working Group will be organising seminars and presentations in different parts of the world in order to discuss the detail with the rail industry. The line to the future has not yet been built, but much groundwork has been completed and we can now be confident that the destination will be reached.

