"The devil" as they say, "is in the detail". Without question, the Luxembourg Rail Protocol adopted last February, or to give it its full name, the "Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock", represents an important step forward for the railway industry. By setting out detailed rules relating to the priority, effectiveness and enforceability of security taken by banks, lessors and other funders providing finance for rolling stock, the Protocol will make it easier and cheaper for operators to finance rolling stock without the need for government support. Specifically, the Protocol creates the concept of an international security interest in rolling stock for three types of secured creditors, namely, a vendor transferring title under a conditional sale agreement, a lessor leasing rolling stock and a bank or similar funder lending money on the security of such equipment. To be fully effective, these interests will need to be registered in an international registry, accessible 24/7 through the internet. Moreover, the Protocol will cover all types of rolling stock from trams and suburban rail systems through to TGVs and maglevs.
This must be in the public interest: more secure, and therefore cheaper and more readily obtainable finance, means more capital investment, lower operating costs and expands the choice of finance available. It also lowers the barriers to entry which is a good thing even for existing operators thereby making the industry more responsive and dynamic – and hopefully more competitive.

An essential element of this new regime is the provision of a clear universal system for (re)possession of rolling stock on default by the operator under the financing contracts or due to its insolvency. And yet there is also a public interest in keeping the trains running. Reconciling these two objectives has been one of the most difficult challenges facing the drafters of the Luxembourg Rail Protocol. Our response has been an unusual one resulting in a key provision of the Protocol which deals with the problem with some subtlety.

Chapter III of the Convention (usually referred to as the "Cape Town Convention" and which is implemented for the railway industry by the Luxembourg Rail Protocol subject to modifications mentioned below) sets out in detail the remedies available to a secured creditor, which has registered its interest, on the occurrence of a default by respectively a borrower, conditional purchaser or lessee (each hereinafter referred to as a debtor). In particular, Chapter III provides that in principle such a creditor may, on a default, subject only to the superior registered security interests, take possession or control of the assets and/or sell or grant a lease in such asset and/or collect or receive income or profits from the management or use of such asset. There is provision for application to the court if necessary in order to exercise remedies and there are also provisions for application to the court by the creditor for interim relief including for orders preserving and maintaining the rolling stock, for possession, control or custody thereof and its lease or management until any dispute is fully resolved.

Articles VII and VIII of the Luxembourg Rail Protocol modify and clarify the Chapter III remedies in the Convention as they apply to railway rolling stock. Article IX of the Protocol sets out various options for States to take up in relation to remedies on insolvency. Whilst I do not propose to go into details here about those options, it is the firm view of the Rail Working Group that Contracting States should either adopt Alternative A or Alternative C in Article IX. Each of these options will give the creditor the possibility of repossessing the financed rolling stock quickly once the debtor is insolvent subject, in the case of Alternative C, to some sensible safeguards for the debtor. Each of these alternatives incorporate provisions for interim preservation, maintenance and use of the rolling stock prior to possession being handed to the creditor and the Article VII modifications apply here also.

At first glance this would all seem to be perfectly logical. If you rent a car but then do not pay the lease rentals, you can hardly complain if the leasing company repossesses the asset. But in the case of the railway sector, we know that the effect of repossession could be disproportionate to the damage suffered by the creditor if repossession does not take place. For example, if commuter trains are financed and a default occurs allowing the creditor to take possession of the rolling stock, this could mean many thousands of commuters stranded on station platforms, not being able to get to work, with consequent huge loss of productivity for the community. Not just because commuters are voters (but this is certainly a factor) governments are understandably reluctant to contemplate such a situation. I recall also at a government experts’ meeting a wonderful discussion about public policy and the Queen’s
train and there was also legitimate concern about what could happen to dangerous freight if the wagons carrying it were repossessed. Devils and details.

Complex discussions took place through the various official government experts’ meetings prior to the diplomatic conference, then in the run up to, and at, the diplomatic conference itself in Luxembourg, aimed at identifying, and then refining, a solution. Papers and working drafts were being exchanged between delegations almost up to the day before the conference began and the Rail Working Group, representing the rail industry, was one of the worst culprits. It is perhaps difficult to see this from the outside, but in the 12 years between the launch of the “Cape Town Project” and last February, when the Protocol was adopted, a clear culture had emerged. Professor Sir Roy Goode sums this up perfectly in his commentary on the Cape Town Convention where he states that the Convention is governed by “five underlying principles”: Practicality, Party autonomy in contractual relationships, Predictability in the application of the Convention, Transparency and Sensitivity to national legal cultures “in allowing a Contracting State to weigh economic benefits against established rules of national law to which it attaches importance”. The discussions resulted in a formula set out in Article XXV of the Luxembourg Rail Protocol which elaborates the so called “public service exemption”. This groundbreaking provision does not occur in the parallel Aviation Protocol to the Cape Town Convention and it represents a carefully engineered solution, working with the five underlying principles to balance the public interest for competitive finance with the public interest to keep rolling stock rolling even after a debtor default or insolvency. Article XXV however has more facets to it than is immediately apparent, as hopefully will become clear.

Article XXV (1) provides that:

"1. A Contracting State may, at any time, declare that it will continue to apply, to the extent specified in its declaration, rules of its law in force at that time which preclude, suspend or govern the exercise within its territory of any of the remedies specified in Chapter III of the Convention and Articles VII to IX of this Protocol in relation to railway rolling stock habitually used for the purpose of providing a service of public importance ("public service railway rolling stock") as specified in that declaration notified to the Depositary."

At first glance, this is a disaster for the secured creditors. It appears to abrogate the most important provisions of the Protocol by giving a Contracting State the ability to override the default and insolvency remedies mentioned above. But even if we just stop the evaluation here, there are two points which should be noted.

Firstly, the Contracting State must make a declaration, on or subsequent to ratification, specifying which rules of law will apply in these cases. Such declaration will be public record and available to all creditors. So, in principle, the creditor will know what it is getting itself into if it provides finance for rolling stock operating in a country making such a reservation. Because the creditor’s risks will rise, so will its charges or, more precisely, the risk premium it will add on to its funding costs in calculating payments to be made by the debtor. A State proposing to make such a declaration can expect to come under pressure from rail operators because it will put them in an adverse competitive position both compared to other international rail operators and transportation companies in the rival aviation and road sectors.
Secondly, the declaration can only be made in relation to "railway rolling stock habitually used for the purpose of providing a service of public importance". It will be for the Contracting State making a declaration to determine exactly what comes within this category but the intention of the drafters is clear. Whilst it can be argued that there is a general public interest in every item of rolling stock operating as there is in every car or aircraft running to maximum efficiency, the focus of this provision is on rolling stock which is used habitually for this purpose (and not occasionally) and the criterion is "public importance" (and not just "public interest"). We can expect therefore it will apply principally in the passenger rail sector (and not definitively applying the whole of the sector) and then subsidiarily in the freight sector to the extent that a wagon qualifies – for example, it transports nuclear or other materials relating to public security. It is an open question to what extent the public service exemption can apply to locomotives, since they can be swapped in and out and technically are providing the locomotion to the rolling stock providing the public service. Probably, however, dedicated locomotives which are part of train sets will come within the category if a ratifying State so determines.

But the story does not stop there. At the meetings of government experts prior to the diplomatic conference, the Rail Working Group made it clear that Article XXV (1) on its own was an unsatisfactory solution even with the caveats mentioned above. Our thought even then, which was broadly supported by the consensus in those States represented in those meetings, was that there was not necessarily an irreconcilable problem. The creditor's position should be that it is entitled to the benefit of its bargain. If it can continue to receive the monies which it bargained for, then it will be no worse off if it does not repossess the assets notwithstanding the debtor default or insolvency. Our expectation, therefore, was (and remains) that a State wishing to freeze or suspend the (re)possession of rolling stock by a secured creditor, notwithstanding a debtor default or insolvency, will have to pay the amounts to the creditor to which the creditor was entitled assuming that a default or insolvency had occurred, with such obligation commencing from the date the government, or an agency appointed by it or another party, would take possession of the assets. Moreover, any party taking this secondary possession would have to have an obligation to maintain the assets from the time of possession until the time they were restored to the creditor. The British government had exactly this problem to confront when it privatised the British railway system in 1996. We had in mind their approach which was to permit the government, or a party designated by it, to step in to the contractual position of the defaulting (in this case) lessee.

Accordingly, Articles XXV (2) and (3) specifically provide for this:

2. Any person, including a governmental or other public authority, that, under rules of law of a Contracting State making a declaration under the preceding paragraph, exercises a power to take or procure possession, use or control of any public service railway rolling stock, shall preserve and maintain such railway rolling stock from the time of exercise of such power until possession, use or control is restored to the creditor.

3. During the period of time specified in the preceding paragraph, the person referred to in that paragraph shall also make or procure payment to the creditor of an amount equal to the greater of:

   a) such amount as that person shall be required to pay under the rules of law of the Contracting State making the declaration; and
(b) the market lease rental in respect of such railway rolling stock.

The first such payment shall be made within ten calendar days of the date on which such power is exercised, and subsequent payments shall be made on the first day of each successive month thereafter. In the event that in any month the amount payable exceeds the amount due to the creditor from the debtor, the surplus shall be paid to any other creditors to the extent of their claims in the order of their priority and thereafter to the debtor.”

Do note the delicate phrasing in paragraph 3 (b). The secondary possessor, either a government, a government agency or another party appointed by a government, is not required to underwrite the rental or debt payments contracted to be paid by the debtor. If it steps in, it will have to pay the greater of the amount required to paid under local law or the market lease rental. This is because this is part of the bargain. The creditor still takes a credit risk on the debtor but its remedy of being able to recycle the asset, with the revenue that would be generated after such recycling, is what it is entitled to when the secondary possessor steps in, not the contractually agreed rent or repayment. In other words, the creditor is restored to the position it would have had if it repossessed, not to the position that it would have if there was no default. There is no debtor guarantee. If a creditor therefore backloads lease rentals so that the payments are delayed and in later years exceed the market lease rental, this still represents a risk for the creditor.

Unfortunately, this is not the end of the story either. Some States represented at the diplomatic conference had constitutional constraints on agreeing in advance the protections for the creditor mentioned above. Effectively, they needed to reserve the possibility of the government or an agency thereof blocking the (re)possession of rolling stock by a secured creditor without compensation. This does not mean that those delegations were unaware of the effect of such a caveat. On the contrary, they were acutely sensitive to the fact that preserving such a right, which to some would appear to be confiscation, would fundamentally undermine the possibility of financing rolling stock in their country through the private sector. So Article XXV (4) provides that where a Contracting State wanted to disapply the maintenance and compensation obligations in paragraphs (2) and (3) it would have to make a separate declaration specifically stating this. The exact text reads as follows:

“4. A Contracting State whose rules of law do not provide for the obligations specified in paragraphs 2 and 3 may, to the extent specified in a separate declaration notified to the Depositary, declare that it will not apply those paragraphs with regard to railway rolling stock specified in that declaration. Nothing in this paragraph shall preclude a person from agreeing with the creditor to perform the obligations specified in paragraphs 2 or 3 or affect the enforceability of any agreement so concluded.”

It will be noted that it is expressly stated in the second sentence that this would not preclude another agency providing a guarantee. So, for example, if a bank was financing a city tram system and local law, because of the declarations made by the Contracting State concerned, effectively undermined the ability of the creditor to (re)possess the assets on debtor default or insolvency and precluded its compensation rights, the municipality concerned or even a regional authority could still come in and provide a guarantee to perform the paragraph (2) or (3) obligations which the State itself had refused to do.
Without question, Article XXV (4) is the most difficult paragraph in Article XXV and, arguably, the most difficult paragraph in the Protocol, but the drafters of the Protocol had to take a pragmatic approach. This is not a provision permitting governments to exclude repossession rights without any measure of compensation or corresponding obligations from the party assuming the assets or stepping in to operate them. It is merely a facility whereby a Contracting State could, in theory, make such a reservation knowing well that this would demolish a key pillar of the Protocol with the corresponding negative effect on the local rail industry. Just as importantly, it facilitates governments with such constitutional difficulties in working out those difficulties after the signature of the Protocol rather than delaying the signature of the Protocol until matters such as these are resolved in accordance with its provisions and gives a State the flexibility to change its position (in relation to future financings) after ratification by modifying or withdrawing declarations once the “offending” local legislation is removed. In other words, it is up to the industry, manufacturers, operators and financiers – and lawyers - to work together to ensure that governments realise the effect of making such reservations and hopefully to ensure that they do not do so.

Further the drafters did not want to leave this assumption to chance. Article XXV requires two separate and detailed declarations from a Contracting State if a creditor’s repossession rights on debtor default or insolvency are to be blocked without adequate compensation. Then in paragraph 6, States making a declaration under Article XXV are required to

"take into consideration the protection of the interests of creditors and the effect of the declaration on the availability of credit".

The wording of Article XXV embodies the spirit of the Convention’s five underlying principles. It is a pragmatic and sensitive solution which prescribes both transparency and clarity without dictating the outcome in advance. In particular, it creates two levels of flexibility, namely on application and on interpretation. No doubt there will be detailed discussions in the future about where a Contracting State should draw its line. When is rolling stock “habitually used for the purpose of providing a service of public importance”? What is “habitual”; what is “public importance”? To what extent should the Article enable States, on public policy grounds, to modify the Protocol’s creditor repossession provisions in relation to freight, wagons and locomotives – or for that matter mountain railways and if it does, who carries the risk? What is a commercially acceptable exposure to the creditor on repossession without making the financing commercially unrealistic? The only rules in this debate are that the debate is far from over and that wherever the line is drawn, it must be done so clearly and publicly so that practitioners know where they stand before the financing closes. That is the real subtlety of Article XXV and surely this is the only practical way to ensure that a public interest in keeping some types of the rolling stock operating and performing a public service is accommodated without sacrificing another public interest, namely the ability to finance rolling stock through the private sector and to facilitate a vibrant and progressive development of the railway industry.