

THE LUXEMBOURG PROTOCOL – WHAT DO YOU NEED TO KNOW?

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WHAT IS IT?

The Convention on International Interests in Mobile Equipment (the “Cape Town Convention” or “CTC”) operates within a fairly narrow area of transactional law and provides a legal framework for the secured financing and leasing of uniquely identifiable high value mobile equipment. It was adopted in 2001 and operates in conjunction with asset-specific protocols. Protocols have been signed in respect of aircraft equipment, rail equipment, space equipment and mining, agricultural and construction equipment.

The CTC has 86 contracting states, however, as regards any particular item of equipment, the CTC does not come into force within a particular contracting state until a related protocol has been adopted in respect of that type of equipment and that protocol has itself come into effect. While the aircraft equipment protocol has been in force for many years, the rail protocol (the “Luxembourg Protocol”) is to enter into force in contracting states on 8 March 2024. To date, those states comprise Spain, Gabon, Luxembourg and Sweden.

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WHAT DOES THIS MEAN FOR RAIL FINANCE AND LEASING?

The rail industry, like the aviation industry, is a cross border industry which is notorious for inconsistent rights for secured lenders and lessors in different jurisdictions. While a lender's asset security may be valid in one jurisdiction, once an item of rolling stock crosses the border into another jurisdiction, that lender's property interest may become invalid or unenforceable. There may also be issues as to whether security can be taken at all (or perfected), depending on various factors specific to a given jurisdiction. Even where a property interest is validly taken and then recognised across borders, the protections and remedies given to creditors may

vary. This can create barriers for entrants into the financing and leasing market given the uncertainties and risks that prevail.

The CTC and associated Luxembourg Protocol (together, the “Convention”) aims to provide a consistent and stable legal framework for rolling stock secured creditors and lessors internationally. The rights of creditors can be registered in a global public registry (the “International Registry”), recognising the priorities of security and other property interests in rail assets. The Convention also creates a basic framework of default and insolvency-related remedies in the event of a default by an underlying debtor under a lease or a loan, for example. The Convention provides a consistent set of underlying principles across jurisdictions, so as to provide creditors with greater certainty and confidence when making credit decisions. This should, as a result, reduce borrowing costs and credit insurance premiums and enhance ratings by rating agencies.

DOES THE CONVENTION APPLY TO MY TRANSACTION?

In order for the Convention to apply to rail transactions, five conditions must be satisfied:

1. the parties must have entered into an “agreement”;
2. the agreement must relate to “railway rolling stock”;
3. the railway rolling stock must be uniquely identifiable;
4. the agreement must comply with the relevant formalities required under the CTC; and
5. there must be a “connecting factor”.

Where such conditions are met, then regardless of the private international law of a particular jurisdiction, the Convention will apply in a Contracting State (i.e. a state which has ratified the Convention) and an international interest will be constituted (discussed further below).

“Agreement” and the formalities required for such agreement under the Convention

For an interest in railway rolling stock to qualify as an international interest, such interest must be constituted under an “agreement”, which can be a security agreement, a title reservation agreement or a lease agreement.¹ The CTC sets out in detail what constitutes these three types of agreement, and whether or not a specific agreement falls under the remit of the CTC is determined by the CTC itself, and not local law (recognising the key CTC principle of consistency across jurisdictions).

Any such agreement must be in writing (subject to certain exceptions), the relevant chargor/lessor/conditional seller must have the right or the power to dispose of the railway rolling stock, the railway rolling stock must be identifiable (see below) and, in respect of a security agreement, the obligations secured must be able to be ascertained (a general description will suffice – it is not necessary to state the actual amount secured).²

Railway rolling stock

The assets covered by the Luxembourg Protocol are broadly defined as any *“vehicles moveable on a fixed railway track or directly on, above or below a guideway, together with traction systems, engines, brakes, axles, bogies, pantographs, accessories and other components, equipment and parts, in each case installed on or incorporated in the vehicles, and together with all data, manuals and records relating thereto”*.³

“Uniquely identifiable”

For the purposes of complying with the formal requirements for the constitution of an international interest, a broad regime of identifiability applies, whereby it is sufficient to describe the rolling stock by item, by type or by reference to the assets being covered by the interest (which would pick up rolling stock covered by a floating charge).⁴ It is not necessary to list identification numbers in the agreement (though it may, of course, be helpful).

However, for registration purposes, more information is required.⁵ Unlike in the aviation industry where aircraft and engines are provided with unique manufacturer serial numbers from the moment they are manufactured, rolling stock does not have the benefit of such a globally recognised identification system for individual assets. The Loxembourg Protocol deals with this by providing for the allocation of a unique number to an item of rolling stock for the purposes of that asset's registration on the International Registry (the Unique Rail Vehicle Identification System, or "URVIS"). Such number will need to be permanently affixed to the relevant asset and the asset will not be registrable on the International Registry without such a number. In addition, a Contracting State can also declare that its own existing national or regional identification system is to be used in connection with the registration of assets on the International Registry, subject to the agreement of the Supervisory Authority (to ensure uniqueness).⁶

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Connecting Factor

Finally, there must be a connecting factor in order for the Convention to apply to a particular transaction.⁷ This means that the debtor of the relevant interest (essentially, the lessee or the security grantor) must be situated in a Contracting State at the time of the conclusion of the agreement that creates or provides for the international interest. "Situated in" can be satisfied by a number of methods, including when the debtor is incorporated in, when it has its registered office or

statutory seat in, or when it has its centre of administration in a Contracting State.

THE CONVENTION APPLIES – SO WHAT?

Satisfaction of the above requirements means that an international interest has been created by a debtor in favour of a creditor in respect of railway rolling stock. An international interest is an interest in property in its own right and is not derived from, or dependent upon, national law.

Examples of international interests include the interests created by leases of railway rolling stock and the interests created by mortgage or pledge security over railway rolling stock.

A creditor is able to register its international interest with the International Registry, which has the effect of establishing the priority of that international interest in all Contracting States over other later-registered or unregistered property interests in the asset, and protecting such interest in the case of an insolvency of the debtor. Failure to register an international interest will not affect the underlying validity of the interest, just its priority and its protection in insolvency.

Assignments of international interests can also be registered, which allows secured creditors to register their interest as assignee of an international interest such as a lease for example.

In addition, it is also possible to register notices of sale of railway rolling stock. However, this is for information purposes only and the provisions of the Convention relating to priorities and remedies do not apply to sale transactions.⁸

WHAT ARE MY RIGHTS AS A CREDITOR IN A DEFAULT SCENARIO?

The Convention sets out certain remedies that are available to creditors upon the default of a debtor under the relevant transaction documents.⁹ These include the ability for (i) a lessor to terminate the lease agreement; (ii) a secured party under a security agreement or a lessor under a lease to take possession or control of the asset; (iii) a secured party under a security agreement to sell or grant a lease of the asset; and (iv) a secured party under a security agreement to collect or receive income in respect of the asset. The creditor may seek a court order to exercise such remedies but it can also proceed without an order provided that, depending on the relevant remedy, either the Contracting State has not issued a declaration requiring leave of the court for exercise of such remedy or the debtor has agreed to the availability of such remedy prior to its exercise (i.e. in the underlying agreement).

In addition, the Luxembourg Protocol provides creditors with the remedy of procuring the export and physical transfer of the asset from the territory in which it is situated, with the relevant Contracting State required to ensure that the relevant authorities co-operate in the exercise of such remedy.¹⁰ The relevant authorities are required to make this remedy available to creditors within seven calendar days of notification by the creditor that it is entitled to procure such remedy.¹¹ However, the Convention does not prescribe any set method for procuring the deregistration of the rolling stock, and so at the start of a transaction creditors should bear in mind what they may need to put into place in order to ensure a smooth de-registration with the relevant authorities (for example, any powers of attorney or pre-signed deregistration documentation). Note also that a creditor may not export the railway rolling stock from the relevant territory without the prior consent in writing of the holder of any registered interest ranking in priority. Therefore, care should be taken in determining the order of priority where there are multiple competing interests (such as a lease and a mortgage).

Note that the Luxembourg Protocol expressly requires CTC remedies to be exercised in a “commercially reasonable manner”. This will be the case where such exercise is in accordance with the provisions of the underlying agreement unless that provision is itself “manifestly unreasonable”.

WHAT HAPPENS IF MY DEBTOR BECOMES INSOLVENT?

The Convention may also provide protection in an insolvency scenario. Where a debtor enters into insolvency proceedings, an international interest is effective if it has been registered in the International Registry prior to the commencement of the insolvency proceedings in a Contracting State.¹² Therefore, even if there has been a failure under national law to perfect a particular security interest, a registered international interest will be effective notwithstanding such failure (subject to certain caveats as regards doctrines of avoidance under insolvency law). This means that the international interest is both recognised by the insolvency proceedings and accorded a higher priority for amounts owed vis-à-vis the relevant asset than the interests of the holders of later registered interests or unsecured creditors.

An effective international interest in insolvency proceedings will provide a creditor with certain remedies, depending upon what elections the relevant Contracting State has made upon its ratification of the Luxembourg Protocol. These remedies are designed to strengthen the creditor's position vis-à-vis the insolvency administrator and ensure as far as possible that, within a specified and binding time-limit, the creditor manages to recover its asset or have any past defaults under the transaction documents cured, with a commitment to perform future obligations.

The Luxembourg Protocol establishes three alternative sets of rules that would apply in an insolvency scenario and a Contracting State can elect to apply any one set of these. Alternatively, a Contracting State can elect to apply none of the alternatives, in which case that state's applicable national insolvency laws will apply.¹³

Alternative A is considered to be a hard set of rules for compliance by the debtor (i.e. the most creditor friendly version), whilst Alternative B establishes a set of rules that are subject to the discretion of the debtor and the insolvency court (i.e. debtor friendly). Alternative C is viewed as a middle ground that may be considered by some Contracting States as being more balanced than Alternatives A or B. In respect of the Aviation Protocol (which allowed only for Alternatives A and B) the vast majority of states have opted for Alternative A, reflecting the underlying principles of the CTC of reducing creditor risk in transactions and so reducing transaction costs.

To date, none of the four Contracting States to the Luxembourg Protocol have made a declaration in respect of one of the Alternatives.

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Alternative A (perhaps the most likely choice, should a state make a declaration at all) requires the Contracting State to designate a "waiting period", at the end of which the debtor must either return the asset to the creditor or cure defaults and agree to perform future obligations under the transaction documents. This waiting period is a hard deadline and cannot be extended by the insolvency court. Whilst the debtor retains the asset during the waiting period, it must preserve the asset and maintain its value in accordance with the terms of the underlying agreements.

Alternative C replicates much of the Alternative A provisions but further allows the debtor (or its insolvency administrator) to apply to court before the end of the cure period for an order allowing it to suspend its obligation to give the creditor the opportunity to take possession of the asset until the expiration of the underlying agreement, on such terms as the court considers just. Such terms will require the debtor to continue to perform its obligations under the agreements and pay sums to the creditor during the suspended period. The creditor is prevented from taking possession of the asset pending any application for a court order to do so.¹⁴

PUBLIC SERVICE CONSIDERATIONS

As discussed, the Convention provides creditors with repossession and other remedies upon the default of their debtor. However, this right must be weighed up against the need for rolling stock to keep running in the interest of public service and whether the economic effect of the exercise of such creditor rights could be disproportionate to the damage caused to the creditor if the repossession did not occur.

Therefore, the Luxembourg Protocol contains specific provisions to allow Contracting States to override the standard creditor remedy provisions of the Convention in the interests of public service. A Contracting State may designate as “public service railway rolling stock” rolling stock which is habitually used for providing a service of public importance. If under national law there are provisions which effectively would block creditor repossession rights for such designated assets, these provisions would continue to apply. If any other party (including a government entity) exercises a power to possess, use or control that asset, it is required to preserve and maintain the asset and pay to the creditor the greater of any relevant amount required to be paid under national law and the market lease rental for such asset.

CONCLUSION

The huge success of the Aviation Protocol has provided the rail industry with a framework as to how the Convention will work in practice and how it can have a positive impact on the rail financing and leasing industry. There remains work to be done to finalise the operations and procedures which will govern the International Registry, but we look forward to the entry into force of the Luxembourg Protocol and hope to see many more countries ratify it in the near future so that the industry can continue to attract existing and new entrants into the market. While it may be of limited value while only four states have signed up to it, given the cross-border nature of many rail assets, as additional countries ratify the Luxembourg Protocol it will surely become more useful to creditors and market participants.

FOOTNOTES

[1] Article 1(a), CTC.

[2] Article 7, CTC.

[3] Article I, Luxembourg Protocol.

[4] Article V, Luxembourg Protocol.

[5] Article XIV(1), Luxembourg Protocol.

[6] Article XIV(2), Luxembourg Protocol.

[7] Article 3, CTC.

[8] Article XVII, Luxembourg Protocol.

[9] Chapter III, CTC.

[10] Article VII(1), Luxembourg Protocol.

[11] Article VIII(6), Luxembourg Protocol.

[12] Article 30, CTC.

[13] Article IX, Luxembourg Protocol.

[14] Article IX, Luxembourg Protocol.

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