A critical aspect of the asset leasing and finance industry is the protection against loss that a security interest in the underlying equipment may provide. A security interest has no value, however, if the creditor is unable to recover the value of its asset due to inadequacies or lack of consistency in the relevant legal system. As a remedy to these potential shortcomings, the 2001 Cape Town Convention on International Interests on Mobile Equipment (the Cape Town Convention)¹ “provides for the constitution and effects of an international interest in certain categories of mobile equipment and associated rights.”

One of the equipment categories referred to in the Cape Town Convention, and addressed through its Luxembourg Protocol (the protocol), is railway rolling stock. In this article, we will review the current business, legal, and economic environment of railway rolling stock financing in emerging markets; its potential; and the possible effects that the adoption of the 2007 protocol will have on this sector of those economies.

**OPPORTUNITIES**

The explanatory reports of the Cape Town Convention state

> Creditors have a vital interest in being able to recover the value of assets in emerging countries. With respect to railway rolling stock, countries that adopt the 2007 Luxembourg Protocol to the Cape Town Convention should see consistent application of the rules and legal provisions to mitigate the obvious risks.

… the Convention system is designed to bring significant economic benefits to countries at all stages of economic development, and in particular to developing countries by bringing within their reach commercial finance for mobile equipment that has previously been unavailable or available only at relatively high cost. A sound, internationally adopted legal regime for security, title retention and leasing interests will encourage the provision of finance and reduce its cost.²

Clearly, railway rolling stock has economic significance to developing countries. While railway rolling stock financing has not been at the top of the list in emerging market financing portfolios, it is hoped that the Luxembourg Protocol will enhance the availability of financing so critical to improving the transportation infrastructure of such economies. A case study of rolling stock in Latin America provides some insight into the potential effects of the protocol.

The history of railways in Latin America has not been a happy one, consisting mostly of dreams that could not become realities. In fact, by the mid-19th century some important South American railways were built with British, U.S., and French capital. These included projects in Argentina, Chile, Bolivia, Peru, Brazil, Ecuador, Colombia, and Venezuela, such as

---

¹ The Cape Town Convention on International Interests on Mobile Equipment (2001) provides a uniform legal framework for the creation and effects of international interests in certain categories of mobile equipment, including railway rolling stock.

² The Cape Town Convention on International Interests on Mobile Equipment (2001) aims to provide a legal framework for the security interest in mobile equipment, including railway rolling stock.
the Transandine Railway that connected Buenos Aires in Argentina at the Atlantic Coast with Valparaiso, Chile, on the Pacific Coast. At the same time, there was optimistic talk of building a “Pan-American Railways” linking New York with Buenos Aires, using the infrastructure that was meant to be built in Central America as well as Colombia, Ecuador, Peru, Bolivia, and Chile. However, the Pan-American Railways never took off, and the Transandino Railways suspended its operations in 1978 for passengers and in 1982 for cargo. In Mexico, railway construction started in the mid-1830s, but it was not until 1878 that, under President Porfirio Diaz, railways became significant in Mexico. Recent privatizations under Ernesto Zedillo’s government have led to ongoing changes in the business.

Notwithstanding the above sad history, rail projects are currently attracting the attention of hundreds of investors and governments. While, since its inception, rail transportation proved to be the only efficient way to transport people and cargo—faster than any other land modality—the later emergence of cars and road vehicles displaced railways and rolling stock as preferred means of transportation. Nowadays, and looking into the future, rail transportation appears to be a “clean” transportation alternative not only from an environmental standpoint but also in terms of its suitability to generate positive economic effects to its users and to the economy as a whole.

Several rail projects are under development in Latin America, including high-speed trains in Brazil, Argentina, and Chile; cargo trains in Colombia and Peru; and large investments in Mexico. Outside of Latin America, there are many projects under way in Africa, the Middle East, and Asia Pacific. China is building interurban train systems at high speed, and many countries such as India, Kenya, and Tanzania are attracting investment for railway projects.

However, unless financial resources flow into them, the history of unattained dreams will be repeated. It is here is that the Cape Town Convention and the protocol may make a difference. The following discussion will explain why and how.

**THE CAPE TOWN CONVENTION AND ASSET-BASED FINANCING**

To appreciate the effects of the Luxembourg Protocol, one must first understand the Cape Town Convention and its context. Asset-based financing has the benefit of bringing additional security to lenders and providers of financing. All lenders and financing providers face the risk that the debtor may not meet its payment obligations as contracted. The creditor may require the debtor to pledge certain assets to mitigate this risk. This practice is particularly relevant in providing financing to small- and medium-sized enterprises as well as in project financing. Most of the large infrastructure projects also fall into this category.

Asset-based financing is an illusion, however, if there is not a legal system in place that enables financiers to recover value by repossessing, seizing or disposing of the asset placed as security. In most emerging markets, the lack of such effective legal system is the case. Asset-based financing contracts do not provide lenders the ability to recover value from the secured asset unless they are able to (1) prevail vis-à-vis the debtor and all third parties in good faith over lender’s or financing provider’s right to repossess the asset; or (2) seek efficient enforcement granted by the legal system, either with court intervention or under a legal system that permits alternative settlement of rights and dispute resolution (including “self help”). Third, there must be a secondary market or some other source of value for the asset.

National or domestic laws have addressed these issues in different ways. In some countries, the legal system has evolved to provide secure, reliable, and efficient means of asset recovery. In others, the legal system is not clear or transparent enough to permit an asset-based financier to recover value from the asset as described.

Due to such real and perceived difficulty to enforce collaterals in emerging markets, the International Institute for the Unification of Private Law, known as UNIDROIT, started work in 1988 toward the adoption of “uniform rules governing security interests in cross-border transactions.” The outcome of this work was the
Cape Town Mobile Equipment Convention and the Aircraft Equipment Protocol, both concluded on November 16, 2001. The convention is aimed to cover the following three principal forms of financing: (1) a loan secured by a security interest in the object; (2) a sale under an agreement in which seller reserves ownership until payment in full (title reservation agreement); and (3) a lease, which may be either a finance lease or an operating lease and may or may not include an option to purchase.

The Cape Town Convention sets forth the rules for the creation and perfection of international security interests on certain assets. Prima facie, these were narrowed into (1) an airframe, an aircraft, or a helicopter; (2) railway rolling stock; and (3) space assets. Such international security interests may be purely international security interests in such countries where there is no national regulation of security interests, or a combination of both national and international security interests, or a co-existence of national and international security interests. The last case is of special importance in countries such as the United States, where the perfection of security interests and registry differ from the system of the Cape Town Convention.

DEFAULT REMEDIES

At the core of the Cape Town Convention system lie the default remedies provisions. Under these provisions, the secured creditor (also called “chargee”), should be legally empowered to “(x) take possession or control of any secured asset; (y) sell or grant a lease of such asset, and/or (z) collect or receive any income or profits arising from the management of the asset.” The convention foresees that such empowerment should be available to such secured creditor, provided that the debtors consented in the agreement to such remedies. Otherwise, remedies should be available only through a court order. These remedies apply whether or not a registration system is in place.

The convention addresses a fundamental concern of any asset-based financing provider, including secured lenders, sellers under conditional sales agreements, and lessors under both finance and operating leases: namely, the ability to repossess and dispose of the secured asset. Remedies provided by the Cape Town Convention entail the three driving forces of repossession, namely the ability to gain physical control of the asset, the ability to sell or dispose of the asset in the secondary markets, and the ability to funnel the inherent productivity of the asset for the benefit of the asset-based financing provider.

These remedies are the manifestations of the two basic faces of repossession. The negative face (that is, the threat of depriving the debtor of its use of the asset) motivates the debtor to keep its obligations current. The positive face of repossession relates to the ability of the secured creditor to recover value from two potential sources: (1) the resale of the asset, and/or (2) the productivity of the asset.

REGISTRATION

The registration system is perhaps the most interesting practical tool of the Cape Town Convention. Registration is addressed to give public notice about the existence of an international interest or a prospective international interest. Further, it provides to the secure creditor, at minimum, the following benefits.

First, the registration system contributes to breaking the presumption of good faith “en fait des meubles, possession vaut titre,” that is, the presumption that all acquirers of personal property are deemed as the legal owner of the asset. This registration system claims that a good-faith purchaser of an asset potentially subject to the Cape Town registration system must first undertake a due diligence search on the asset prior to being protected by such presumption. Second, it enables the secured creditor to preserve its priority on the asset. Third, it grants support to the effectiveness of the international interest in insolvency proceedings against the debtor. However, it must be noted that registration is only a public notice system: It neither substitutes nor validates the lack of legal validity of such security interest.

The registration system is asset based; therefore, it demands that the asset must be identifiable and that it must meet all the identification criteria. For purposes of railway rolling stock, the 2007 Luxembourg Protocol
to the Cape Town Convention provides that a railway rolling stock shall be identifiable by type and by item. The registrar must allocate serial numbers to such items considering manufacturers as well as national and/or regional identification numbers. Such identifications must be affixed to the corresponding railways rolling stock. Additionally, there are other important derivative consequences of the main regulations of the Cape Town Convention, such as provisions regarding priorities and consequences of a debtor’s insolvency.

PROVISIONS OF THE LUXEMBOURG PROTOCOL SPECIFIC TO RAIL

The Luxembourg Protocol contains numerous provisions. Since it is not the purpose of this article to address all of them, the most important have been selected for highlighting. These provisions (a) define “railways rolling stock,” (b) govern default remedies for this kind of equipment, (c) regulate priorities and insolvency procedures, (d) regulate the potential re-exportation of repossessed railway rolling stock, and (e) address the application of remedies in the event of government intervention of public utilities services.

Article I (2)(e) of the protocol defines “railway rolling stock” as vehicles movable 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.

This definition introduces interesting elements into emerging markets' infrastructure projects.

The first relevant aspect of the definition is that it covers not only rolling stock over fixed railway tracks but also above or below a “guide way.” This definition opens the door to rolling stock that not only circulate over or below (hanging on) rails but also that can operate over roads, subject to the guide-way limitations. Thus, all equipment subject to and protected by the Luxembourg Protocol will not only embody new technologies such as the “magnetic levitation” (mag-lev) trains but also trams and other similar massive transportation solutions with rubber tires, such as the automated guideway transit (AGT) systems.

France (Lille), Japan (Osaka and Kobe), and several Latin American cities are operating AGTs with recent success, namely Curitiba (Brazil), Bogota (Colombia), and soon Lima (Peru). These AGT systems have proven highly successful and useful for the economies. However, prior to the Luxembourg Protocol, these assets would not have been protected by the provisions of the Cape Town Convention. Therefore, as is the case with the guide-way system operating in Bogota, Colombia, the rolling stock (mainly Mercedes-Benz buses and other equipment), can be subject to and protected by the Luxembourg Protocol.

The inclusion of traction systems as part of the definition of railway rolling stock also opens the door to expand financing to items such as the pantographs, which are, in essence, devices that collect electric current from overhead lines for electric trains or trams. This inclusion also opens the door to increasing financeable assets such as bogies, wheeled wagons, or trolleys—a chassis or framework carrying wheels attached to a vehicle.

Another expansive factor in the definition of railways rolling stock is the inclusion of certain items that otherwise would be considered as “soft costs,” thus normally excluded from financing, namely data, manuals, and records related to such equipment. This is also good because it relieves the burden of the project owners, providing full financing to all acquisition costs of such equipment.

DEFAULT REMEDIES

In terms of default remedies, the good news is that the protocol preserved the default remedies under Article 8 of the Cape Town Convention as described above: namely, the right of the secured lender or chargee to take possession of the asset, sell it in the secondary market, and/or collect revenues arising from the management or
use of such asset. In addition, the protocol expands the first and second remedy with the right to “procure the export and physical transfer of railway rolling stock from the territory in which it is situated.”11 This expansion of remedies implies the possibility of limiting interference from any government authority from the repossession, recovery, and movement of railways rolling stock to such markets where such equipment are more saleable (in other words, more liquid).

The bad news is that the Luxembourg Protocol breaks the presumption about whether the application of repossession remedies shall be commercially reasonable, and places on the creditor the burden of proof as to whether or not its applications to such remedies was in fact “commercially reasonable.” This is certainly a problem that the protocol generates to secured creditors because it opens the door to long-lasting litigation that may prevent the expeditious use of the default remedies.

In civil-law countries, such as all Latin American countries, the concept of “commercial reasonability” is not developed. This, therefore, opens the door to many contradictory constructions that may actually neutralize the effectiveness of the remedies. To bring a standard to the table, it would be worthwhile to examine both statute and case law, although this examination is beyond the scope of this paper. However, for starters, we suggest that the Section 355.9-62712 of the Kentucky Statute brings a definitional approach to the subject matter.

In case law, some criteria have been adopted for “commercially reasonable manner,” such as

The standard of commercial reasonability is predicated on two concepts prevalent throughout the UCC. All commercial transactions are required to be conducted in “good faith.” “Good faith” means honesty in fact in the conduct or transaction concerned. (12A O.S. 1971 Sec. 1-201 (19).

Commercial matters should be, if at all possible, resolved by means normally employed for handling such matters in the business involved, so long as the means deals fairly with all parties.

Generally, the creditor acts in a commercially rea-

sonable manner when in the process of disposing of repossessed security such creditor acts in good faith and in accordance with commonly accepted commercial practices that afford all parties fair treatment.”13 Unfortunately, the aircraft protocol has the same provision for placing the burden of the proof about applying commercially reasonable practices to the creditor. This burden of proof on the creditor may prevent capital to flow to Latin America and other emerging markets for financing rolling stock. However, the key question is this: Can lessors, secured lenders, and conditional sellers live with that? Of course they can, but at a risk premium cost.

Attention also must be paid to the new provision of the protocol that grants the right to secured creditors to export and/or physically transfer the railway’s rolling stock out of the territory where it is located. This is an aspect that had not been addressed by any international treaty until it was brought up by the aircraft protocol. The case for rolling stock is more critical, in particular, if such rolling stock operates only over rails: Unless there is enough infrastructure in place in the country and financially sound operators that could be potential buyers or lessees of such equipment, the only real possibility of a secured creditor of such rolling stock should be to re-export the equipment.

The Cape Town Convention certainly takes into consideration the fact that in many emerging markets the lack of clear re-exportation rules may render repossession remedies useless. Therefore, it is clearly an important provision that the Luxembourg Protocol brings in this regard. Simply, the protocol requires only giving timely notice, and therefore opportunities arise for any third party claiming to have rights on such equipment to exercise them. The Luxembourg Protocol requires such notice whenever there has not been a repossession and order of re-export pursuant to a court order. It also requires that such notice be given within a reasonable time frame to allow such third parties to exercise any opposition or to ensure that their rights shall be preserved even in events of re-exports.
The time for a prior notice to be reasonable is either left at the domestic or national law discretion or to the court's discretion. Such reasonableness also shall be determined in view of the beneficiary person, which, under Article 1(m) of the Cape Town Convention is

(i) the debtor; … (ii) any person who, for the purpose of assuring performance of any of the obligations in favour of the creditor, gives or issues a suretyship or demand guarantee or a standby letter of credit or any other form of credit insurance; and (iii) any other person having rights in or over the object …

Since the debtor shall be aware of the repossessing, the time required to give the prior notice to the debtor should be shorter than such required for any guarantor or third party claiming to have any right (such as labor liens or mechanical liens, where applicable). This is one of the beneficial aspects of the Luxembourg Protocol: It consecrates a clear right to the secured creditor to enforce the performance of governments and customs authorities to cooperate with the export of repossessed rolling stock, shortening the cash-to-cash cycle associated with such deals.

Article XXV of the Luxembourg Protocol introduces a rule that has extremely important connotations from the point of view of international law. In the first instance, it recognizes the reality that sovereign states may impose restrictions on the remedies of secured creditors for public interest reasons, namely for “public service railway rolling stock.” This eliminates the discussion about whether or not in international law the rights and remedies can be limited or restricted by public interest or under state of necessity circumstances.14

The Luxembourg Protocol makes abundantly clear that such sovereign right can be exercised. However, and most important, Article XXV (3) mandates that such person, exercising authority in behalf of the government

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.

This additional remedy under Article XXV is certainly the grounds for obtaining commercial and political risk insurance. At the end of the day, it provides the remedy to go either into the national courts of the country concerned or into international arbitration to seek from the government (or of such “person, including a governmental or other public authority …”) such remedies that shall provide the recovery to such secured creditors of all their investment at risk.

SUMMARY AND CONCLUSIONS

One of the effects of the 2008 global economic crisis is that equipment financing is growing faster in emerging markets than in developed countries in Europe, the United States, Canada, and Japan. In addition, equipment financing is tending to focus in environmentally sustainable equipment. Rail equipment financing fulfills such requirements.

Having all that potential in place, the question is how to provide a legal support to equipment lessors and lenders who venture to lease or lend on such equipment in emerging markets. The answer to that question lies in the Luxembourg Protocol to the Cape Town Convention, namely, such countries that adopted the Luxembourg Protocol will consistently apply rules and legal provisions that are predictable and appropriate to mitigate the obvious risks associated to financing abroad. Country risk will be mitigated as well, since the remedies foreseen in the Luxembourg Protocol in some cases override political risk issues.

In the rail financing industry, it is critical to review whether the country involved in a rail project (whether a high-speed train, a subway system, an intercity system, or a massive transportation system based upon highways) is a member of the Luxembourg Protocol. The potential of such business is growing and the demand for emerging markets is increasing. Risk mitigation is clearly necessary, and such mitigation is provided by the Luxembourg Protocol. Creditors' rights should be enforced according to the expectations they have in developed countries.
Endnotes

1. The Cape Town Convention is one of the work products of the International Institute for the Unification of Private Law, UNIDROIT. UNIDROIT is a multilateral organization created by an international treaty in 1926. www.unidroit.org


3. For a detailed and passionate history of railways in Latin America, see Frederick M. Halsey, Railway Expansion in Latin America (New York: Moody Magazine and Book Co., 1916).


6. The Ferrocarriles Nacionales de México (N de M) was nationalized by President Lázaro Cárdenas del Río in 1938, and privatized 60 years later by President Ernesto Zedillo. N de M operated most railway trackage through the central and northeastern regions of the republic. See http://en.wikipedia.org/wiki/Ferrocarriles_Nacionales_de_M%C3%A9xico (accessed Nov. 4, 2007).

7. Goode, p. 3.

8. Article 8 (1)(a) of the Cape Town Convention.

9. Article 8 (1)(b).

10. Article 8 (1)(c).

11. Article VII (1) of the Luxembourg Protocol.

12. Sec. 355 9–627 of the Kentucky Statute. Determination of whether conduct was commercially reasonable.

(1) The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.

(2) A disposition of collateral is made in a commercially reasonable manner if the disposition is made:
(a) In the usual manner on any recognized market;
(b) At the price current in any recognized market at the time of the disposition, or
(c) Otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

(3) A collection, enforcement, disposition, or acceptance is commercially reasonable if it has been approved:
(a) In a judicial proceeding;
(b) By a bona fide creditors’ committee;
(c) By a representative of creditors; or
(d) By an assignee for the benefit of creditors.


14. The State of Necessity Doctrine in international law has been a recent subject of debate. In recent international arbitral decisions, the tribunals have mischaracterized and mistaken the concept of whether a state can adopt measures limiting rights under state of necessity, with respect to whether, when such sovereign attribution is exercised, such states should or should not compensate or indemnify the affected private parties. (See ICSID Decision, LG&E v. Argentine Republic.) In contrast, CMS Energy v. Argentine Republic.)

Rafael Castillo-Triana
rafael.castillo@thealtagrouplar.com

Rafael Castillo-Triana, based in Weston, Fla., is a principal in The Alta Group and its managing principal for Latin America. Previously, he was executive vice president of Leasing Grancolombiana, S.A., leading a successful turnaround of the company; the first CEO of Megaleasing S.A., for big-ticket leases in the energy leasing business in Latin America; the first CEO of Equileasing S.A., captive for Canon in Latin America; and eventually advisor and counsel to Siemens, Mitsui, Corporacion Financiera Union, AT&T Capital, Newcourt, CIT Group Inc., and the International Finance Corp. (the private arm of the World Bank). Mr. Castillo-Triana was instrumental in drafting the leasing laws of El Salvador and Tanzania. He has represented Colombia on the advisory board of UNIDROIT for the Model Law on Leasing, including the third draft adopted in 2008. Mr. Castillo-Triana received both his master’s in economics and JD from Javeriana University in Bogota, Colombia.
Emerging markets debt has delivered outsized year-to-date returns, but the current environment is challenging global investors with divergent crosscurrents. As the global growth outlook has grown more uncertain, liquidity from central banks has supported emerging markets debt; however, current valuations provide less compensation for the increased risks. Equity. Emerging markets equities rose 0.6% in the second quarter but remained well in positive territory—up 10.6% for 2019. The asset class's performance was volatile over the period, reflecting extraordinary uncertainty among investors about Chapter 2. Rail markets in the Russian Federation. 2.1. Introduction. Table 2.1 2.2. Transport markets. 2.3. Railway performance. 2.4. Geographic characteristics of the rail market. Notes. Chapter 3. The government's railway reform programme. 3.4. Changes to the franchising process. 3.5. Emerging role of regional and local stakeholders. 3.6. Funding of rail freight. 4. Track access and final user charges.