Whither the Hell-or-High-Water Clause? Will This Venerable Leasing Construct Survive the Expanding Use of Managed Solutions Transactions?

By Paul Bent

The venerable, time-honored hell-or-high-water clause has been the mainstay of equipment leasing structuring and documentation for decades, particularly in connection with the underwriting of payment risk and the assignment of rental obligations to third-party funders. In the emerging marketplace of highly flexible managed solutions transactions, however, the usefulness and applicability of the HOHW clause are increasingly open to question.

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By Phillip L. Durham and Marek Dubovec, SJD

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The 2001 Cape Town Convention on International Interests in Mobile Equipment (Cape Town Convention, or CTC) comprises three protocols governing aircrafts objects, railway rolling stock, and space assets. This convention has been heralded as the most economically significant international treaty of the 21st century.

In the mid-2000s, the International Institute for the Unification of Private Law (UNIDROIT) began exploring the possibility of developing a protocol, termed the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Mining, Agriculture and Construction Equipment (MAC Protocol). Work on that protocol is now sufficiently advanced, and a Committee of Governmental Experts has been convened to consider the draft text in March 2017.

Perhaps to a greater extent than its senior siblings, the MAC Protocol holds tremendous potential to facilitate access to finance and equipment, particularly for developing nations. Lessors and secured creditors will benefit from a new international regime that provides certainty and ample protections for their interests in equipment, both within and outside insolvency proceedings.

This article discusses the key features of the present draft of the MAC Protocol and analyzes the economic and legal justifications for the protocol, even as it makes a case for increased support and ratification of the protocol amid the current spate of domestic secured transactions law reforms across the world. Ultimately, this article details the coming intergovernmental negotiations and possible challenges to the present draft of the MAC Protocol in anticipation of its eventual adoption in 2018.

SUCCESS IN LEGAL CERTAINTY

The Cape Town Convention and its Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Aircraft Protocol) have been a smashing success, attracting 66 ratifications (65 countries and the European Union) since 2006.1

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The root of this success is the Cape Town Convention’s ability to provide legal certainty for creditors, especially in cross-border transactions. This in turn increases the availability of financing for covered equipment, while in many instances also reducing the cost of financing. In fact, the Aircraft Protocol is expected to generate savings of US$161 billion in aggregate financing costs from 2009 to 2030.2 Since its establishment in 2006, the International Registry, created pursuant to the Aircraft Protocol, has recorded over 750,000 registrations against aircraft objects.3

Emboldened by the success of the Aircraft Protocol, UNIDROIT began working in earnest in 2009 on the preparation of a fourth protocol to the Cape Town Convention covering agricultural, construction and mining equipment.4 The work on this protocol follows the adoption of the protocols governing railway rolling stock and space assets, neither of which has yet entered into force.5
Like its predecessors, the objective of the MAC Protocol will be to provide the certainty, predictability, and adequate protections of the rights of lessors and secured creditors to allow them to confidently lease and finance equipment across the world.

In 2014 UNIDROIT convened a study group entrusted with preparing a draft of the MAC Protocol. At the same time, the Mining, Agriculture and Construction Working Group (MAC WG) was formed to provide an avenue for the private sector — the mining, agriculture, and construction equipment industries — to provide input on the MAC Protocol project. To date, the MAC WG has 12 member companies, and organizations representing the interests of more than 10,000 companies doing business on six continents.

In March 2016, the study group produced a final draft of the MAC Protocol for consideration at intergovernmental negotiations.5

THE KEY FEATURE OF THE MAC PROTOCOL: SCOPE

Like its predecessors, the objective of the MAC Protocol will be to provide the certainty, predictability, and adequate protections of the rights of lessors and secured creditors to allow them to confidently lease and finance equipment across the world.

Given the variety of such equipment, the study group faced the daunting task of identifying equipment suitable for coverage.7 Many items of MAC equipment may be predominantly for general use (such as trucks); some have multiple MAC uses (such as drills used in mines and tunnel construction); still others have specialized MAC use (such as commercial harvesters). Ordinarily, the mere reference to MAC equipment would have also captured assets that may not be mobile, of high value, or uniquely identifiable.

In order to limit the risk of the MAC Protocol covering assets that do not meet the Article 51 criteria of the Cape Town Convention for future protocols: (1) mobility, (2) high value, and (3) unique identifiability, the study group decided to base the scope on the Harmonized Commodity Description and Coding System (HS System).8 The HS System is used by more than 200 countries to classify goods for purposes of customs tariffs covering approximately 98% of international trade. However, it is used much less regularly by institutions providing financing for such equipment.9

The draft MAC Protocol includes six-digit codes from the HS System that it categorizes into three annexes: (1) Annex 1 for HS codes covering agricultural equipment, (2) Annex 2 for HS codes covering construction equipment, and (3) Annex 3 for HS codes covering mining equipment. Some HS codes cover equipment designed to be used in more than one MAC industry, such as HS code 870410, which covers off-highway dump trucks that could be used in mining or construction.

The MAC WG has been tasked with categorizing the HS codes under one or more annexes based on the type of MAC equipment they cover. Prior to the formation of the MAC WG, the MAC industry identified and supplied a list of HS codes it deemed to be suitable for coverage under the MAC Protocol. In evaluating the proposed list of HS codes and thus determining the scope of the MAC Protocol, the study group was guided initially by the Article 51 criteria.10

The study group determined that a strict application of these standards would result in a dramatic reduction in the scope of the MAC Protocol to the point it would make very little sense to pursue it. For example, a number of equipment items, such as cranes, are affixed to immovables and may not be moved at all or only occasionally, such as when they are relocated to a new construction site.

Furthermore, some HS codes cover equipment that is manufactured in different types and engine capacity, such as the HS code 842919, which covers bulldozers that sell for US$2 million as well as those that sell for US$100,000.

Although the three standards (of Article 51) still serve as the main criteria in determining the scope of the MAC Protocol, the study group wanted to ensure that the equipment covered by the selected HS codes is financed separately. This approach eliminated a number of HS codes that cover (1) only parts (for example, HS 850300, which covers only parts used with machines, such as electric motors and generators), or (2) equipment not predominantly used in the MAC industries, which eliminated those codes covering multipurpose and general use equipment (such as HS 870442, which covers motor vehicles for transport of goods even though it may cover machines such as timberjack forestry forwarders).

The HS System is revised every five years, so the study group also devised procedures for (1) the alignment of the HS codes included in the annexes with those of the future HS System revisions, and (2) amendment of the HS codes that may in the future cover new types of MAC equipment not presently covered.11 The three annexes covering different types of MAC equipment are designed to operate independently, allowing countries either to apply the
protocol to all three or to opt out of one or two of them.

It is notable that the MAC Protocol, unlike the Aircraft Protocol, will not apply to engines as separate objects over which an international interest may be created separately from the equipment itself. An international interest over the equipment would thus extend to the engine. Implements such as harrows, which are connected to other equipment, will constitute objects separate from the equipment to which they may be attached when used.

**ECONOMIC BENEFITS OF THE MAC PROTOCOL**

Depending on the MAC Protocol’s final scope, it could generate even more savings in financing costs and result in a greater increase in trade than the very successful Aircraft Protocol. At its most expansive, the potential coverage of the MAC Protocol has been estimated at approximately US$8 billion per year between 2009 and 2030. However, a further economic study is required in order to quantify the exact magnitude of the potential impact of the MAC Protocol on trade and financing costs.

In extending to MAC equipment the proven economic benefits of the CTC framework, the MAC Protocol should also make the acquisition of high-value MAC equipment possible for companies that previously did not have access to it due to the lack of affordable financing. Further, companies in emerging and developing economies should also expect to be able to acquire high-value MAC equipment cheaper and more efficiently than they would without the MAC Protocol, because the legal frameworks of many developed economies are unpredictable and complex.

It is also worth noting that by accomplishing these ends, the MAC Protocol will assist in achieving United Nations Sustainable Development Goals 9.3, 17.3, and 17.5, adopted and committed to by more than 150 world leaders at the U.N. in September 2015.

**WHY COUNTRIES SHOULD RATIFY**

Many countries have recently completed or undertaken (or are contemplating) reform of their secured transactions laws with general application to personal property, including MAC equipment. It is therefore necessary to examine how the MAC Protocol could be integrated into these frameworks.

On the one hand, an argument can be made that the MAC Protocol is an unnecessary duplication of reform efforts and that resources should instead be dedicated to the reform of general secured transactions law. On the other hand, such reforms are extremely challenging to complete, and many have resulted in deficient legal frameworks. This is so either because certain vested interests (e.g., notaries in civil-law jurisdictions) could not be upended or because of fundamental drafting errors, such as in Ghana where the legal framework prescribes double-registration of interests in collateral in the secured transactions and the companies’ registries.

Furthermore, many countries lack the kind of market environment that generates receivables, intellectual property rights, or securities, so rules allowing the utilization of these assets are of no immediate concern. Instead, many countries’ immediate needs are to build infrastructure and further develop the agricultural sector. For these countries, the MAC Protocol would be an ideal modernization tool that is much cheaper to implement as the country would not need to establish a registry of security interests because all international interests in MAC equipment would be registered in an international registry, similar to the one established under the Aircraft Protocol. The MAC Protocol also provides predictable and uniformly applicable rules that are not in danger of being intentionally or inadvertently altered during the enactment process, as has often happened with domestic law reform.

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International Registry regulations that will need to address other thorny issues, including the unique identification of MAC equipment by serial numbers in registrations.

In relation to the International Registry, the question of who will be appointed the supervisory authority remains open. Industry involvement and continued support will be key to the eventual success of the MAC Protocol.

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Endnotes


7. For similar challenges in establishing the scope of the potential future Protocol on marine assets, see Michael Kim, A Cape Town Protocol for Marine Assets: What Can We Agree on Now?, 34(3) JOURNAL OF EQUIPMENT LEASE FINANCING (Fall 2016).


11. Id. at 346-347.

12. See the equipment covered by HS843220.


14. Id. at 1.

15. Study by Vadim Linetsky, supra n 2.

16. See further Mooney, Dubovec, and Brydie-Watson, supra n 10.


18. See further Mooney, Dubovec, and Brydie-Watson, supra n 10, at 354-360.


21. See article 10 of the MAC Protocol.


23. See supra n 4.


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