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

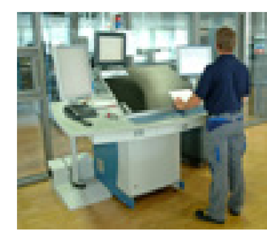
By Paul Bent

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.

More Good News From Cape Town: How the New MAC Protocol Will Benefit the Mining, Agriculture and Construction Industries

By Phillip L. Durham and Marek Dubovec, SJD

For several years, UNIDROIT has been working on a protocol on mining, agriculture, and construction equipment. Consideration of that draft is planned for March 2017, with an eye toward adoption of the MAC Protocol next year. Here is a look at the upcoming intergovernmental negotiations and possible challenges to the present draft.



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For several years, UNIDROIT has been working on a protocol on mining, agriculture, and construction equipment. Consideration of that draft is planned for March 2017, with an eye toward adoption of the MAC Protocol next year. Here is a look at the upcoming intergovernmental negotiations and possible challenges to the present draft.

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]

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.[6]

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 asHS 870423, 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,[12] 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 representing US$2000 billion in annual trade, which would be 16 times the size of the Aircraft Protocol.[13] Even at the more limited scope currently being contemplated by the Committee of Governmental Experts, the scope of the MAC Protocol would be roughly equal to that of the Aircraft Protocol.[14]

Moreover, if the economic benefits of the Aircraft Protocol are any indication, the hope is that the MAC Protocol will result in a US$600 billion aggregate increase in trade in MAC equipment over five to seven years and savings in financing costs of approximately US$8 billion per year between 2009 and 2030.[15] 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 developed 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 even 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.[16]

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.[17]

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.[18]

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.

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.

The MAC Protocol builds on the effective framework set out in the Cape Town Convention, including a set of efficient remedies applicable both within and outside of insolvency. Creditors will thus have access to extrajudicial remedies (unless a country opts out from this article) and should be able to count on expeditious cooperation from local administrative agencies in the enforcement of their rights.

Although the MAC Protocol gives country three alternatives with respect to the type of insolvency provisions contained therein — alternative A being the most protective of creditors' rights with alternative B being its antipode — it is expected that most countries would choose the insolvency alternative that provides the most protection to creditors.

> The MAC Protocol could also play a positive role in eliminating certain disadvantages faced by foreign lenders in competing with local incumbents, primarily because of their unfamiliarity with the local legal framework that governs equipment financing.

The MAC Protocol could also play a positive role in eliminating certain disadvantages faced by foreign lenders in competing with local incumbents, primarily because of their unfamiliarity with the local legal framework that governs equipment financing, and penetrate the existing networks even more forcefully than the reform of a domestic secured transactions law.[19] The argument in favor of legal harmonization and reduced transactional costs continues to play a significant role in law reform,[20] and the MAC Protocol is a means to achieve harmonization and reduce the cost of credit.

Moreover, cross-border secured transactions are viable only to the extent that the security interest of the creditor is adequately protected in insolvency. A foreign lender or counsel may not even examine the local secured transactions law, however modern, if the insolvency law of the target country does not provide adequate protection.

This challenge can be avoided under the MAC Protocol, as the analysis under the CTC is much more straightforward because the international interest of the secured creditor is protected not only when the debtor is solvent but also when it becomes subject to insolvency proceedings.[21] The MAC Protocol may usefully complement a reform of the domestic law based on the United Nations Commission on International Trade Law's (UNCITRAL) Model Law on Secured Transactions (UNCITRAL Model Law).[22]

However, the process of reforming a domestic secured transactions law must be properly coordinated with the ratification of the MAC Protocol to ensure, for instance, that lessors are aware of the consequences of perfecting their security interests only by filing in the local registry. That perfection will result in the subordination of that interest to an international interest, or that a registration in the international registry is required to perfect an international interest in the nature of an operating lease, which is not typically a requirement of secured transactions laws, including UCC Article 9.

NEXT STEPS IN THE MAC PROTOCOL PROJECT

At its 95th session, May 18–20, 2016, UNIDROIT's governing council approved the convening of a Committee of Governmental Experts to consider the draft MAC Protocol. The first meeting of the committee will be held in Rome on March 20–24, 2017, and it is expected that an additional meeting will be necessary.[23]

Subject to the approval of the committee, a diplomatic conference to adopt the MAC Protocol could be held sometime in 2018. UNIDROIT invited comments on the draft MAC Protocol that could be submitted until January 8, 2017. There will also be an opportunity to comment prior to the second Committee meeting. Input from manufacturers, lenders, and lessors would be especially valuable, particularly in relation to the scope ensuring that no valuable items of MAC equipment have been left out of the lists of HS codes.

During its last meeting, the study group discussed whether the MAC Protocol should apply to aquaculture equipment, but no firm decision has been made on this subject, and input on the question would be welcomed.[24]

The committee is expected to revisit some of the issues examined by the study group, particularly those that have not been dealt with in any of the preceding protocols, such as the provisions relating to fixtures and amendments of the annexes. In particular, the matter of fixtures is expected to generate long debates because of the potential impact of the local law of real property on an international interest in equipment that is affixed to real property in such a manner that a competing interest may arise in it under the law of real property.

Other issues could also be sensitive for certain participants who may, for instance, wish to debate the appropriateness and applicability of the remedial framework of the MAC Protocol to family farmers. The members of the study group expressed mixed opinions on a few issues, such as the potential application of the MAC Protocol to sales of equipment, which should follow the model of the Rail Protocol rather than the Aircraft Protocol, under which the registration of a sale is only voluntary, without any third-party effects.

This and a couple of other unsettled issues (e.g., the application of the MAC Protocol to aquaculture equipment) are expected to attract the attention of participants at the committee meetings. The Committee of Governmental Experts is also expected to lay the groundwork for the future

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

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4. For a complete history of the MAC Protocol project, see *UNIDROIT, Study LXXII K — Development of a Fourth Protocol to the Cape Town Convention on Matters Specific to Agricultural, Construction and Mining Equipment* (last updated Dec. 19, 2016), available at http://www.unidroit.org/work-in-progress-studies/current-studies/mac-protocol (last accessed Jan. 4, 2017).

5. *See Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock* (Luxembourg, Feb. 23, 2007), *available at* http://www.unidroit.org/instruments/security-interests/rail-protocol (last accessed Jan. 4, 2017); and *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets* (Berlin, March 9, 2012), available at http://www.unidroit.org/instruments/security-interests/space-protocol (last accessed Jan. 4, 2017).

6. The draft text of the MAC Protocol is *available at* http://www.unidroit.org/english/documents/2016/study72k/s-72k-sg04-06-e.pdf (last accessed Jan. 4, 2017).

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).

8. The HS System was established pursuant to and is governed by the International Convention on the Harmonized System (HS Convention), *available at* http://www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs_convention.aspx (last accessed Jan. 4, 2017), which entered into force on Jan. 1, 1988. For an analysis of the HS System in the context of the MAC Protocol see UNIDROIT 2016 Study 72K – SG4 – Doc. 2, *Section A – The Harmonized Commodity Description and Coding System* (hereinafter, UNIDROIT Analysis). Unless otherwise noted the description of the HS System that follows is based on the UNIDROIT Analysis, which in turn was based on the 2013 World Customs Organization (WCO) Handbook. *See* WORLD CUSTOMS ORGANIZATION, CLASSIFICATION HANDBOOK (2nd ed., 2013).

9. See further, UNIDROIT Secretariat, Legal Analysis, Study 72K – CGE1 – Doc. 4, 36–41 (September 2016), *available at* http://www.unidroit.org/english/documents/2016/study72k/cge1/s-72k-cge01-04-e.pdf (last accessed Jan. 4, 2017).

10. See further Charles W. Mooney Jr., Marek Dubovec, and William Brydie-Watson, *The Mining, Agricultural and Construction Equipment Protocol to the Cape Town Convention Project: The Current Status*, 21 UNIFORM LAW REVIEW 332, 346 (2016).

11. *Id.* at 346–347.

12. See the equipment covered by HS843230.

13. THE CENTER FOR THE ECONOMIC ANALYSIS OF LAW, *Extending UNIDROIT's Cape Town Convention To Mining, Agricultural And Construction Equipment: Economic Issues* at 1 (2013), *available at* http://www.unidroit.org/english/governments/councildocuments/2013session/cd92-05b-e.pdf (last accessed Jan. 4, 2017).

14. *Id.* at 1.

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16. UNITED NATIONS, *Sustainable Development Goals, available at* https://sustainabledevelopment.un.org/topics/sustainabledevelopmentgoals (last accessed Dec. 28, 2016).

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

18. See Marek Dubovec and Benjamin Osei-Tutu, *Reforming Secured Transactions Laws in Africa: The First African Collateral Registry in Ghana*, 45(1) UCC LAW JOURNAL 77, 104–111 (2013).

19. R. Haselman, Katharina Pistor, and Vikrant Vig, *How Law Affects Lending*, MPRA Paper No. 157, at 11 (Oct. 7, 2006).

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21. See article 10 of the MAC Protocol.

22. Ole Böger, *The Cape Town Convention and Proprietary Security over Ships*, 19 UNIFORM LAW REVIEW 52 (2014).

23. See supra n 4.

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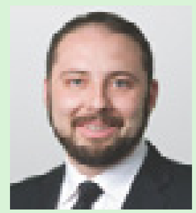

Phillip L. Durham

phillip.durham@hklaw.com

Phillip Durham is a partner in the New York office of Holland & Knight. His practice focuses on domestic and cross-border asset-based financing, leasing, acquisitions, sales, and securitizations, with a particular emphasis on aviation and equipment finance in Latin America, the Middle East, Africa and Asia. Global transactions that Mr. Durham has handled include Airline Economics' 2015 debt deal of the year; Airfinance Journal's 2015 North American deal of the year and the same journal's capital markets deal of the year; and Jane's Transport Finance's aviation deal of the year. As secretary general of the MAC Working Group, Mr. Durham collaborates with the ELFA Legal Committee's international subcommittee, the MAC Protocol working group. He has been recognized as a leading practitioner by Chambers USA, Legal 500 USA, Legal 500 Latin America, Expert Guides, Client Choice, Who's Who Legal, and Super Lawyers. Mr. Durham obtained a BA from Creighton University in Omaha, Nebraska. He holds a JD from the University of Iowa College of Law, Iowa City, where he served as the articles editor for the Iowa Law Review, received the Alan I. Widiss Faculty Scholar Award, and was a member of the Order of the Coif.

Marek Dubovec, SJD

mdubovec@natlaw.com

Marek Dubovec is the senior research attorney at the National Law Center for Inter-American Free Trade in Tucson, Arizona. He also serves as a consultant on secured transactions law reform for the World Bank Group, the International Finance Corporation, the U.S. Agency for International Development, and the U.S. State Department. Dr. Dubovec has assisted in the secured transactions law reform efforts of several countries, including Nigeria, China, Mozambique, Mexico, Honduras, the Philippines, Zambia, Zimbabwe, Kenya, Ghana, Sierra Leone, Liberia, Chile, Colombia, Bangladesh, Indonesia, and Honduras. He is a professor of practice at the University of Arizona, James E. Rogers College of Law, in Tucson, teaching secured transactions (UCC 9) and international commercial transactions. Dr. Dubovec is a member of the United Nations Commission on International Trade Law (UNCITRAL) Working Group VI on Security Interests. He earned a magister of law degree in 2003 from the University of Matej Bel College of Law in Banská Bystrica, Slovakia. He attended the University of Arizona's James E. Rogers College of Law (Tucson), where he obtained a master of law degree in international trade law (2004) and a doctor of juridical science (SJD) degree (2009).