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Focus: Railcar Finance

What Does an STB Filing Tell You?

by Francis X. Nolan III

In deciding whether to purchase an asset or to accept it as collateral security for a debt, a sober investor naturally wishes to confirm that the offeror in fact has unencumbered title and ownership. When it comes to planes, trains and ships, what can the diligent investor find and reasonably rely upon?

The registration regime for aircraft is relatively straightforward. With only limited exceptions, the Federal Aviation Act prohibits anyone from operating an aircraft that is not registered with the Federal Aviation Administration (FAA). 49 U.S.C. § 44101(a). Registration is available for aircraft owned by a U.S. citizen provided the aircraft is not registered in another country. Any ownership change must be registered under Section 44107. Thus, as a practical matter, aircraft must be registered or documented in the name of a person who can provide the required evidence of ownership in order for it to be operated in the United States.

Practitioners of transportation finance may be accustomed to the application of several federal schemes for the perfection of security interests in this category of mobile assets. The Federal Aviation Act, in 49 U.S.C. § 44103, provides for filing of leases and mortgages with the FAA in Oklahoma City, with the relatively recent overlay of internationally effective filings under procedures put into effect through the Cape Town Convention. *See* 49 U.S.C. § 44107(e).

Likewise, the U.S. registration regime for vessels is easily followed and provides assurances as to proper title and registration. Both the Federal Aviation Act and the Vessel Documentation Act, 46 U.S.C. ch. 121, provide that a certificate of registration is conclusive evidence of nationality of the equipment but is not evidence of ownership in any proceeding in which ownership is challenged. U.S. commercial vessels, for the most part, are documented with the U.S. Coast Guard National Vessel Documentation Center (NVDC) in Falling Waters, W. Va., where mortgages on such vessels must be filed in order to constitute "preferred mortgages." Ship Mortgage Act, 46 U.S.C. § 31301 *et seq*. The Federal Aviation Act *requires* registration of aircraft, while the Vessel Documentation Act *permits* documentation, although certain trades are denied to a vessel that is not documented in the United States with appropriate endorsements. However, as a practical matter, unregistered aircraft and undocumented vessels could not operate or cross international borders without registry or documentation, as these provide a national identity, or "flag."

Rolling stock is another matter—in the United States, at least. There is no recognized system for

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governmental registration of railcars or locomotives and, hence, no such thing as a U.S.-flag railcar. Instead, in the rail world, there are two entities, one governmental—the Surface Transportation Board (STB or the Board)—and one nongovernmental—the Association of American Railroads (AAR).

The STB has a number of functions as the scaled-down successor to the Interstate Commerce Commission (ICC). Among these are the continuation of the work of the ICC's office for filing and recording of security agreements on rolling stock and appurtenances. The authorizing statutory provisions are set forth in 49 U.S.C. § 11301(a), which states:

> (a) A mortgage [other than a preferred ship mortgage under title 46], lease, equipment trust agreement, conditional sales agreement, or other instrument evidencing the mortgage, lease, conditional sale, or bailment of or security interest in vessels, railroad cars, locomotives, or other rolling stock, or accessories used on such railroad cars, locomotives, or other rolling stock (including superstructures and racks), intended for a use related to interstate commerce shall be filed with the Board in order to perfect the security interest that is the subject of such instrument. The assignment of a right or interest under one of those instruments and an amendment to that instrument or assignment including a release, discharge, or satisfaction of any part of it shall also be filed with the Board. The instrument, assignment, or amendment must be in writing, executed by the parties to it, and acknowledged or verified under Board regulations. When filed under this section, that document is notice to, and enforceable against, all persons. A document filed under this section does not have to be filed, deposited, registered, or recorded under another law of the United States, a State (or its political subdivisions), or territory or possession of the United States, related to filing, deposit, registration, or recordation of those documents. This section does not change chapter 313 of [the Ship Mortgage Act].

This creates a national, central filing system for agreements evidencing security interests in rolling stock and preempts any state statutes requiring filing of financing statements to perfect state-created security interests in such highly mobile equipment. The provision does *not* create a registry of ownership or changes in ownership. Although the Section allows perfection of security interests in vessels, this manner of perfecting is seldom used (for reasons numerous enough to support another newsletter article).

. . . no filing with the STB can cure an inadequate or incomplete grant of a security interest. Nor can it burden a unit of property that the grantor does not, in fact, own.

It is important to recognize that centralized perfection against rolling stock is all that an STB filing can do. It is applicable state law that governs the question of whether an agreement creates an enforceable security interest, and state law, together with the federal Bankruptcy Code, that determines the ranking and priority of liens, security interests and other claims in rolling stock. Remember, as well, that no filing with the STB can cure an inadequate or incomplete grant of a security interest. Nor can it burden a unit of property that the grantor does not, in fact, own.

So what is filed with the STB? The parties may file the documents embodying the security agreement itself, such as a lease or security agreement. In the alternative, the parties may file a memorandum of lease or security agreement. In either case, the filed documents must set forth the name of the grantor and the secured party as well as the identity of the rolling stock subject to the security interest. Simple enough.

However, care must be taken to identify exactly which documents actually convey a security interest. In rail finance, lessors frequently use the master lease device, which, in and of itself, may not create a lease. The master lease merely sets out general terms and conditions that are incorporated by reference in individual lease schedules which by their terms convey interests in specifically identified units of rolling stock for specific rents and lease terms. Often these schedules include provisions in conflict with master lease provisions and provide for the supersession of the conflicted master lease provisions. These lease schedules are in reality the "leases" or security agreements that must be filed with the STB, perhaps with the master leases, inasmuch as they contain general terms applicable to the individual lease schedules.

When railcars are sold, especially in large lots or when under lease to heavily scheduled lessees, such as coal-dependent utilities, it is sometimes months, if not years, before the car marks and road numbers are changed on the cars themselves—as well as the UMLER after the fact.

After identifying the relevant documents, railcar financiers (lessees and lenders) still must figure out how to identify the specific units of rolling stock. In order to operate in interchange on the nation's rail lines, railcars are required to be registered in the Uniform Machine Language Equipment Register (UMLER) under the auspices of the AAR. Each railcar is identified in the system by an alphabetical prefix and a numerical road number. Although the common understanding is that these car marks identify the car as belonging to a specific owner, the facts are more complicated. Railcars are commonly registered under the car mark of a lessee or even under a railcar management entity such as Greenbrier. Car marks themselves are bought, sold and licensed. When railcars are sold, especially in large lots or when under lease to heavily scheduled lessees, such as coal-dependent utilities, it is sometimes months, if not years, before the car marks and road numbers are changed on the cars themselves—as well as the UMLER after the fact.[1]

. . . in our experience, the Equipment Identification Number has not emerged as a tool for tracking ownership or liens for sale or financing purposes and is not referenced on any STB filing to identify a unit of rolling stock.

In very recent years, Railinc, which administers UMLER for the AAR, has apparently broadened access to an Equipment Identification Number (EIN) for each unit of rolling stock registered in UMLER. This number has been likened to a VIN number on a road vehicle and continues to identify an item of equipment through any number of car mark changes during the life of the asset. It allows for more accurate review of maintenance and repair histories than would be available, for example, on an UMLER search of a car mark and road number. However, in our experience, the EIN has not emerged as a tool for tracking ownership or liens for sale or financing purposes and is not referenced on any STB filing to identify a unit of rolling stock.

Good practice requires that filings be amended at the STB (and the UCC filing office) in order to assure that the collateral is properly identified. A new lender or buyer needs to be aware of this casual practice in regard to car marks so that the diligence conducted is extensive enough to ascertain what railcars are involved and whether the assets to be purchased or pledged are properly identified or identifiable.

Finally, it is important to remember that the STB records are only recordations of encumbrances

[1] This potential for confusion in identifying railcars due to changing car marks and road numbers is largely avoided in vessels by virtue of the requirement to keep the same official number throughout the vessel's life under a specific flag.

(leases and security interests), and thus the STB is not a title registry. An inspection of STB records will show filings with respect to identified car marks and numbers. Certainly the identification of a grantor or other party to a filed agreement implies that a party must have either legal or equitable ownership, or both, of the rolling stock concerned. But there is a certain risk in relying on such filings alone to convince the reviewer that ownership is thus confirmed. An effective due diligence will consider public filings, notwithstanding statutory disclaimer of evidentiary values, as is the case with FAA and NVDC filings. If someone claims ownership on a public record that sits unchallenged, the claim becomes more credible with each passing day. But the proper diligence includes a review of the chain of title reflected in prior instruments of sale and orders of the courts where arrest, seizure, foreclosure or bankruptcy has inserted itself into the history of the asset. Nowhere is this more important than in confirming title in rolling stock, where no ownership registry exists.

If you have any questions regarding this article, please contact ***Francis X. Nolan III*** *(212-407-6950).*

UPDATE: The Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock

by David S. Golden

In February 2007, representatives from 42 countries met in Luxembourg and adopted a Protocol to the Cape Town Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock. As some readers probably know, the Cape Town Convention, signed by 20 participating states in Cape Town, South Africa in November 2001, established for the first time an international legal framework for the registration of rights in mobile equipment including aircraft and aircraft engines, railway rolling stock and satellites. The Convention is structured with the basic objectives and provisions set forth in the treaty, with three separate protocols to be adopted, each applying and adapting the treaty to a relevant industry sector. A protocol applying the Convention to the aviation industry (the Aviation Protocol) was adopted in 2001 and took effect in March 2006. At the same time, an International Registry for the registration of interests in aircraft commenced operations.

In June 2010 the Intergovernmental Organization for International Carriage by Rail (OTIF) and the International Institute for the Unification of Private Law (UNIDROIT) began a tender process inviting interested entities to submit proposals to be appointed as the Registrar for an International Registry for railway rolling stock, much like the aircraft registry currently in operation. The Rail Protocol will become effective when at least four states have ratified it and the registry has become operational.

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The Rail Protocol differs from the Aviation Protocol in several key respects, and the drafters of the Rail Protocol grappled with several issues that did not arise in the preparation of the Aviation Protocol. One such issue involved the political fallout that could result from the protection of creditors' interests in rail equipment. Trains are used for mass transportation to a much greater extent than aircraft; a creditor's repossession of certain rail equipment could, for example, prevent an entire city's commuters from getting to work or bring a halt to crucial freight service in a particular geographic location. Under the Rail Protocol, a contracting state with laws in place that would prevent a creditor from repossessing rolling stock could, upon acceding to the Rail Protocol, make a declaration that would apply to rolling stock that is "habitually used for the purpose of providing services of a public importance."[1] The declaration would enable the state to require a creditor to continue to use such equipment for the same purpose in exchange for government compensation equal to the greater of (a) the amount the government would be required to pay under its national law and (b) the market lease rental for such equipment.[2]

In his Official Commentary to the Rail Protocol, Professor Sir Roy Goode notes that determining whether certain railway rolling stock is used for "a public importance" will depend upon the facts in each case. He points to two criteria of particular importance: (1) "the volume of traffic carried by the service" and (2) "the perception of public importance of the service in the Contracting State."[3] The availability of alternatives to the service in question does not disqualify that service from being one of public importance—the nature of the service provided will be the most important factor. The drafters of the Rail Protocol extended this public-service exemption to freight rolling stock only reluctantly, and it is therefore expected that the exception will apply primarily in the passenger rail sector and secondarily in the freight sector if, for example, the freight in question has public safety implications, such as nuclear waste or other hazardous material.[4]

The Rail Protocol's approach to insolvency options differs from that of the Aviation Protocol. The latter allows contracting states to apply their own national insolvency laws or to adopt one of two regimes: an Alternative A, which enables a creditor to repossess equipment following the expiration of a state-specified waiting period unless the default is cured; or Alternative B, which requires the creditor to comply with state law requirements before repossession.[5] The Rail Protocol follows the same model but provides an additional Alternative C, a middle ground between the creditor-friendly Alternative A and the more pro-debtor Alternative B. Under Alternative C, the debtor or insolvency administrator can, during a period within which it may cure all defaults (such period to be specified by the contracting state), apply for a court order suspending the right of creditors to repossess the equipment, which court order would also require the debtor or its administrator to preserve and maintain the equipment and continue to pay the creditor the amounts it would have been paid had no default occurred.[6]

Therefore, the Rail Protocol leaves it for the regulations governing the International Registry to prescribe a system by which the Registrar will allocate unique identification numbers to each item of rolling stock.

An additional difference between the Aviation Protocol and the Rail Protocol concerns their respective approaches to the identification of particular equipment, both for purposes of constituting an "international interest" and for purposes of the registration of that interest. For both such purposes, the Aircraft Protocol simply requires that an object be identified by manufacturer, model and serial number.[7] The drafters of the Rail Protocol, however, could not adopt those simple criteria for either purpose because (a) it has not

[1] Rail Protocol, Article XXV (1).

[2] Rail Protocol, Article XXV (3).

[3] Sir Roy Goode, *Convention in International Interests in Mobile Equipment and Luxembourg Protocol Thereto on Matters Specific to Railway Rolling Stock – Official Commentary* 109 (1st ed. 2008).

[4] Howard Rosen, *The Luxembourg Rail Protocol: A Major Advance for the Railway Industry*, XII Unif. L. Rev. 427, 440 (2007).

[5] Aviation Protocol, Article XI.

[6] Railway Protocol, Article IX.

[7] Aviation Protocol, Article X(1).

always been the practice for rail equipment manufacturers to allot serial numbers to their products, (b) in some, more modern rolling stock, serial numbers are not always readily apparent upon inspection and (c) in some parts of the world, industry practice has been to identify rolling stock by reference to numbers generated through a national or international agency (for example, the UMLER numbering system used in North America and the RIV/RIC system used in Europe), and there is potential for those numbers to be reused and applied to different items of rolling stock. Therefore, the Rail Protocol leaves it for the regulations governing the International Registry to prescribe a system by which the Registrar will allocate unique identification numbers to each item of rolling stock.[8] A unique identification number will be generated by the Registry and (1) affixed to the item of equipment or (2) associated in the Registry with the manufacturer's name and identification number

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already affixed to the item or (3) associated in the Registry with a national or regional identification number already affixed to the item. This will be a complex system and will require the Registry to effectively maintain a library of identification numbers and to note where numbers have changed on the rolling stock. The Request for Proposals for the International Registry issued by OTIF and UNIDROIT posits 20-digit identification numbers, and the Registry's system must be capable of generating numbers that incorporate national or regional identification numbers.

Much work remains to be done before the Rail Protocol will come into effect. When it does, and as it is widely adopted, it is expected to help revitalize the railway sector, drawing more private capital into the industry, especially in places like Africa, where it has traditionally been difficult for lenders to take security interests in rolling stock that passes through multiple jurisdictions and their patchwork legal systems.

If you have questions regarding any of the issues in this article, please contact ***David S. Golden*** *(312-609-7686).*

Two Recent Cases Shed Light on Liquidated Damages

by John I. Karesh and Michael E. Draz

Virtually every equipment financing contract (lease or mortgage) provides a fixed claim for damages (liquidated damages) payable by the Obligor (lessee or mortgagor) upon a breach of such contract. While the concept of liquidated damages is relatively straightforward, there is a long and complicated history of litigation regarding the enforceability of claims for liquidated damages, as two recent cases demonstrate. Liquidated damages are damages agreed to by the parties to a contract at the time of contract formation which establish a formula or predetermined sum that must be paid upon a specific breach. Liquidated-damages clauses are common in contracts, as they provide for greater predictability of damages payments in the event one party does not fulfill its contractual obligations. While contracting parties are free to agree to the payment of liquidated damages, such provisions are not always enforceable. In determining whether a liquidated-damages provision is enforceable, there are a number of factors courts will consider. Primarily, courts will look to whether the amount of damages is reasonable in light of the anticipated or actual harm caused by the breach. Other important factors include the difficulty of establishing proof of loss and the feasibility of obtaining an adequate remedy at the time of breach.

[8] Railway Protocol, Article XIV.

While reasonable liquidated-damages clauses are typically enforceable, penalties are not. A penalty acts to deter nonperformance or to serve as punishment for a breach, rather than being fair compensation to the nonbreaching party. Thus, if the amount of liquidated damages is disproportionate to the anticipated or actual harm caused, it will be considered an unenforceable penalty.

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Banc of America Leasing & Capital, LLC v. Walker Aircraft, LLC[1] is a recent federal case involving the enforceability of a liquidated-damages clause. The case involved loans made for the purchase of aircraft. The loan agreements in question contained acceleration clauses, allowing the lender to demand the full balance of the loans to be due and payable upon the occurrence of specific events of nonperformance by the borrowers. The borrowers failed to make principal and interest payments, triggering the lender's right to accelerate the loans. The borrowers argued that the acceleration clauses were punitive and unenforceable.

The court stated that an acceleration clause is unenforceable if it can be triggered by any breach of the contract's terms, whether serious or trivial, because a party breaching a minor term of the contract would be forced to pay an amount that is disproportionate to the harm such breach caused the other party. In the loan agreements at issue, the parties enumerated specific events that would trigger the right to accelerate the loans. After analyzing these provisions, the court found that the right to accelerate was not triggered by merely any trivial default, but by specific events that the parties deemed to be material. Moreover, the acceleration clauses were not punitive because they were intended to serve as compensation to the lender for the unpaid balances of the loans. Thus, the court held that the loan acceleration provisions were enforceable.

Another recent case, *ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC*,[2] while not involving equipment finance, is also germane to the issue of liquidated damages. This case involved a $145 million loan secured by mortgages on real property. While the obligations of the borrower and guarantors under the loan documents were nonrecourse (that is, the lender's recovery was limited to the proceeds from the sale of the property through foreclosure), the loan documents allowed for the liabilities of the borrower and guarantors to become full recourse upon the occurrence of specified events. The borrower eventually became delinquent in paying its property taxes, leading to a tax lien being levied against the property, which the lenders argued triggered the liability of the borrower and guarantors on a full-recourse basis.

While this day-late, dollar-short hypothetical is rather extreme, it illustrates that certain "minor" default triggers can render the liquidated-damages provision unreasonable and, consequently, unenforceable.

Ultimately, under the court's interpretation of the contract, the borrower and guarantors were not liable for the $145 million debt on a full-recourse basis. However, the court went on to discuss liquidated-damages provisions in general. The court stated, "immediate liability for the entire debt is not a reasonable measure of any probable loss

[1] 2009 WL 323885 (D. Minn. 2009).

[2] 2010 WL 653972 (N.Y. Sup. Feb. 24, 2010).

associated with the delinquent payment of a relatively small amount of taxes."[3] The court created a hypothetical situation under which a loan agreement gave a lender the right to call the entire amount of the loan due in the event that the borrower was one day late paying one dollar in taxes. This is a scenario in which the amount of damages is clearly disproportionate to the harm caused by the breach. While this day-late, dollar-short hypothetical is rather extreme, it illustrates that certain "minor" default triggers can render the liquidated-damages provision unreasonable and, consequently, unenforceable.

These recent cases highlight important issues that should be considered when drafting liquidated-damages provisions. While such provisions are common in contracts, contracting parties should be mindful that they are not always enforceable. Enforceable liquidated-damages clauses should specifically enumerate the material breaches that will trigger a liquidated-damages provision. Additionally, a fixed sum or formula used to calculate damages should be tied to the harm that the parties anticipate the nonbreaching party will suffer.

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[3] *Id.* at 5.

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