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Legal Analysis

(prepared by the UNIDROIT Secretariat)

<i>Summary</i>	Analysis of major legal issues facing the creation of the MAC Protocol.
<i>Action to be taken</i>	Discussion.
<i>Related documents</i>	UNIDROIT 2014 - Study 72K – SG1 – Doc. 3

Introduction

1. The purpose of this document is to set out the most significant legal and technical issues facing the creation of the MAC Protocol. The information contained in this document is drawn primarily from previous documents (most notably the CEAL and NLCIFT studies), consultations with the private sector and analysis of the Cape Town Convention and existing Protocols. The document is designed to outline only the basic facets of each issue, to allow the Study Group to discuss and resolve the more complex aspects of each issue.

2. The document is to be considered in conjunction with the Annotated Draft Protocol (Study 72K – SG1 – Doc. 3). This document will reference the Article(s) of the Protocol that will need adaption to solve the legal and technical issues considered.

3. It should be emphasized once more that this document is a discussion tool, and should not be considered as providing any final or absolute views of how legal issues should be solved.

4. The issues dealt with in this document are as follows:

(i) Scope of the MAC Protocol

a. High value criterion

b. Mobile criterion

- c. Unique identifiability criterion
 - d. Multi-purpose equipment
 - e. Severability
 - f. Multiple purpose equipment
- (ii) Accessions
 - (iii) Merged Collateral
 - (iv) Inventory
 - (v) Insolvency
 - (vi) Interaction with domestic secured transaction regimes
 - (vii) Additional Issues

(i) Scope of the MAC Protocol¹

5. There are two competing interests that need to be reconciled in delimiting the scope of the MAC Protocol:

- (i) Limiting interest: The nature of the Cape Town Convention as an instrument that regulates secured transactions law for special categories of equipment, rather than providing a general universally applicable secured transactions law. This consideration would suggest limiting the scope of the MAC Protocol to a narrow category of equipment.
- (ii) Economic interest: While the Protocol must be strictly kept within the structural confines of the Cape Town Convention, the more types of MAC equipment falling within the scope of the Protocol, the greater the economic benefit gained from its creation. If its application is limited to a point where its economic benefits are greatly diminished, there is very little incentive for States to adopt the Protocol. Correspondingly, if the Protocol is then only ratified by a small number of States, its effectiveness and value are further diminished.

6. As such, the Study Group should retain both of these interests in mind when considering how to delimitate the Protocol's scope.

7. It is suggested that the scope of the Protocol could be delineated using the following principles:

- Use of the Harmonised System (HS) to create three separate lists of equipment (agricultural, construction and mining) that are included under the scope of the Protocol.
- Use of the criteria under Article 51(1) of the Convention to assess eligibility for any type of equipment for inclusion in the Protocol.
- The use of minimum thresholds for each criterion to exclude certain types of equipment.

¹ For a useful starting point on Scope, please see pages 40 – 52 of the NLCIFT paper.

- The ability for types of equipment under the HS to be reconsidered for inclusion/exclusion under the Protocol on recommendation from either the Working Group or the UNIDROIT Governing Council (or other appropriate body).
 - Severability of the lists to allow Contracting States to opt out of each of the three areas covered by the Protocol.
8. Each of these principles will be considered below.

The Harmonised System (HS)

9. During the first Issues Dialogue in Washington in November 2013, three approaches were identified to assess what categories of equipment would fall within the scope of the MAC Protocol: 1) a value/mobility axis graph approach; 2) a linear economic/legal approach; and 3) utilisation of the harmonized system of tariffs. The second Issues Dialogue in January 2014 agreed that the Harmonized System of Tariffs presented the greatest potential for delineating the scope of the MAC Protocol.

10. The Harmonised System is a global system developed by the World Customs Organisation to achieve uniform classification of commodities or merchandise in international trade. The system uses a basic six-digit level of detail to classify categories of equipment. Each country may designate additional subdivisions, resulting in codes up to a maximum ten digits. Thus, Harmonised System's greatest utility is in identifying classes of equipment that may fall within the scope of the MAC Protocol.

11. The Harmonised System approach could be incorporated into the Protocol under Article V in the annotated draft:

Article V – Identification of agricultural, mining or construction equipment

A description of agricultural, mining or construction equipment that satisfies the requirements established in the Regulations is necessary and sufficient to identify the agricultural, mining or construction equipment for the purposes of Article 7(c) of the Convention.

12. This drafting of Article V would allow the creation of three annexes in the Regulations to the International Registry, each with lists of Harmonised System codes for agriculture, construction and mining equipment.

Criteria for assessment types of equipment for inclusion under the MAC Protocol

13. The natural starting point when considering the scope of the MAC Protocol is Article 51(1) of the Cape Town Convention itself, which provides:

The Depositary may create working groups, in co-operation with such relevant non-governmental organisations as the Depositary considers appropriate, to assess the feasibility of extending the application of this Convention, through one or more Protocols, to objects of any category of high-value mobile equipment, other than a category referred to in Article 2(3), each member of which is uniquely identifiable, and associated rights relating to such objects.

14. Article 51(1) sets out three clear elements that equipment must demonstrate to be capable of being the subject of a future Protocol: i) high-value, ii) mobile and iii) uniquely identifiable. In doing so, Article 51 naturally limits the scope of the Convention by ensuring it is not of general application in regulating international securitisation law.

Use of the assessment criteria

15. While it is broadly agreed that Article 51 sets out the appropriate criteria for determining eligibility for types of equipment under the Protocol, there is still not a clear consensus on how these criteria should be applied. As a starting point, the two approaches to determining the scope of the Protocol that were discussed at the Issues Dialogue should be reconsidered by the Study Group (CD (93) 4(b) paras 8 – 18).

16. There are various methods that could be used to assess whether a particular type of equipment identified by a HS code should be included under the Protocol. In addition to the methods discussed at the Issues Dialogues, two other potential approaches could be:

- **Low minimum threshold/collective approach:** under this approach, step one would be to set a low minimum threshold which automatically excludes MAC equipment clearly outside the scope of the Article 51 of the Convention from the Protocol (low cost equipment, equipment that does not cross international borders and equipment that cannot be uniquely identified). Step two would be to assess the remaining equipment for potential inclusion in the Protocol using a 'collective' approach. In other words, all three criteria should be considered together collectively to determine the overall suitability for inclusion of a type of MAC equipment under the Protocol.

For example: a type of agricultural equipment is assessed for inclusion under the Protocol. This type of equipment has tens of thousands of units frequently moving across international borders on an annual basis (internationally mobile) and is easily identifiable with a unique serial code. Further, there is strong evidence that its listing under the MAC Protocol will allow its acquisition and use in many more countries, doubling the number of units moving across international borders. However, it is only in the medium-high bracket in terms of cost price. The type of equipment passes the minimum thresholds under step one of the test. In applying the collective approach under step two of the test, weighing the factors together would indicate that this type of equipment should be listed under the Protocol.

- **High minimum threshold/flexible exception approach:** The problem with a rigid minimum threshold system is that it might arbitrarily exclude equipment types, which comply with all criteria of Article 51 of the Convention but fall short of the minimum threshold by only a small margin. In order to render the system more flexible, it might be worth considering setting a higher minimum threshold and including certain exceptions regarding the minimum threshold criteria.

For example: A high minimum threshold in relation to value is set at 500 000 USD. A number of exceptions to this minimum threshold also exist. One such exception is that if the type of mining equipment is within 10% of the minimum threshold but does not meet the minimum threshold, it can still be included in the Protocol if it meets additional criteria, such as it is a highly internationally traded type of equipment, or is considered to be of exceptional importance to developing countries who currently do not have access to this type of equipment.

A type of mining equipment has a value of 470 000 USD and, therefore, does not meet the minimum threshold of 500 000 USD. However, the piece of mining equipment moves across borders on an annual basis, is easily identifiable with a unique serial code and meets other additional criteria. Since the piece of mining equipment only misses the minimum threshold by 30 000 USD (less than 47 000 USD [= 10% of its total value]) and complies with other additional criteria, it can be included in the Protocol.

17. These are only two possible approaches to use of the assessment criteria. The low minimum threshold/collective approach is used further to illustrate the subsections below.

Minimum threshold

18. To keep the scope of the Protocol necessarily restricted, it appears prudent to set minimum thresholds for each of the criteria, which supersedes the collective approach. The failure of a certain type of equipment to meet a minimum threshold criteria on any of the three set assessment criteria would require automatic exclusion from the Protocol, even if it scores extremely well on the other criteria. If this approach is adopted, the question of how to set the minimum threshold for each of the three criteria is a matter the Study Group will have to give significant consideration to.

The high value criterion

19. It may be necessary to set a minimum initial sales price threshold for individual types of equipment. This would require the calculation of a minimum sales price, and the automatic exclusion of all equipment under this value. The HS can be used to identify the average sales price for individual types of equipment.² The registrability of security interests in the asset concerned should not change during the lifetime of the asset, therefore lower prices for any secondary sale of the asset should be irrelevant.

20. The difficulty with this approach is in setting the minimum threshold. To restrict the scope of the Protocol, the minimum sales price threshold could be set quite high to ensure that only truly high-value equipment falls within the scope of the Protocol. The problem with setting a minimum threshold is that by automatically excluding the vast majority of equipment under its value, it effectively negates the collective approach to assessing eligibility under the Protocol. In doing so, it would not take into account other important factors such as the number of units being exported internationally, the overall value to the global economy of the international trade in a specific type of equipment and whether the equipment is easily identifiable.

21. A different approach could be to restrict the minimum sales price threshold to the price point where it remains economically viable for a creditor to assert repossession rights over a registered piece of equipment.

For example, a piece of low value agricultural equipment is sold for 6,000 euro and exported internationally, and the creditor registers its security in the equipment. After three years, the debtor fails to meet its obligations and the creditor obtains possession rights over the equipment. If the equipment has depreciated in value to 2,000 euro, it is unlikely that it will be economically viable for the creditor to complete the legal process required to repossess the property, and resell the equipment on the secondary market (including potential costs associated with shipping the product internationally). Under these circumstances, the registration of such a low-value good is not beneficial for the creditor on an economic basis.

22. Under this approach, economic data would be used to establish the minimum sales price where it would be viable for a creditor to assert repossession rights over a registered piece of equipment. It should be noted that this approach does not mean that all equipment above the

² The HS provides the export values and quantities of each category of equipment. This allows unit values to also be derived for items within each product code. The US Department of Commerce has noted that these unit values provide a useful and consistent baseline for estimating product prices, and could be used for assessing whether certain types of equipment meet the minimum sales price threshold.

minimum sales price will be included in the Protocol. It simply means that it will be eligible for assessment under the collective approach, rather than automatically excluded by failing to meet the minimum value threshold criteria.

23. If a piece of equipment is found to be above the minimum sales price threshold, a number of other value-related factors could be used to assess its viability for inclusion in the Protocol under the value criterion, including:

- The sales price (the higher the price above the minimum threshold, the more suitable for inclusion).
- The total value of all units being traded internationally (total sales value).
- Economic value of equipment in use (as noted in the NLCIFT report, the economic significance of a combine harvester with a value in the hundreds of thousands US dollars may actually be in the millions of dollars in significance to the end user).

24. It may also be necessary to set different minimum initial sales price thresholds for the different categories of equipment (agricultural, construction and mining).

International mobility criterion

25. Similarly, to the value criterion, the Study Group will have to carefully consider the appropriate minimum threshold for international mobility. It is suggested a common sense approach could be to set the minimum threshold as MAC equipment that is demonstrated to move once or more over international borders during its working lifecycle, or is certain to once it has been listed under the MAC Protocol. A more restrictive approach would be to confine the Protocol to equipment that is demonstrated to move over national borders in the course of its activity.

26. If a piece of equipment is found to be above the minimum international mobility threshold, a number of other value-related factors could be used to assess its viability for inclusion in the Protocol under the mobility criterion, including:

- Whether the equipment typically moves more than once in its lifetime across international borders.
- Whether the equipment moves across borders in the course of its activity.
- What proportion of the equipment produced moves across international borders (as opposed to equipment being produced primarily for domestic use rather than export).
- Whether the equipment's international mobility is going to be increased by including it under the MAC Protocol (whether there is strong evidence indicating that it will be exported to new markets).

Uniquely identifiable

27. The approach to identifiability under the MAC Protocol will necessarily be different to the previous Protocols. This issue is linked closely with considerations of how equipment will be identified for listing on the International Register. In relation to the minimum threshold, if a piece of equipment is uniquely identifiable in any way from other pieces of the same type of equipment (by serial number or otherwise) then that should be sufficient to meet the minimum threshold. However, this may not be sufficient for overall inclusion, especially if the method of unique identification cannot be easily entered into the International Register.

Advantages and disadvantages

28. The above approach is the first attempt to reach a compromise between the limiting and economic interests set out at the start of the section (paragraph 5).

29. The benefits of this approach are:

- Clarity and certainty: By having three clear lists of equipment categorised using the HS system, it will be clear and certain to users of the system which types of equipment are covered by the Protocol.
- Consistency with the nature of the Cape Town Convention: The minimum threshold ensures that the MAC Protocol cannot become general in nature or be expanded beyond the Article 51 criteria.
- Flexibility: In setting relatively low minimum thresholds and then subsequently adopting a collective approach to assessing equipment for inclusion, there is also some degree of flexibility in deciding which equipment is suitable for inclusion. This will further ensure that equipment that is appropriate for inclusion taking into account all relevant considerations will be included.

The issues with this approach are:

- Onerous assessment process: By having to assess each type of equipment both against minimum threshold criteria and then under a collective approach, initial assessment of types of the MAC equipment under the HS system will be a lengthy and complex process.
- Onerous monitoring process: This approach will require reassessment of whether types of equipment should be added to or removed from the Protocol. This monitoring role may be onerous in relation to the MAC Protocol as compared to previous Protocols under the Cape Town Convention.

Severability

30. It has been suggested during consultations that it may be worth splitting the MAC Protocol into three Protocols covering agriculture, construction and mining separately. The basis for this view is that the three fields are very different from one another, with diverse groups of stakeholders and categories of equipment that need to be considered. Further, the national Questionnaire completed by different jurisdictions in 2008 revealed that certain States favoured the creation of a Protocol regulating secured transactions for one of the three areas, but not necessarily for the others.

31. While there might be different interests involved in the contracting states regarding these three industry areas, it is suggested that the Protocol should probably remain unified and cover all three fields of mining, agriculture and construction without providing for different rules for each of them.

32. Tentatively, it could be allowed that Contracting States may opt out concerning the application of the Protocol to one or several of these industry areas. This would allow contracting states to give disapply the Protocol in relation to one area (for example, agriculture), but still allow its operation for the other areas (mining and/or construction). Potential drafting options for this issue are available in the annotated draft at Article VI.

33. If this opt out approach was adopted, it would have to be ensured that this does not endanger the effectiveness of a security in any MAC-equipment, in relation to the registration of equipment with multiple purposes (see multiple purpose equipment below).

Multiple purpose equipment

34. Further consideration must also be given to equipment that has multiple purposes. There are three scenarios of particular note:

- Equipment that is general in nature but has an application in the agriculture, construction or mining fields (for example, trucks) should not be excluded from the Protocol, even where they satisfy minimum threshold requirements.
- Equipment that is predominantly for use in agriculture, construction or mining (for example, a crane that in 90% of cases is used for construction purposes but in limited instances has also been used for loading and unloading shipping containers at ports) may still warrant inclusion in the Protocol.
- Equipment that is predominantly used in agriculture, construction or mining, but is also frequently used in one or more of the other MAC areas (for example, a drill used in both mining and construction). This becomes an issue both in relation to (i) which list in the regulations the item is added to, and (ii) what happens if equipment is listed in two lists and a Contracting State opts out of one of the fields. For example, if an encumbered mining asset is subsequently used in the construction industry, and the relevant Contracting State does apply the Protocol only to mining, then the security interest should remain effective. However, the answer becomes less clear if the asset is used in the construction industry from its purchase (even though its primary purpose is deemed to be mining use) and the Contracting State does not apply the Protocol to construction.

(ii) Accessions³

As discussed in the NLCIFT paper, there are certain accessions for MAC equipment that could be of substantial enough value to warrant consideration for inclusion under the Protocol. As such, it may be worth considering whether the MAC Protocol needs to include alternate provisions to deal with accessions.

(iii) Merged Collateral⁴

35. An established practice in the MAC financing industries is to provide financing to customers for new equipment in the form of a financial lease which takes a security interest over both the new equipment and other assets of the customer as additional collateral. The additional collateral is typically other machinery.

36. Where all equipment involved in the transaction (both the new equipment and the equipment being used as additional collateral) is MAC equipment within the scope of the Protocol, the security interests could all be internationally registered, which would have priority over any prior registered interests under national law. However, where the collateral equipment falls outside the scope of the Protocol, there is an uncomfortable potential overlap between the Protocol and domestic law (i.e. the creditors would have to register their interest in the new MAC equipment in the international registry, but the associated collateral equipment would require registration and compliance with the domestic secured transactions laws.)

37. New provisions may need to be drafted for the MAC Protocol to better deal with this situation.

³ NLCIFT pages 52 – 56.

⁴ NLCIFT pages 60 – 61.

(iv) Inventory⁵

38. In principle, there is no problem with MAC equipment within the scope of the Protocol being held on inventory being registered in the international registry. Indeed, allowing for such registration may be an improvement on the current situation, where in some circumstances dealers are working with manufacturers on an unsecured basis based on long-standing relationships.

39. The issue becomes slightly more complex when considering unfinished MAC equipment held by the manufacturer, which may also constitute inventory against which the manufacturer may seek secured financing. As noted in the NLCIFT report, extension of the MAC Protocol to the financing of inventory requires further consideration, including the protections of buyers in due course, trade-ins of used MAC equipment that are exchanged for new equipment and for unfinished equipment.

(v) Insolvency

40. It is suggested that, in most parts, the insolvency provisions in the MAC Protocol follow those established in Article XI of the Aircraft Protocol. The insolvency provisions in the Aircraft Protocol were developed by international experts from different legal systems and provide a sound and well-balanced insolvency regime to govern the creditor's rights where the debtor becomes subject to insolvency proceedings or an insolvency-related event. The Railway Protocol and the Space Protocol both follow – in main parts – the insolvency provisions contained in the Aircraft Protocol.

41. Article X of the annotated draft provides commentary on the possible inclusion of Alternatives A and B from the previous Protocols. In particular, the Study Group should consider whether there is a need for Alternative B in the MAC Protocol given that only one of the 56 Contracting States to the Aircraft Protocol (Mexico) has opted for Alternative B while 40 Contracting States have opted for Alternative A. However, a MAC-Protocol offering only the "hard" or ruled-based version of Alternative A might be a reason for certain States to refrain from ratifying the Protocol at all.

(vi) Interaction with domestic secured transaction regimes⁶

42. Assets covered by the Cape Town Convention and its Protocols are typically excluded from general domestic secured transaction regimes, as consistent with Recommendation 4 of the UNCITRAL Legislative Guide on Secured Transactions. Where there is a collision between national laws and the Cape Town system, Article 29 of the Cape Town Convention provides that the international interest takes priority. It is suggested that interests registered under the MAC Protocol should be expected to have priority over national law, as consistent with the previous Protocols.

43. The NLCIFT paper notes that several countries⁷ that have specific laws governing security interests in agricultural equipment. These specialised domestic regimes may prove to be an additional impediment for countries to adopt the MAC Protocol. The Study Group should discuss whether it is possible for these specialised regimes to operate in conjunction with the MAC Protocol. Further research may be required to ascertain whether there are other similar legal regimes in other countries. If there are only a very small number of countries with such specialised laws, this issue should not be a major impediment to the creation and success of a MAC Protocol.

⁵ NLCIFT pages 59 – 60.

⁶ NLCIFT pages 68 – 75.

⁷ Argentina, Ecuador and certain US states.

(vii) Additional issues*Fixtures*⁸

44. Issues may arise where MAC equipment requires physical affixation to real property and thus could be treated as a fixture under domestic law. This is a difficult and complex issue, as any attempt by the MAC Protocol to interfere with domestic law in relation to fixtures may be resisted by States.

45. It is more likely that this issue will arise in relation to construction and mining equipment, rather than agricultural equipment. Research is required to identify specific types of affixable equipment that may fall within the scope of the MAC Protocol. Further research is also required to ascertain how cross-border financing for affixable MAC equipment is currently done. If there are only very few types of equipment in this category, it may be prudent to exclude them from the MAC Protocol to avoid this difficult issue altogether.

46. If it is decided to include under the Protocol MAC equipment with the potential to become a fixture, it may be worth separately identifying those HS codes of equipment in the Regulations, especially if the rules applying to them differ from the rules applying to other types of MAC equipment under the Protocol.

*Public service exception*⁹

47. Article XXV of the Rail Protocol and Article XXVII of the Space Protocol provide an exemption to the operation of certain aspects of the Cape Town Convention and the relevant Protocols in relation to the provision of public services. While the approach to this issue in the two Protocols is materially different, the underlying policy is the same: the State has a natural interest in ensuring that a creditor exercising its rights under the Convention/Protocol does not cause the abrupt termination of a service of public importance.¹⁰

48. Article XXV of the Rail Protocol provides that a Contracting State may, at any time, enter a declaration that it will continue to apply its domestic law in force at the time of the declaration that precludes, suspends or governs the exercise by the creditor of any remedies under the Convention/Protocol in relation to public service railway rolling stock. Article XXV applies to both passenger vehicles and freight vehicles and must be habitually providing a service of public importance (i.e. a passenger vehicle habitually carrying a substantial number of passengers on a main line would ordinarily be considered to provide a service of public importance).¹¹ If the public service is exercised by the Contracting State, it has duties to preserve and maintain the asset and pay to the creditor compensation under either the national law or the market lease rental within 10 calendar days of taking possession of the asset (and thereafter on the first day of each successive month). There is no time limit on the period the Contracting State can prevent the creditor from exercising a remedy in relation to public service stock.

49. Under Article XXVII of the Space Protocol, a debtor who enters into a contract providing the use of a space asset to provide public services can agree with other parties to the contract for the provision of the public service and the Contracting State to register a public service notice under the Protocol. Technically, it does not require the creditor's consent, as the creditor is not a party to the contract for the provision of public services. However, the creditor can impose contractual restraints on the debtor's consent to registration of a public service notice at the time of the creation of the international interest, and therefore in practice is likely to be a part of the negotiations.¹² Subject to certain exceptions, a creditor may not exercise any Convention/Protocol

⁸ NLCIFT pages 57 – 58.

⁹ NLCIFT pages 65 – 67.

¹⁰ Space Protocol Official Commentary, page 194.

¹¹ Rail Protocol Official Commentary, page 181.

¹² Space Protocol Official Commentary, page 196.

remedies in the event of a debtor default on an asset that is subject of a public service notice. The period that a creditor cannot exercise its remedial rights is limited to 3-6 months. During the suspension period, the creditor, debtor and public service provider are required to cooperate in good faith with a view to find a commercially reasonable solution permitting the continuation of the public service. The approach in Article XXVII appears to be more complex than the approach in the Rail Protocol.

50. The types of important public services relating to rail transport (carriage of persons and goods) and space assets (national security, transport safety, communications) are obvious. Conversely, the agriculture, construction and mining sectors do not provide public services. Rather, they simply operate in fields of significant public interest. The public service exception was the most difficult to negotiate and contentious issue involved in the creation of both the Rail and Space Protocols. As such, the Study Group should take a cautious approach in deciding whether it would be suitable to include a provision in the draft MAC Protocol.

Application of the MAC Protocol to sales

51. The Aircraft and Space Protocol extend the application of the Cape Town Convention to outright sales and prospective sales. No such provision has been included in the annotated draft of the MAC Protocol. The Study Group may wish to discuss this issue.

De-registration and export request authorisation

52. The Study Group may wish to consider whether it is necessary to include an Article in the MAC Protocol on 'de-registration and export request authorisation', as consistent with Article XIII of the Aircraft Protocol.

Modification of Assignment provisions

53. The Study Group may wish to consider whether it is necessary for the MAC Protocol to modify the assignment provisions in the Cape Town Convention, as consistent with Article XV of the Aircraft Protocol and Article XXIV of the Space Protocol.