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**Item No. 5 on the agenda: International Interests in Mobile Equipment**

**(b) Preliminary Draft Protocol to the Cape Town Convention on Matters Specific to Agricultural, Construction and Mining Equipment**

(prepared by the Secretariat)

<i>Summary</i>	<i>Presentation of the preliminary draft Protocol to the Governing Council</i>
<i>Action to be taken</i>	<i>Review the preliminary draft Protocol, decide whether a Committee of Governmental Experts should be convened to further consider the Protocol</i>
<i>Mandate</i>	<i>Work Programme 2014-2016</i>
<i>Priority level</i>	<i>Medium</i>
<i>Related documents</i>	UNIDROIT 2016 – Study 72K – SG4 – Doc. 6; UNIDROIT 2016 – Study 72K – SG4 – Doc. 7 and UNIDROIT 2016 – Study 72K – SG4 – Doc. 8

**INTRODUCTION**

1. The *Convention on International Interests in Mobile Equipment* was opened for signature on 16 November 2001. Article 2(3) of the Convention provides that the initial three protocols, adopted respectively in 2001, 2007 and 2012, should cover aircraft, railway rolling stock and space assets. Article 51(2) of the Convention specifically contemplates the possibility of adopting additional protocols, which cover other categories of equipment.

2. At its 84<sup>th</sup> session (Rome, 2005), the UNIDROIT Governing Council decided to include in the 2006 – 2008 Work Programme of the Institute the preparation of a fourth Protocol to the 2001 Cape Town Convention on International Interests in Mobile Equipment on matters specific to agricultural, construction and mining equipment (the 'MAC Protocol'). Between 2005 and 2012 a range of background research activities were conducted in relation to the project, including a questionnaire distributed to Member States, consultations with private industry and a preliminary economic analysis (for further information on the background of the project, see document [UNIDROIT 2015 – C.D.\(94\) 5\(b\)](#)).

3. At its 93<sup>rd</sup> session (Rome, 2014) the Governing Council agreed to convene a Study Group entrusted with preparing a first draft of the MAC Protocol prior to its 95<sup>th</sup> session. The Study Group is composed of various international experts<sup>1</sup> in secured transactions law and is chaired by Dr Hans Georg Bollweg, member of the UNIDROIT Governing Council.

4. The Study Group met four times (15-17 December 2014, 8-9 April 2015, 19-21 October 2015 and 7-9 March 2016) to consider legal issues associated with the preparation of the MAC Protocol and to prepare a preliminary draft text. In addition to the members of the Study Group, the meetings were attended by observers from various international organisations and academic institutions, including the United Nations Commission on International Trade Law (UNCITRAL), the International Finance Corporation (IFC), the Food and Agriculture Organization of the United Nations (FAO), the International Fund for Agricultural Development (IFAD), the World Customs Organization (WCO) and the National Law Center for Inter-American Free Trade (NLCFT). Several out-of-session teleconferences have also been held to further work on specific issues relating to the Protocol.

5. At the conclusion of the fourth Study Group meeting on 8 March 2016, the Study Group decided that the preliminary draft Protocol was sufficiently developed to be submitted to the Governing Council with a recommendation that an intergovernmental committee of experts be convened to further consider the Protocol. This document has been prepared to provide additional information, which will assist the Governing Council in their consideration of the preliminary draft Protocol.

6. Three key documents have been provided to the Governing Council in relation to the MAC Protocol project. The first document is the sixth annotated preliminary draft Protocol (UNIDROIT 2016 – Study 72K – SG4 – Doc. 6), as endorsed by the Study Group at its fourth session in March 2016. The second document is the preliminary list of Harmonized System codes (UNIDROIT 2016 – Study 72K – SG4 – Doc. 7), which provides information on the types of agricultural, construction and mining equipment that would be covered by the MAC Protocol. The third document is a legal analysis (UNIDROIT 2016 – Study 72K – SG4 – Doc. 8) which provides a comprehensive commentary on the various legal issues considered by the Study Group in producing the preliminary draft Protocol.

## **I. PRELIMINARY DRAFT PROTOCOL**

7. As consistent with the drafting approaches adopted in the preparation of the Luxembourg Rail Protocol and the Space Protocol, the articles of the preliminary draft MAC Protocol are overwhelmingly consistent with the articles of the existing protocols. Where possible, the 33 articles in the MAC Protocol mirror the language and legal substance of the corresponding provisions in the three previous Protocols. Most articles are almost identical to previous protocols. For example, the articles governing representative capacities, insolvency remedies, waivers of sovereign immunity, territorial units, signature, ratification, acceptance, approval or accession and the articles governing declarations mirror the corresponding provisions of the previous protocols. The structure of the Protocol, including the six chapters, is identical to the previous Protocols.

8. Where previous protocols differed from one another in their approach to a particular issue, the Study Group adopted the provisions from the previous protocol that were most suitable to the MAC equipment context. For example, the Aircraft and Space Protocols apply to sales, as consistent with the

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established practice in aircraft and space asset financing, whereas the Rail Protocol only allows for the registration of notices of sale without any legal effect. On advice from the private sector, it was decided that the MAC Protocol should adopt the Rail Protocol approach (as reflected in Article XVIII of the preliminary draft Protocol).

9. Given the differences in the financing, acquisition and use of agriculture, construction and mining equipment, certain provisions depart entirely from the approaches of previous Protocols. Most notably, this was necessary in relation to establishing the scope of the Protocol (Article II, Annexes 1, 2 and 3) and association with immovable property (Article VII). These particular issues are extensively discussed in the legal analysis.

## II. SCOPE OF THE FUTURE PROTOCOL

10. At previous meetings, members of the Governing Council had raised concerns about the scope of a future MAC Protocol.<sup>2</sup> Specifically, the concern most often raised was that the scope of a protocol covering all agricultural, construction and mining equipment was simply too broad. Governing Council members had also queried whether it was possible to limit the scope of a protocol to agricultural, construction and mining equipment, which was inherently mobile and high-value, and whether it was appropriate to cover agricultural, construction and mining equipment in the same instrument. After considering a variety of different approaches to limiting the scope of the draft Protocol, the Study Group identified one mechanism that could be used to ensure the scope of the MAC Protocol would be clear, precise and appropriate.

11. The preliminary draft Protocol uses the Harmonized Commodity Description and Coding System (HS System) to identify the types of agricultural, construction and mining equipment to be covered by the Protocol. The HS System is a global nomenclature system developed by the World Customs Organisation (WCO) to achieve uniform classification of commodities or merchandise in international trade. Countries also use it to monitor controlled goods and quota controls, calculate and collect internal excise and sales taxes, compile transport statistics, etc. The HS System is utilised by more than 200 countries and covers 98% of all international trade. The WCO was consulted in determining how the HS System could be utilised for determining the scope of the Protocol, and a senior technical officer from the organisation attended the third Study Group meeting to provide their expertise.

12. The annexes to the preliminary draft Protocol list the HS codes that cover the types of agricultural,<sup>3</sup> construction and mining equipment which fall within the scope of the Protocol (HS System codes for agricultural equipment are listed in Annex 1, construction equipment in Annex 2 and mining equipment in Annex 3). Use of the HS System to define the scope of the preliminary draft Protocol ensures that the Protocol will apply to high value equipment used primarily in the agriculture, construction and mining industries. Further, the listing of the HS codes covering equipment from the different industries (agriculture, construction and mining) in different annexes allows Contracting States to apply the Protocol to equipment used in only one or two of the agriculture, construction and mining industries if they so wish.<sup>4</sup>

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<sup>2</sup> See [UNIDROIT 2006 – C.D. \(85\) 19](#), page 10; [UNIDROIT 2009 – C.D. \(88\) 17](#), paragraphs 143 – 147; [UNIDROIT 2010 – C.D. \(89\) 17](#); paragraphs 33 – 37; [UNIDROIT 2011 – C.D. \(90\) 18](#), paragraphs 68 – 70; [UNIDROIT 2012 – C.D. \(91\) 15](#), paragraphs 46 – 47; [UNIDROIT 2013 – C.D. \(92\) 17](#), paragraphs 44 – 48; [UNIDROIT 2014 – C.D. \(93\) 14](#), paragraphs 34 – 38.

<sup>3</sup> The Study Group decided that the definition of 'agriculture' for the preliminary draft Protocol should be consistent with the Food and Agriculture Organization of the United Nations (FAO) definition, which includes forestry and fisheries (to the extent that fisheries covers aquaculture equipment).

<sup>4</sup> For example, Contracting States are permitted to make a declaration under Article 2(3) of the preliminary draft Protocol to apply the Protocol to only agricultural equipment in Annex 1 and mining equipment in Annex 3, but not construction equipment in Annex 2.

13. There are 36 HS codes listed in the annexes to the preliminary draft Protocol (20 in Annex 1, 28 in Annex 2 and 17 in Annex 3).<sup>5</sup> The HS codes were suggested by the private sector through the MAC Working Group (further information on the Working Group below), and were scrutinised by the Study Group. Originally, 113 codes had been proposed by the private sector Working Group for consideration by the Study Group. The Study Group considered the following factors in deciding whether an HS code was appropriate for inclusion in the annexes to the preliminary draft Protocol:

(a) Whether the HS code covered equipment used primarily in the agriculture, construction and mining industries. Where the equipment was commonly used outside these industries, it was deemed multiple purpose equipment and was excluded from the annexes.

(b) Whether the HS code covered equipment that was of high value. The Study Group noted that an HS code did not need to cover exclusively high value equipment to be included in the annexes. Individual unit prices for new equipment covered by the HS codes listed in the annexes to the draft preliminary Protocol range from \$ 10,000 USD-\$ 7,000,000 USD, however most HS codes had a minimum individual unit value of at least \$100,000 USD.

(c) Whether the HS code covered equipment that was individually financed under current industry practice. Where the equipment was not currently individually financed, the Study Group decided that it was inappropriate for it to be included under the scope of a Protocol.

(d) Whether the HS code covered equipment that had individual unique manufacturer-issued serial numbers. Individual serialisation is required for registration of an interest in the equipment in the international registry. As such, equipment without unique manufacturer serial numbers was excluded from the annexes.

(e) Whether the HS code covered parts as well as equipment. The HS System explicitly provides that certain HS codes cover parts of equipment. The Study Group decided that HS codes explicitly covering parts should be excluded from the annexes, as parts to the relevant types of equipment were generally not of sufficiently high individual value or individually financed in practice.

(f) Whether the HS code covered significant amounts of international trade. The Study Group considered 2014 global export data for the HS codes in the annexes to the preliminary draft Protocol, which had been extracted from the COMTRADE<sup>6</sup> platform (maintained by the United Nations Statistics Division). Certain HS codes were of particular importance to the private sector as they covered a large amount of global trade in agricultural, construction and mining equipment, which made their inclusion essential to the economic viability to the Protocol (as long as they satisfied the other criteria for inclusion as listed in sub-points (a)-(e) above).

14. Using these criteria, the Study Group categorised the 113 HS codes suggested by the Working Group into three tiers of suitable (Tier 1), possible (Tier 2) and unsuitable (Tier 3) lists of HS codes. Tier 1 codes have been included in the annexes to the preliminary draft Protocol on the basis that they are suitable for inclusion under the scope of the Protocol. Tier 2 codes were considered to have some merit, however failed to satisfy one or two of the criteria (set out in paragraph 12 above) and required further evidence from the Working Group to demonstrate they did meet all relevant criteria for inclusion. Tier 3 codes failed to meet several key criteria and were excluded from consideration. The Tier 1 codes are further divided up into agricultural, construction and mining equipment. The Working Group continues to provide input for inclusion in the preliminary list to ensure that the information it contains is as accurate and detailed as possible.

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<sup>5</sup> It should be noted that the same HS code may be listed in more than one annex, because equipment covered by that HS code is used in more than one of the three relevant industries (for example, an HS code might cover excavators that are used in both construction and mining and thus would be listed in both Annexes 2 and 3 respectively).

<sup>6</sup> COMTRADE is the United Nations Commodity Trade Statistics Database. COMTRADE is the largest depository of international trade data, with 1.7 billion data records dating back to 1962. Over 170 reporter countries provide the United Nations Statistics Division with annual international trade statistics data detailed by commodities and partner countries.

### III. LEGAL ISSUES

15. The Study Group considered and resolved 23 legal issues during its four meetings (as set out in the Legal Analysis).

16. One of the most significant legal issues considered by the Study Group was how the Protocol should address the relationship between international interests in MAC equipment under the Protocol and domestic interests arising out of the equipment's affixation or use on immovable property. Issues may arise where MAC equipment becomes so associated with immovable property that domestic law interests in the immovable property extend to the MAC equipment.

17. Initially, association with immovable property appeared to be a matter of limited significance, as it was originally understood that it would only be relevant for types of MAC equipment that were physically connected to immovable property (for example, certain types of cranes and drills). However, following a comparative law analysis conducted by the Secretariat, it became apparent that certain jurisdictions permitted interests in immovable property to extend to mobile equipment that was utilised for the economic exploitation of the immovable property, even where there was no physical connection between the equipment and the immovable property.<sup>7</sup>

18. The issue was considered at length during the third and fourth Study Group sessions, and was the subject to two out-of-session teleconferences in December 2015 and February 2016. In drafting an article to resolve the issue, the Study Group adopted the following principles:

(a) Association with immovable property should be directly addressed by a standalone article in the Protocol.

(b) The article governing association with immovable property should be the object of a mandatory declaration under the Protocol, giving contracting states flexibility in their approach to the issue, but also requiring states to make an active selection of the alternative they favour.

(c) Due to the complex and sensitive nature of the issue, the Protocol should provide an array of options on how to address the potential effect of international interests in MAC equipment on domestic interests arising out of immovable property law.

(d) The article and various options need to take into account all potential interests arising out of association with immovable property (i.e. interests arising out of physical connection between the equipment and the immovable property, referred to as 'fixtures' in some jurisdictions and interests arising out of the utilisation of mobile equipment for the economic exploitation of the immovable property, referred to as 'accessories' in some jurisdictions).

(e) If possible, the article should avoid substantively defining the words 'fixture' and 'accessory'. If they are required to be defined, they should be defined with reference to the domestic law in which the equipment is located.

(f) The article should apply the declaration made by the Contracting State in which the immovable property is located, as opposed to the location of the debtor (as is the traditional case for the Cape Town Convention).

19. Article VII of the preliminary draft Protocol addresses the issue of association with immovable property. Article VII provides that a Contracting State must apply one of three alternative approaches in resolving the potential conflict between international interests in MAC equipment and domestic interests in the immovable property that the MAC equipment has become associated with:

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<sup>7</sup> See research paper *Jurisdictional analysis on association with immovable property* in the annexes to the Legal Analysis.

(a) Alternative A: An international interest in MAC equipment retains its priority as against any domestic interests in the immovable-associated equipment that exist as a result of the equipment's association with immovable property.

(b) Alternative B: A distinction is made between MAC equipment that becomes so associated with immovable property that it loses its individual legal identity (under the domestic law of the country in which the equipment is located) and MAC equipment that retains its legal identity. International interests in MAC equipment that loses its individual legal identity are subordinated to domestic interests (where the domestic law provides for such a subordination), whereas international interests in MAC equipment that retains its individual legal identity loses its priority only where (i) the interest in the immovable property is registered under domestic law prior to the registration of the international interest and (ii) the equipment has become associated with the immovable property prior to the registration of the international interest in the equipment.

(c) Alternative C: The domestic law of the Contracting State in which the equipment is located determines whether the international interest is subordinated to domestic interests that exist as a result of the equipment's association with immovable property.

20. Paragraph 1 of Article VII also provides that the domestic law determines whether the international interest is subordinated to domestic immovable property interests where the equipment is located in a non-Contracting State.

21. The Study Group considered that the policy and legal approaches of the three alternatives gave Contracting States sufficient flexibility in balancing the traditional primacy of the international interests over domestic interests and the protection of immovable property interests, although further work on the exact language of Article VII might be required to ensure the desired policy outcomes were realised.

#### **IV. ECONOMIC VIABILITY**

22. Preliminary economic analyses on the viability of the MAC Protocol have been conducted. Mr Heywood Fleisig, Director of Research at the Center for the Economic Analysis of Law (CEAL) prepared a paper on the potential economic benefits of the MAC Protocol which was presented to the Governing Council at its 92<sup>nd</sup> session in 2013 (available [here](#)). The CEAL study noted that the MAC Protocol could increase the sales of MAC equipment by up to \$600 billion over five to seven years, but found it difficult to make precise predictions due to a lack of clarity around the scope of the Protocol.

23. The utilisation of the HS System to define the scope of the Protocol allows the compilation of data regarding the value of trade in MAC equipment that would be covered by the MAC Protocol. Based on data extracted from the COMTRADE platform, \$ 116 billion USD worth of MAC equipment was exported globally in 2014 under the 36 HS codes currently listed in the annexes to the preliminary draft Protocol. This data clearly indicates that there is sufficient international trade in high-value agricultural, construction and mining equipment to warrant the creation of an additional Protocol to the Cape Town Convention, and that an International Registry for such a Protocol would likely attract a sufficient number of registrations to remain economically viable.

24. The Secretariat intends to conduct additional economic analysis on the MAC Protocol during 2016.

## V. PRIVATE SECTOR SUPPORT

25. Throughout the life of the MAC Protocol project, there has been consistent support from the private sector. Initial consultations with the 50 private sector stakeholders in Germany in the United States in 2010 and 2011 demonstrated general interest and support for the creation of a MAC Protocol. This support was reaffirmed during subsequent discussions at the Issues Dialogues held in Washington in 2013 and 2014.

26. As consistent with the established practice for the other Protocols to the Cape Town Convention, in 2015 leading private stakeholders were invited by the Secretary-General to form a MAC Protocol Working Group. The MAC Protocol Working Group is responsible for encouraging private sector participation in developing the Protocol, as well as communicating and representing private sector interests during the drafting process. It is an independent body outside the purview of UNIDROIT. The Working Group has been critical in providing data on value, financing and usage of agricultural, construction and mining equipment for consideration by the Study Group. The Working Group first met in September 2015 in London and had a second meeting via teleconference in December 2015.

27. The Working Group currently consists of 13 members<sup>8</sup> from six countries<sup>9</sup> and continues to grow. Included in the Working Group membership are many of the largest MAC equipment manufacturers globally, as well as several trade associations, including the Association of Equipment Manufacturers (AEM), which has 917 members in the agriculture and construction industries, the Equipment Leasing and Finance Association (ELFA), which represents over 575 financial service companies, banks and manufacturers and the *Verband Deutscher Maschinen und Anlagenbau* (VDMA), which is one of the largest industrial associations in Europe representing 3,100 member companies in the engineering industry. The Working Group is led by Mr Phillip Durham who is a partner in the Structured Finance Group of law firm Holland and Knight in New York.

28. The Working Group will continue to play an important role in providing private sector views on the drafting of the Protocol and its promotion.

## VI. NEXT STEPS

29. If the Governing Council decides that the preliminary draft Protocol is sufficiently developed to warrant the convening of a Committee of Governmental Experts to further consider the Protocol, the Secretariat will commit the necessary resources to prepare for such a meeting.

30. It was noted at the fourth Study Group meeting in March 2016 that if such a decision was made, the scheduling of the first meeting of a Committee of Governmental Experts would likely to be in early 2017. This scheduling would allow for additional promotional activities to be carried out among industries that would have an interest in the Protocol, especially those from regions of the world that have thus far had limited involvement in the project and would provide Member States with further notice to budget to send delegations the meeting.

31. Following the conclusion of the fourth Study Group meeting, it was suggested that an Academic Advisory Group be established, consisting of the members of the Study Group and other academic experts who have contributed to the MAC Protocol project.

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<sup>8</sup> Association of Equipment Manufacturers (AEM), AGCO, Caterpillar, CNH Industrial, Equipment Leasing and Finance Association (ELFA), General Electric, Hitachi, Holland and Knight, John Deere, Komatsu, Pfaandbrief, Tafe, Verband Deutscher Maschinen- und Anlagenbau (VDMA) and Vermeer.

<sup>9</sup> Australia, Germany, India, Italy, Japan and the United States.

32. The Secretariat would work with the Academic Advisory Group (once established) and the Working Group to further refine the preliminary draft Protocol throughout the remainder of 2016. It is anticipated that a conference may be scheduled in the final quarter of 2016 bring stakeholders together to promote the Protocol.

### **ACTION TO BE TAKEN**

33. *The Governing Council is invited to review the preliminary draft Protocol to the Cape Town Convention on matters specific to agricultural, construction and mining equipment. The Governing Council is invited to consider whether the preliminary draft Protocol is sufficiently developed to warrant the convening on a Committee of Governmental Experts in early 2017 to further consider the Protocol.*