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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.

The use of the hell-or-high-water (HOHW) provision in equipment leases has been ongoing since the beginning of equipment leasing as an independent discipline. Obligors under many forms of commercial transactions (including real property loans, trust deeds, mortgages, and personal property purchase money notes, to name a few) are required by these instruments to continue making timely payments regardless of the circumstances surrounding the possession and use of any property pledged to secure repayment. However, it has become customary to state this requirement in a specific contractual provision in equipment leases. This is the HOHW clause, and it is unique to our industry.

Although the actual language and formulation of the HOHW clause may vary from one transaction to another, virtu-

ally every U.S. equipment lease written over the past four decades has included such a provision. In a standard equipment lease or financing transaction, the lessee or borrower must expressly commit to continuing to make scheduled payments of rent (or of principal and interest) throughout the term of the transaction without regard to the physical condition, usefulness, or (in many cases) even existence of leased or collateralized assets (e.g., the loss by theft or physical destruction) without applying any setoffs or abatements and without the benefit of any defenses or counterclaims.

Such a provision has come to be considered essential in every equipment lease, primarily because it assures lessors and third-party funders alike of their right under all circumstances to continue receiving contractually defined streams of payments.

Such provisions effectively limit the exposure of lessors and funders to considerations of obligor creditworthiness and ability to pay (and in some cases the realization of residual value) rather than to concerns over equipment repair, maintenance, availability, or value.

MANAGED SOLUTIONS TRANSACTIONS

In reality, however, HOHW provisions offer this protection only in transactions that are based on a defined term, fixed (or readily determinable) payment, fixed obligation structure, and the predictability of a lessee's or borrower's payment obligations over time. Because their lessees' obligations are nearly always well defined in this way,¹ equipment lessors have historically been insulated from virtually every foreseeable risk other than lessees' simple

failure to pay rent as and when it becomes due; and the HOHW clause has historically played the largest role in this result.

By contractually preventing lessee disputes and forestalling defenses based on other lessee claims, including failures of leased equipment or of performance by third parties (e.g., equipment vendors or service providers), the HOHW clause has been the bulwark of lessors' and funding sources' confidence in equipment leasing transactions.

But what if equipment transactions were structured to include the features described in Table 1?

Such features together comprise the definition of managed solutions transactions (MSTs), sometimes referred to as managed equipment services (MES) agree-

In general, the more essential the solution is to the end-user's success, the greater the motivation for the end-user to remain current under an MST and the lower the risk of a failure to pay.

ments, variable use agreements, or bundled solutions. The essential characteristic is flexibility — in payment term, in payment amount, and in recourse for the failure of service providers to meet their continuing obligations to end-users.

Where will traditional HOHW provisions fit into this kind of structure? Where can they provide protection for funding sources? Or can they? Will they provide any protection at all? End-users that are becoming accustomed to the flexibility provided by MSTs are by definition becoming less receptive to the restrictions inherent in traditional equipment leases, equipment finance agreements, or conditional sales contracts, many of which spring from the use of the HOHW provision.

Given this fundamental shift in attitude toward traditional HOHW-based equipment lease structures, what is likely to happen to the HOHW clause itself as a trusted tool of equipment lessors?

THE HOHW CLAUSE IN RISK AND ASSET MANAGEMENT

Traditionally, funding sources' assessment of risk has been centered primarily on the obligor's ability to pay and much less on the use or management of the leased assets. Under an MST, however, it is the integrated customer "solution" that is the focus of the transaction, and the funder's assessment of the performance risk associated with specific service providers or vendors comes to the fore.

The role of vendor or service-provider due diligence becomes much more prominent in assessing such risk; and, rather than being considered secondary to credit underwriting, the vetting of vendors, service providers, and their forms of agreement with primary obligors becomes prevalent in a wide range of MST structures, types, and sizes.

Scrutiny of vendors and service providers becomes even more important based on the degree to which the underlying solution or service is essential to the end-user's business operation and applications. In general, the more essential the solution is to the end-user's success, the greater the motivation for the end-user to remain current under an MST and the lower the risk of a failure to pay.

Accordingly, the level of due diligence focused on the service provider is frequently related to the degree of essentiality of the solution being provided. Although the HOHW provision is often viewed as a kind of proxy for an obligor's ability to pay, the removal of the HOHW clause may be considered less of an impediment to credit approval in MSTs, under which the strength, support, and solutions rendered by the service provider are essential to the long-term financial health and strength of the end-user obligor.

Of course, traditional credit risk remains an important factor in MST underwriting as well, particularly in transactions involving a greater proportion of soft costs and less reliance

on tangible goods to provide collateral credit support. Even when obligor credit underwriting is carried out in a more customary fashion, however, the role of the HOHW clause is likely to be diminished as MSTs place more focus on end-user flexibility and on overall solutions and relatively less focus strictly on the end-user's ability to make timely periodic payments throughout the term of the financing.

Accordingly, it is anticipated that the use of traditional HOHW provisions as a means of backstopping end-user obligations and customary payment risk exposure will decline, both as the use of MSTs by credit-

worthy obligors and reputable service providers becomes more widespread and accepted by funding sources throughout the industry, and as proportionally less reliance is placed on traditional methods of assessing and managing transactional risk.

Conversely, decreasing reliance on the standard HOHW provision may lead to greater reliance on the role played by asset management in assessing the risk of an MST transaction. Whereas under a traditional equipment lease it is anticipated that the leased assets will be returned at the time of expiration or termination of the full term of the lease (or perhaps at

Table 1. Key Features of a Managed Solutions Transaction²

- The end-user (customer) enters into "solutions" agreements with one or more service providers that are not lessors.
- The solution includes access to equipment, software, ongoing services, and support.
- The end-user's payment may be based on usage, or it may be in the form of a subscription.
- The agreement may be cancelable at will by the end-user.
- The end-user may have broad rights to substitute and/or upgrade the equipment supporting the bundled solutions.
- The software and even the equipment may be owned by the service provider(s).
- The funding source (formerly a lessor) has no direct control over the equipment or software.
- The agreement may or may not be monetized by the service provider(s).

the predetermined time of an early termination option or early buyout option), under the more flexible MST arrangement the end-user may be able to return the assets at any time.

Consequently, under an MST a funding source must not only be aware of the value of the assets throughout the term of the transaction but also of their “utility” — that is, of the secondary market for such assets, of their usefulness in the hands of a typical end-user in the relevant space, and of the range of end-users that may be prospective users of these particular assets under applicable forms of MSTs.

THE HOHW CLAUSE IN TRANSACTION ACCOUNTING

Because the fundamental economic concept behind MSTs is the payment for bundled assets and services over a possibly indeterminate period of time, such transactions are generally viewed for financial reporting purposes as executory contracts. Long-standing rules for such reporting by vendors and service providers are most likely to be applied for MSTs as well. Thus, from a financial reporting

and accounting point of view, the presence or absence of a customary HOHW provision is not expected to have any effect.

Perhaps the biggest accounting challenge for equipment vendors under such transactions is the matter of revenue recognition, including most notably the question of whether a vendor should pursue revenue recognition on the sale of the underlying assets or should focus on recognizing revenue that occurs over time throughout the life of an MST.

Because this determination, and the consequent treatment of the transaction for financial reporting purposes, is not generally affected by the characterization of the underlying end-user obligations (either as arising from a net lease or as subject to certain obligor defenses), the use of a traditional equipment lease HOHW provision is expected to have no bearing on the accounting treatment of the transaction.

Likewise, the accounting issues that arise in such transactions (e.g., transitioning from “standard” lease management software systems to those that can accommodate MST structures, adapting to the new

accounting rules concerning leases and related transactions generally) do not depend on the presence or absence of an HOHW provision in the transaction documents. Moreover, the use (or lack of use) of HOHW language for other purposes is not expected to bear on the financial reporting treatment of an MST.

THE HOHW CLAUSE IN TRANSACTION DOCUMENTATION

In contrast to their limited accounting implications, the nature and structure of MSTs are already having — and are expected increasingly to have — an impact on how such transactions are documented and, more generally, on how they are negotiated and treated from a legal standpoint. In particular, the continued use and usefulness of customary HOHW language in MST transaction documents is the subject of much scrutiny and reassessment throughout the equipment leasing industry.

The HOHW provision found in nearly all traditional equipment leases is, as noted above, built on the notion of long-term, fixed, and predictable periodic

payments from a determinate obligor. Thus, the customary language used to document such provisions assumes limited flexibility, constrained responsiveness to changing circumstances, and an absence of end-user ability to adjust obligations based on third-party performance — all the elements that MST obligors increasingly expect.

Consequently, the ability of customary HOHW provisions simultaneously to accommodate the needs of transaction funders and the growing demands of MST end-users has become a challenge. Various methods are used by leasing companies and funding sources to address this conundrum, including those described in Table 2.

None of these structures offers (and most likely none is intended to offer) a direct substitute for the funder protections given under the customary HOHW provision, since each requires an assessment of transaction yield, risk, and operational details — quite different from those of a customary equipment lease HOHW clause. All those structures raise currently unanswered questions regarding funding

sources’ remedies, applications of creditors’ rights, applications of long-standing principles under the Uniform Commercial Code, enforceability of contracts under current legal precedents, and other important issues. But all of them (or variations on them) are currently being used by equipment lessors and funding sources participating in the MST marketplace.

From a financial reporting and accounting point of view, the presence or absence of a customary HOHW provision in an MST is not expected to have any effect.

Importantly, given the direction that transaction documentation appears to be going, as more MSTs are developed and documented throughout the industry, it is becoming more apparent that the customary HOHW provision that has been considered sacrosanct by lessors, their lawyers, and their funding sources throughout the history of U.S. equipment leasing is being

replaced by alternative contractual structures and related contract language.

Companies offering solutions-based alternatives such as MSTs without customary HOHW provisions are in the near term likely to struggle to find third-party funding sources willing to advance substantial funds against such financial assets.

In particular, as the use of MSTs continues to expand, funding sources are tending to become more comfortable providing financing under documents that include comprehensive and specific provisions addressing the issues of end-user flexibility, essential use of assets, disposition of assets (e.g., in trade-ins, upgrades, and replacements), rights and obligations of all parties (including service provider(s)), and other details³ in lieu of actual (and customary) HOHW language.

As MSTs become more accepted and more prevalent, largely as the result of customer demand and evolving market conditions and opportunities,⁴ it is likely that the HOHW clause as we have known it for many decades will become less relevant and will eventually be superseded by other documentation alternatives that better address these market forces.

THE HOHW CLAUSE IN FUNDING AVAILABILITY

Perhaps the most important feature of the customary HOHW provision in leasing has been its effect in assuring third-party funding sources of the reliability and inviolability under every equipment lease of a predictable stream of periodic payments that will be realized “come hell or high water.” The ability to collateralize third-party debt through equipment leases has nearly always required that the underlying contracts include some level of HOHW language.

It has traditionally been an article of faith in the equipment leasing industry that without the HOHW provision leases (and

their concomitant rental streams) could not be assigned nor could equipment lessors adequately monetize their receivables and properly capitalize their businesses.

Accordingly, companies offering solutions-based alternatives such as MSTs without customary HOHW provisions (or other features closely resembling them) are in the near term likely to struggle to find third-party funding sources willing to advance substantial funds against such financial assets. Traditional fund-

ing sources are accustomed to relying on the contractual obligations of end-users, supported by HOHW provisions, for assurance of future payments throughout a fixed term of obligations.

Although certain structural alternatives are being used with increasing frequency, including the requirements for end-users to make certain minimum payments and for service providers or vendors to meet certain minimum uptime or service level requirements,⁵ there is still most often a mandate imposed by

funding sources that some form of HOHW language be included in transactions intended for assignment and discounting. Thus, some form of HOHW provision is expected to be used for the time being by originators and “bundlers” who intend to “back leverage” or discount their transactions in the traditional bank or institutional lending marketplace.

CONCLUSION

The venerable and 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 MSTs, however, the usefulness and applicability of the HOHW clause are increasingly open to question.

As new payment structures, new ideas regarding the undertaking of risk by originators and by third-party funders, and new alternatives for providing combinations of flexible service with hardware and tangible assets and platforms continue

Table 2. Methods of Documenting MSTs

- Some of the methods used by leasing companies and funding sources to document MSTs include:
- The bifurcation of transaction documents into separate sections (or even separate agreements) representing the service components and the financing components of the transaction
- The use of separate agreements running between funding sources and vendors (or service providers) under which funders may avail themselves of remedies tailored specifically to failures to provide adequate service levels, response times, maintenance, uptime, or other services to the end-user, with such agreements often incorporating various contractual protections (e.g., financial covenants) traditionally found in financing agreements between funders and end-users
- The integration of service agreements with financing agreements, with specific provisions addressing the rights and remedies of all three parties (end-user, service provider, and funding source)
- The use of indemnification or hold harmless provisions as a kind of substitute for the assurance of payment that has traditionally been provided by HOHW language, particularly with respect to the risk presented under MSTs, which now may rely on the continued performance of third-party vendors or service providers, which typically were not party to the agreements entered into between lessees and lessors

to evolve, it is expected that the HOHW provision will slowly but inevitably be replaced by alternative methods of risk-sharing and flexible financing.

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Endnotes

1. Setting aside the risk of material changes in residual values under true leases, while noting that in any event the true lease structure appears to be on the wane throughout the equipment leasing industry.
2. See "Managed Solutions: Evolutionary or Revolutionary?," Equipment Leasing & Finance Foundation, 2016.
3. Often combined with more robust service provider due diligence.
4. See note 2 above.
5. Such alternatives may frequently be found in the office imaging industry, which pioneered the MST concept and has used it successfully for many years, and increasingly in the energy industry.



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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.

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 as HS 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 with-

out 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 challeng-

ing 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

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.

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, 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

1. See UNIDROIT, *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment — Status*, available at <http://www.unidroit.org/status-2001cape-town-aircraft> (last accessed Jan. 4, 2017).

2. Study by Vadim Linetsky (Northwestern University): *Economic Benefits of the Cape Town Treaty at 2–4* (2009), available at <http://www.awg.aero/assets/docs/economicbenefitsofCape-Town.pdf> (last accessed Jan. 4, 2017).

3. Statements during the UNIDROIT Symposium on the Luxembourg Rail Protocol (Rome, Nov. 30, 2016). See the agenda at <http://www.unidroit.org/>

[english/news/2016/20161130-ctc-rail-programme-e.pdf](http://www.unidroit.org/english/news/2016/20161130-ctc-rail-programme-e.pdf) (last accessed Jan. 4, 2017).

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-72ksg04-06-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/cd92-05be.pdf> (last accessed Jan. 4, 2017).

14. *Id.* at 1.

15. Study by Vadim Linetsky, *supra* n 2. See further Mooney, Dubovec, and Brydie-Watson, *supra* n 10.

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).

20. J.A. Estrella-Faria, *Future Directions of Legal Harmonisation and Law Reform: Stormy Seas or Prosperous Voyage?*, 14 (1–2) UNIFORM LAW REVIEW 5 (2009).

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.

24. UNIDROIT Secretariat, *Legal Analysis, Study 72K – CGE1 – Doc. 4, 15* (September 2016).



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