Railroad Equipment Financing Redux

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I. SUMMARY OF DEVELOPMENTS

Since my survey of railroad equipment financing in 1989[1], the business has re-emerged as a significant method of capital formation. During the mid-1980's, the railroad industry had a surplus of equipment and many car-builders closed their shops, but by the end of the decade, equipment orders began to increase. In 1990, railroads and private car

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1. Michael D. Rice, *Railroad Equipment Financing*, 18 TRANS. L. J. 85 (1989) [hereinafter *Railroad Equipment Financing*].

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lines in the United States took delivery of about 32,000 freight cars and about 600 locomotives, representing a total value of about $2 billion. The economic downturn reduced those numbers somewhat for 1991 and 1992, but the industry expects a stable flow of new equipment for the foreseeable future. Aging equipment must be replaced, and new types must be brought in to continue gains in productivity. Institutional investors will be financing these acquisitions through the special instruments of railroad equipment finance.

In addition to new rolling stock and motive power, many of the railroads have undertaken major rebuilding programs. Under Rule 88[2], rebuilt rolling stock can be given a new "birthday" for purposes of car hire charges (which are based on age and value). Locomotives have gone into railroad shops, rebuilding facilities, and even the builders' works for recycling into "remanufactured" units. Institutional investors also finance much of this rebuilding.

As has been the custom, railroad equipment financing is arranged and repaid without rancor or controversy, so there is little case law to provide grist for the legal writers' mill. But aircraft financing has many parallels with railroad equipment financing, and there has been no shortage of controversy in aircraft financing in recent years.[3] Railroad equipment financing once set the pattern for aircraft financing[4], but now the opposite is true. We look to aircraft financing for both the form and substance of railroad equipment financing transactions.

The bankruptcies of Eastern Airlines, Continental Airlines, and Pan Am, all with substantial equipment obligations on the books, have kept bankruptcy and appellate courts busy interpreting section 1110 of the Bankruptcy Code,[5] a special protective provision for aircraft financing. The railroad industry counterpart is section 1168.[6] The common heritage and the similarities in language of the two sections impel us to consider the effect of those airline decisions on railroad equipment financing.

On the positive side, the airlines and their financers have developed some interesting techniques that can be applied to railroad equipment financing. Transactions to finance equipment with some foreign content can be arranged to take advantage of tax benefits of equipment ownership in two jurisdictions—a "double dip." And the financing cost of rail-

2. Association of American Railroads, Office Manual of the Interchange Rules (1991).

3. *See generally* Michael D. Rice, *Current Issues in Aircraft Finance*, 56 J. OF AIR L. & COM. 1027 (1991) [hereinafter *Aircraft Finance*].

4. Leonard D. Adkins & De Forest Billyou, *Developments in Commercial Aircraft Equipment Financing*, 13 BUS. LAW. 199 (1958).

5. 11 U.S.C. § 1110 (1988). *See* Sandor E. Schick, *When Airlines Crash: Section 1110 Revisited*, 48 BUS. LAW. 277 (1992).

6. 11 U.S.C. § 1168 (1988).

road equipment for export can be reduced by the use of Foreign Sales Corporations.

We must mention one legislative development limited to railroad financing transactions—the repeal of section 10 of the Clayton Act.[7] This section, on the books since 1914, prohibited transactions between common carriers and other entities with common officers or directors, unless the transaction was done pursuant to competitive bidding.[8] We need no longer face the task of searching out such interlocks, or put warnings in offering memoranda for railroad equipment obligations.

II. Section 1168 and the Airline Bankruptcies

A. *Section 1110 and Section 1168*

Section 1168 of the Bankruptcy Code provides special protection for holders of certain types of railroad equipment obligations in bankruptcy.[9] This section overrides the automatic stay in bankruptcy, and permits equipment creditors and lessors to recover equipment if the obligations relating to that equipment are not kept current.[10] We explored the history

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7. Antitrust Amendments Act of 1990, Pub. L. No. 101-588, 104 Stat. 2880 (1990); 136 Cong. Rec. H13317 (October 27, 1990).

8. 15 U.S.C. § 20 (repealed 1988).

9. Section 1168. Rolling Stock Equipment.

(a) The right of a secured party with a purchase-money equipment security interest in, or of a lessor or conditional vendor of, whether as trustee or otherwise, rolling stock equipment or accessories used on such equipment, including superstructures and racks, that are subject to a purchase-money equipment security interest granted by, leased to, or conditionally sold to, the debtor to take possession of such equipment in compliance with the provisions of a purchase-money equipment security agreement, lease, or conditional sale contract, as the case may be, is not affected by section 362 or 363 of this title or by any power of the court to enjoin such taking of possession unless—

(1) before 60 days after the commencement of a case under this chapter, the trustee, subject to the court's approval, agrees to perform all obligations of the debtor under such security agreement, lease, or conditional sale contract, as the case may be; and

(2) any default, other than a default of the kind specified in section 365(b)(2) of this title, under such security agreement, lease, or conditional sale contract, as the case may be—

(A) that occurred before such date and is an event of default therewith is cured before the expiration of such 60-day period; and

(B) that occurs or becomes an event of default after such date is cured before the later of—

(i) 30 days after the date of such default; and

(ii) the expiration of such 60-day period.

(b) The trustee and the secured party, lessor, or conditional vendor, as the case may be, whose right to take possession is protected under subsection (a) of this section may agree, subject to the court's approval, to extend the 60-day period specified in subsection (a)(1) of this section. 11 U.S.C. § 1168 (1988).

10. The commencement of a case under the Bankruptcy Code operates as a stay against any action to enforce a lien or recover possession of property from the bankrupt debtor. Secured

of this provision and some interpretive issues in the earlier article.[11]

Section 1168 of the Bankruptcy Code, and its predecessor in the old Bankruptcy Act, the last sentence of section 77(j)[12], have been successful. Equipment creditors enjoy special protection through railroad reorganizations, and as a result, weak and strong railroad companies enjoy access to capital at reasonable cost.[13] The only controversy regarding this special status of railroad equipment obligations arose in the Penn Central reorganization: The railroad assumed and serviced its equipment obligations early in the reorganization but ran out of cash later on, and the court temporarily enjoined repossession of the equipment by the creditors until the federal government could step in and assume the obligations.[14]

The success of old section 77(j) in preserving access to capital for railroads was a topic of some envy in the airline industry. In 1957, faced with enormous capital needs to finance new generations of turbo-prop and turbojet aircraft, the airlines sought, and obtained, similar protection for aircraft equipment creditors—section 116(5) of Chapter X of the old Bankruptcy Act.[15] At the time, the Securities and Exchange Commission opposed the legislation. The SEC pointed out that equipment represented a much higher proportion of total assets of an airline than of a railroad, and that giving aircraft equipment creditors special treatment would seriously impair or even eliminate the prospects of a successful airline reorganization.[16]

Sections 116(5) and 77(j) survive as sections 1110 and 1168 of the Bankruptcy Code. Their language is very similar, reflecting their common root, old section 77(j).[17] Both protect "The right of a secured party with a purchase-money equipment security interest in, or of a lessor or conditional sale vendor of . . ." carrier equipment. In construing section 1168,

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parties are entitled to adequate protection of the collateral, and lessors are entitled to eventual assumption or rejection of their lease, but all of this takes time, and without the special protection of section 1168, payment of debt and lease obligations may be suspended. 11 U.S.C. § 362 (1988).

11. *Railroad Equipment Financing, supra* note 1, at 106.

12. Pub. L. No. 381, ch. 774, 49 Stat. 911 (1935).

13. Both Moody's Investors Service and Standard & Poor's Corp., the leading rating services, have rated railroad equipment trust obligations having the protection of section 1168 of the Bankruptcy Code in one of the three highest grades, regardless of the rating assigned to other debt of the railroad issuing the obligation. *Railroad Equipment Financing*, supra note 1, at 105. Standard & Poor's has recently dropped its "guideline minimum rating" for these issues to its fourth highest grade, "BBB-." This is still regarded as "investment grade." Standard & Poor's Corp., CREDITWEEK, October 28, 1991.

14. *In re* Penn Central Transp. Co., 402 F. Supp. 127 (E.D. Pa. 1975); *see also Recent Developments Concerning Equipment Financing, a Position Paper of the Committee on Developments in Business Financing*, 33 BUS. LAW. 401 (1977).

15. Pub. L. No. 85-295, 71 Stat. 617 (1957).

16. S. Rep. No. 1032, 85th Cong., 1st Sess. 4 (1957).

17. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 238, 405, 423 (1977).

a court would inevitably look to cases construing section 1110 for guidance. Consequently, we must consider the implications of recent section 1110 airline cases for railroad equipment financing situations.

B. The Sale-Leaseback Controversy

Both section 1110 and section 1168 of the Bankruptcy Code explicitly protect lessors. Some leases in which these lessors participate are acquisition transactions, that is, the lessor purchases the aircraft or railroad rolling stock and leases it to the carrier. In other circumstances, the carrier may already own the equipment, and will then sell it to the lessor and lease it back. This is quite common in the airline industry. Sometimes an airline will sell and leaseback older aircraft in the fleet, to raise capital, but more often the airline will simply take delivery of new aircraft and then arrange financing by sale-leaseback a few weeks or months later, when it senses that conditions are right in the money markets. Railroads do that, too, but to a lesser extent; most railroad equipment leases are arranged and closed at the time of delivery of the equipment. However, railroads often finance rebuilding programs by sale-leaseback, and because these rebuilding programs run over for a significant period of time, the lease financing may not be consummated until the rebuilding program is virtually complete, and many of the rebuilt units have already gone into in service.

The history of sections 77(j) and 116(5) of the old Bankruptcy Act, the predecessors of section 1168 and 1110 of the Bankruptcy Code, clearly indicate a Congressional intent to promote acquisition of equipment by carriers.[18] This notion was carried over into sections 1110 and 1168 of the new Bankruptcy Code. Certainly the phrases "purchase-money equipment security interest" and "conditional sale" in the statutes contemplate acquisition transactions. But certain individuals suggested, in a published article, that the term "lessor" should also be limited to acquisition situations.[19] Thereafter, parties to sale-leaseback transactions have been concerned that a court would take the same position and would not apply the protection of section 1110 or section 1168, as the case may be, to a sale-leaseback.

This issue first came before a court in the second Braniff bankruptcy. In the first bankruptcy, part of the reorganization plan involved a conveyance of some of Braniff's aircraft to a special trust, from which the airline

18. *See* H.R. Rep. No. 1283, 74th Cong., 1st Sess. (1935); S. Rep. No. 1032, 85th Cong., 1st Sess. (1957); H.R. Rep. No. 944, 85th Cong., 1st Sess. (1957); *see generally* Michael D. Rice, Asset Financing 381 (1989 & Supp. 1992) [hereinafter Asset Financing].

19. Louis B. Goldman, Michael J. Album & Mark S. Ward, *Repossessing the Spirit of St. Louis: Expanding the Protections of Sections 1110 and 1168 of the Bankruptcy Code*, 41 Bus. Law. 29 (1985).

leased the aircraft back. Then in the second bankruptcy, the airline sought a declaratory judgment that section 1110 did not apply to that lease, because the leased aircraft were originally owned by the airline; the lease did not involve acquisition. Judge Corcoran considered the arguments of the airline, derived from legislative history, but concluded that he "must apply the statutory language as written; Section 1110 is not limited to leases that permit aircraft to be newly acquired by the lessee."[20]

The *Braniff* decision was reached in a Bankruptcy Court in the Middle District of Florida, and not appealed, so there remained some concern that another court might conclude otherwise than Judge Corcoran. This concern was well-founded. When Continental Airlines sought the protection of the bankruptcy laws in late 1990, its capital structure included an overwhelming amount of lease transactions. Of its fleet of 365 aircraft, 259 were leased; off-balance sheet lease obligations exceeded $4 billion. Thus appeared the problem predicted by the SEC prior to the passage of section 116(5), section 1110's predecessor: the cash flow demands of the protected obligations seriously impaired the prospects of successful reorganization. To obtain relief from the burden of meeting these lease obligations, Continental urged the Bankruptcy Court for the District of Delaware to take a very narrow view of section 1110, and to hold that the protection of that section was not applicable to aircraft sale-leasebacks that did not involve acquisition.

Judge Balick, the Bankruptcy Judge hearing the matter, accepted Continental Airlines's position and held that a sale-leaseback transaction would not be covered by section 1110 unless the transaction was a "package deal" with the acquisition of the aircraft.[21] That raised a ruckus in the aircraft financing community; new financing by lease was suspended. The affected aircraft lessors immediately appealed; they were supported by a group of major carriers, which filed a brief as amicus curiae. The decision was reversed by the District Court, Judge Gawthrop holding that leases resulting from sale-leaseback transactions are indeed entitled to section 1110 protection.[22] The Third Circuit affirmed that decision.[23]

Pan American had petitioned for reorganization under the Bankruptcy Code a few weeks after Continental. The same issue of sale-leasebacks and section 1110 arose in that case, because Pan Am's capital structure was also dominated by aircraft leases, and servicing those leases would be a substantial, perhaps crippling, burden on the bankrupt estate. Pan Am proposed to treat all sale-leaseback transactions as not

20. Braniff, Inc. v. Toren (*In re* Braniff, Inc.), 110 B.R. 980, 985 (Bankr. M.D. Fla. 1990).
21. *In re* Continental Airlines, Inc., 123 B.R. 713 (Bankr. D. Del. 1991).
22. *In re* Continental Airlines, Inc., 125 B.R. 399 (Bankr. D. Del. 1991).
23. *In re* Continental Airlines, Inc., 932 F.2d 282 (3d Cir. 1991).

covered by section 1110, and to suspend lease payments while retaining the aircraft.

Although the matter came before the Bankruptcy Court (in the Southern District of New York) after the Bankruptcy Court decision in the Continental case and before that decision had been reversed, Pan Am got nowhere with its efforts to avoid section 1110 protection for sale-leasebacks. The Bankruptcy Court disagreed with Judge Balick and held that sale-leasebacks were covered by section 1110,[24] the District Court affirmed,[25] and the Second Circuit affirmed that decision, per curiam.[26] The Supreme Court denied certiorari.[27]

So the world was again safe for sale-leasebacks. Although these cases put to rest the sale-leaseback issue, another issue emerged. The District Court in the *Pan Am* case and the Third Circuit Court of Appeals in the Continental case emphasized that only "true" leases, not disguised loans, would be covered by the "lessor" and "lease" language of section 1110.

C. The "True" Lease Issue

The threat of judicial recharacterization of a transaction styled as a lease as a secured transaction is very real in both the airline and the railroad settings. While there are situations in which a carrier hires equipment from another carrier or from an owner that maintains an inventory of equipment for lease, most of the lease transactions in which section 1110 and section 1168 questions arise are financing transactions: the typical lessor purchases the equipment and leases it to the carrier as a financial accommodation. The carrier selects and orders the equipment, bears the burden of maintenance and the risk of loss, pays the insurance and all taxes, and agrees to pay the rents come Hell or high water. Consequently, there is a rather fine distinction between this type of finance lease and a secured loan.

That distinction is drawn in three separate contexts: accounting, tax, and secured transaction law. Accountants have developed a quantitative method of distinguishing between a "capital" lease, which must appear on the lessee's balance sheet as a liability, like debt, and an "operating" lease, which need not.[28] The Internal Revenue Service, concerned with whether a nominal lessee should be entitled to deduct from income the

24. *In re* Pan Am Corp., 124 B.R. 960 (Bankr. S.D.N.Y. 1991).

25. *In re* Pan Am Corp., 125 B.R. 372 (S.D.N.Y. 1991).

26. Section 1110 Parties v. Pan American Corp. (*In re* Pan Am Corp.), 929 F.2d 109 (2d Cir. 1991).

27. Pan Am Corp. v. Section 1110 Parties, 111 S. Ct. 2248 (1991).

28. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 13, (Accounting for Leases 1976).

full amount of rents or only a portion allocable to interest, and whether the lessor should be entitled to the tax benefits of ownership, has distilled from case law some standards for determining what kinds of lease transactions should be regarded as secured loans.[29] The I.R.S. has also developed quantitative guidelines for recognition of a true lease for ruling purposes.[30] The distinction made by courts for other than tax purposes usually involves an interpretation of Section 1-201(37) of the Uniform Commercial Code, the definition of "security interest."

Parties to lease financing transactions usually pay close attention to the first two types of distinction between a lease and secured loan, accounting and tax, because the transactions are driven by certain accounting and tax objectives. But the distinction as a matter of secured transaction law has not received much attention in this context, perhaps because the federal recordation statutes for aircraft and railroad equipment cover both types of transactions; it would not matter if a transaction styled as a lease becomes recharacterized as a secured loan because the federal recordation of the instrument would protect the financer either way.[31]

But the distinction will matter very much in cases under section 1110 and section 1168 of the Bankruptcy Code. If a sale-leaseback transaction is recharacterized as a secured loan, the benefits of section 1110 or 1168 will be lost. If the transaction cannot regarded as a lease, the protection of section 1110 or 1168 will only be available if the transaction can be characterized as a "purchase-money equipment security interest" or conditional sale. Both of these alternatives require acquisition.

Bankruptcy courts look to state law on the recharacterization issue,[32] and there is a troublesome lack of uniformity of decision in distinguishing between leases and secured loans. Many of the carrier lease transactions exhibit characteristics that judges in many jurisdictions have found to indicate secured loans.[33]

In the case of the airlines, financers must be concerned about recharacterization of individual lease transactions and possible loss of

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29. Rev. Rul. 55-540, 1955-2 C.B. 39.

30. Rev. Proc. 75-21, 1975-1 C.B. 715.

31. The federal recording statute for interests in aircraft is section 503 of the Federal Aviation Act, 49 U.S.C. § 1403 (1988). The federal recording statute for interests in railroad equipment is 49 U.S.C. § 11303 (1988). *See generally* ASSET FINANCING, *supra* note 18, at 251, 271.

32. Butner v. United States, 440 U.S. 48 (1979); *see* Bankruptcy Law Revision, H.R. REP. No. 95-595, 95th Cong., 1st Sess. 314 (1977).

33. There will be greater certainty in this area as the various states adopt Article 2A of the Uniform Commercial Code, covering leases of personal property. Article 2A validates the notion of finance leases, and brings with the new Article a revised section 1-201(37) definition of security interest. This new definition is more comprehensive than the old, and confines judicial discretion in this area.

section 1110 protection, on a case by case basis.[34] That is also true in the case of railroads and section 1168. But in the case of railroads and section 1168, we also must consider the vulnerability of an entire class of transactions—"Philadelphia" plan equipment trusts. This venerable financing device, as old as railroading, is based on a lease that by any modern test would be regarded as a secured loan.

The Philadelphia plan equipment trust is a title-retention security device, invented before Article 9 of the Uniform Commercial Code gave us the concept of a security interest and discarded the notion of "title" for personal property. Under the Philadelphia plan, a railroad conveys into trust the equipment to be financed, and then leases the equipment back for the period of the financing, usually 15 years. The trustee issues certificates to purchase the equipment; the obligation represented by the certificates is payable only out of the rent from the equipment. The rent payments under the lease are measured by the interest and installments of principal to be paid on those certificates; at the end of the term, when the obligations on the certificates were fully discharged, the trustee conveys the equipment back to the railroad for no additional consideration.

The proceeds of the sale of certificates in a Philadelphia plan equipment trust are often paid directly to the suppliers of the equipment covered by the trust. But more often, the equipment would already have been delivered to the railroad, paid for, and put into service, and the proceeds of the sale of certificates is paid to the railroad to reimburse it for amounts previously paid for the equipment. This is because an order of railcars is not delivered all at once, but over a period of months, and the car-builder expects to be paid as the cars are delivered, not when the order has been completed.

In the first hundred years of railroading, rolling stock was often constructed in a railroad's own shops. To avoid conflict with system mortgages having after-acquired property clauses,[35] during construction the equipment would be held in the names of individuals, usually employees of the road. These individuals then sold the equipment to the trustee of the equipment trust when the financing was arranged. They were sometimes called "straw men."

When the "modified Philadelphia plan" was adopted toward the mid-

34. Pan American attempted to disqualify a transaction as a true lease on the basis that the agreement permitted the lessee to substitute engines for the engines originally covered by the lease. The court held that this feature (an altogether common one) did not disqualify the lease as a "true" lease, and accordingly, the protection of section 1110 of the Bankruptcy Code was available. *In re* Pan American Corp., 130 B.R. 409 (S.D.N.Y. 1991). Railroad equipment leases usually permit the lessee to provide substitutes for units that are lost or wrecked during the lease term.

35. Most mortgages on railroad property covered equipment then existing or "hereafter acquired."

dle of this century, most railroad mortgages had provisions for releasing recently acquired equipment for a financing. Thus there was no need to insulate the equipment under construction from the mortgage, and the use of the straw men as vendors was discontinued. The railroads simply bought and paid for the equipment, and later conveyed it to the trustee under an equipment trust. The typical railroad equipment trust form contemplates financing equipment in service for a period of up to six months or a year prior to the date of the trust.

The lease in the Philadelphia plan equipment trust is clearly what was contemplated by the last sentence of section 77(j) of the old Bankruptcy Act at its passage in 1935, even though such a lease is not a true lease. The Congressional report accompanying its passage is clear on that point.[36] And whatever was protected under that old language was intended to be protected by sections 1168 and 1110 of the Bankruptcy Code. The Congressional report accompanying the passage of the Bankruptcy Code is clear on that point.[37] But the courts in the *Continental* and *Pan American* section 1110 cases, having in mind, no doubt, the meaning of the term "lease" in the context of aircraft financing practice in 1978, when the Bankruptcy Code was enacted, limited their decisions to "true" leases. The lease in a Philadelphia plan equipment trust does not meet current criteria for a "true" lease.

The *Continental* and *Pan American* cases can certainly be distinguished, because they construed section 1110 and not section 1168. The analysis of section 1110 involved examination of aircraft financing practice; decisions under section 1168 should be made by reference to railroad equipment financing practice. The terms "lessor" and "lease" in section 1168 should be construed to cover the bailment lease in a traditional Philadelphia plan equipment trust, even though it does not meet the criteria for a "true" lease, and even though the resulting security interest does not meet the criteria for a "purchase money equipment security interest."

That's what a court should do. But we cannot be confident that that's what a court would do.

D. *Purchase Money Equipment Security Interests*

If there is doubt that an equipment financing transaction meets the criteria for a "true" lease (or if there is no doubt that it doesn't), railroads and their financers can look to the other categories of transactions covered by section 1168 of the Bankruptcy Code: "purchase-money equip-

36. H.R. Rep. No. 1283, 74th Cong., 1st Sess. 4 (1935).
37. Bankruptcy Law Revision, H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 405 (1977).

ment security interests" and "conditional sale contracts."[38] They differ only in form.

The reference to "conditional vendor" and "conditional sale contract" in section 1168 are carried over from section 77(j) of the old Bankruptcy Act.[39] In 1935, when the last sentence of section 77(j) was enacted with these words, conditional sale agreements were commonly used for railroad equipment financing.[40]Their use continued long after the adoption of the Uniform Commercial Code made such forms obsolete, because of a loophole in the scheme of securities regulation by the Interstate Commerce Commission.[41] Since the loophole was enlarged to admit other forms in 1985,[42] the conditional sale format has largely been abandoned.

In the traditional conditional sale format, the railroad agrees with a car or locomotive builder to pay the purchase price of the cars or locomotives in installments, with interest on the unpaid balance. The builder immediately assigns this obligation to a group of institutional investors, in an integrated transaction arranged by an investment banker acting for the railroad. The builder thus does not actually extend financing, but joins in as a party to the documents as an accommodation in order to create the conditional sale form.

Outside of the railroad industry, the conditional sale form has been replaced by the notion of a "purchase money security interest" under Article 9 of the Uniform Commercial Code.[43] This can be "taken or retained by the seller of the collateral to secure all or part of its price."[44] That is what happens in a conditional sale. But a purchase money security interest can also be "taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or use of the collateral."[45] This avoids the need to involve the seller of the collateral: the secured party can extend credit directly to the debtor, if the debtor uses the money to pay the seller.

The term used in section 1168 of the Bankruptcy Code, "purchase-money equipment security interest," is slightly different from the "purchase money security interest" of the Uniform Commercial Code.

38. 11 U.S.C. § 1168 (1988).

39. Pub. L. No. 381, ch. 774, 49 Stat. 911 (1935). *See Railroad Equipment Financing*, *supra* note 1, at 108.

40. *See* ASSET FINANCING, *supra* note 18, at 65.

41. Association of American R.R.s v. United States, 603 F.2d 953 (D.C. Cir. 1979); *see also Railroad Equipment Financing*, *supra* note 1, at 100.

42. *Ex Parte* No. 397, Exemption of Railroads from Securities Regulation Under 49 U.S.C. § 11301, 1 I.C.C. 2d 915 (1985); *see also* 49 C.F.R. § 1175 (1990).

43. U.C.C. § 9-107.

44. *Id.*, at cl. (a).

45. *Id.*, at cl. (b).

The Bankruptcy Code term was added by the drafters of the new bankruptcy law to avoid confining financing parties to the old forms, conditional sales and equipment trusts, contemplated by section 77(j) of the Bankruptcy Act.[46] This new term is not defined in the Bankruptcy Code. The extra hyphen and extra word suggest that the drafters of the Code wanted to provide some room for judicial maneuvering beyond the confines of the Uniform Commercial Code usage of the similar term. But when courts were obliged to construe the term under the Bankruptcy Code under section 1110, the provision for aircraft correlative to section 1168, they concluded that a "purchase-money equipment security interest" could be nothing other than a "purchase money security interest" within the meaning of section 9-107 of the Uniform Commercial Code.[47] Thus we must look to U.C.C. section 9-107 and its interpretive gloss.

The language of section 9-107 suggests a direct connection between the advance made by the financer and the acquisition of the collateral by the debtor. But that requirement presents practical difficulties in railroad equipment financing. Railroad cars and locomotives are delivered unit-by-unit as they are built over a period of time, and the builder expects to be paid upon delivery. Thus there may be situations in which a financing enables the acquisition of equipment, but without a direct connection or payment flow from the financer to the seller of the equipment.

This may seem to be a technical problem, but it is not one to be ignored in the structure of a transaction. Professor Gilmore, in his treatise on *Security Interests in Personal Property*, comments that there is an evident intent on the part of the draftsmen of Article 9 to free the purchase-money concept from artificial limitations and particular formalities and sequences.[48] But he adds that "no lender in his right mind will deliberately experiment with how much play there is in the joints . . ." The lender will make the loan before acquisition and making a loan direct to the seller."[49] Case law supports the notion that the language of clause (b) of section 9-107, "to enable the debtor to acquire rights in or the use of collateral," disqualifies a situation where the debtor already has possession and ownership of the collateral when the advance is made.[50]

When the railroad already has all elements of ownership of the equipment, qualification of a financing transaction as a "purchase-money equipment security interest" under section 1168 of the Bankruptcy Code

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46. H.R. REP. No. 95-595, 95th Cong., 1st Sess. 240 (1977).

47. *In re* Ionosphere Clubs, Inc., 123 B.R. 166, 171 (S.D.N.Y. 1991); *In re* Express Air, Inc., 136 B.R. 328 (Bankr. D. Mass. 1992).

48. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 782 (1965).

49. *Id.*

50. *E.g.*, North Platte State Bank v. Production Credit Ass'n of North Platte, Nebraska, 200 N.W.2d 1 (Neb. 1972).

is thus doubtful, too doubtful to be offered to institutional investors. The notion then comes to mind of constructing a transaction to qualify as a conditional sale contract under section 1168, by having the railroad sell the equipment to an agent or trustee for financing parties, and then buying it back under a conditional sale. This has always been regarded as bogus, however, and nothing more than a chattel mortgage. [51] Professor Gilmore says that "the keystone of modern conditional sale theory came to be that the device was limited to use in financing sales transactions."[52] It is apparent from the literature that conditional sales and purchase money security interests have much in common, and that the latter is the modern counterpart of the former.[53] Thus if the circumstances preclude a purchase money security interest, they will also preclude a conditional sale.[54]

This is not a major problem for the railroads, once the requirements of a purchase-money equipment security interest are recognized, and taken into account in planning financing programs. The principal task is convincing railroad financial and purchasing people that the opportunity for section 1168 protected financing can be lost unless current practices are revised. Railroad equipment destined for a financing cannot be paid for upon delivery; arrangements must be made to defer some significant part of the acquisition until the "permanent" financing is available.[55]

Two techniques come to mind. The first is some sort of interim lease or security agreement with the builder of the cars or locomotives, so that the builder retains either ownership or a security interest in the equipment until the permanent financing is put in place and the builder is paid. This, of course, puts the builder in the position of financer until the permanent financing is arranged, and this may not be practical. In such a case, the railroad may be able to arrange for short-term financing to be extended to

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51. *E.g.*, Commercial Securities Corp.s Consol. v. Lindsay Mercantile Co., 267 P. 766 (Cal. Ct. App. 1928).

52. 1 GILMORE, *supra* note 48, at 68.

53. 2 *Id.*, at 743.

54. There is precedent in the railroad industry for conditional sale financing of rebuilding programs, whereby the railroad would sell the hulks to an outside agency which would then contract with the railroad for rebuilding. The conditional sale would involve that outside agency as vendor. In the usuaal course, the vendor would assign the conditional sale indebtedness to another agent, acting for the institutions providing the financing. The proceeds of the financing would be paid to the vendor, which in turn would pay the same to the railroad in discharge of the vendor's obligations under the rebuilding contract. *See* Leonard D. Adkins & DeForest Billyou, *Current Developments in Railroad Equipment Financing*, 12 BUS. LAW. 207, 212 (1957). This creation of a conditional sale was intended to avoid the securities regulation jurisdiction of the Interstate Commerce Commission. *See Railroad Equipment Financing*, *supra* note 1, at 89.

55. A similar connection between acquisition and financing is necessary to obtain the exemption from registration available under section 3(a)(6) of the Securities Act of 1933. *See Railroad Equipment Financing*, *supra* note 1, at 100, 104.

the car-builder, secured by the obligation of the railroad to purchase the equipment. Such financing should come from outside sources, not the railroad itself. When the "permanent" financing is arranged, the interest in the equipment retained by the builder (or the interim financer) would be reassigned to the trustee or agent for the long-term debt participants.

The second technique involves the creation of an equipment trust before delivery. The trustee would issue certificates to a party providing interim financing, perhaps a bank that has an existing line of credit in place for the railroad, or enter into a noteless form of borrowing arranged and guaranteed by the railroad. The proceeds would be used to pay the builder for the cars or locomotives. The trustee would hold a security interest in the locomotives for the benefit of the certificate holders. When the permanent financing is arranged, the certificates would be amended to reflect the then-market rate, and sold to the new debt participants.[56]

With proper planning, the railroad could arrange for the issue of long-term equipment trust certificates or other method of permanent financing before the first deliveries of equipment. The proceeds of the issue of certificates would be deposited with the indenture trustee pending "take-down" from time to time as equipment is delivered; pending such delivery, the proceeds would be invested in short-term obligations meeting some standard of investment quality. The disadvantage of this arrangement is that the short-term investments inevitably earn less than the interest due on the long-term certificates, and the railroad must make up the difference. Most railroads prefer to use some sort of interim financing arrangements to cover the cost of the equipment until a large enough group has been assembled for an issue of equipment trust certificates or other medium of long-term financing.

III. Some Tax Topics

A. *The Foreign Tax Credit*

Railroad companies in Canada and the National Railways of Mexico participate in the system of interchange of railroad equipment promulgated by the Association of American Railroads. Thus railroad rolling stock, placed in interchange service, occasionally may be used outside of the United States. This may have some income tax consequences for lessors of railroad equipment; while limited foreign use of leased equip-

56. The drafter of this arrangement must take considerable care to ensure that the long-term debt does not constitute a novation, extinguishing the original debt and the purchase money security interest that goes with it. *See, e.g.*, *In re* Hassebroek, 136 B.R. 527 (Bankr. N.D. Iowa 1991). The interim financing arrangements should clearly contemplate the ultimate long-term debt, and the initial security instruments should be flexible enough to be retained for the long-term debt. *See generally* Robert M. Lloyd, *Refinancing Purchase Money Security Interests*, 53 Tenn. L. Rev. 1 (1985).

ment may not jeopardize the accelerated cost recovery deductions, some portion of the rental income and transaction losses[57] would be attributable to the foreign use, and would have an effect on the lessor's foreign and domestic tax liability. The issue of foreign source income always comes up in the negotiation of an equipment leasing transaction, and it can be troublesome, indeed.

Section 901 of the Internal Revenue Code[58] provides that a taxpayer is entitled to a credit against its United States income taxes in the amount of any income, war profits, and excess profits taxes paid or accrued to any foreign country. There are limitations on that credit specified in section 904 of the Code: In general, the total amount of the credit taken cannot exceed the same proportion of the tax against which the credit is taken which the taxpayer's taxable income from sources without the United States bears to its entire taxable income for the same taxable year.

This can be expressed as follows:

$$\frac{\text{Foreign tax credit}}{\text{Total U.S. tax liability}} \leq \frac{\text{Taxable income from foreign sources}}{\text{Total taxable income}}$$

In the early years of a lease financing, the transaction generates losses for the lessor. A taxpayer is required to allocate depreciation deductions and interest deductions with respect to property ratably to sources of income, within and without the United States. As a result, transaction losses in those early years follow the equipment, and foreign use means foreign source losses. Losses from foreign sources reduce equally both the numerator and the denominator of the fraction on the right (thus reducing the magnitude of the entire fraction), and this has the effect of reducing the limit on foreign taxes creditable against United States taxes; if the taxpayer has other foreign activities generating foreign tax liability, part of the credit for that liability may be lost. That is why foreign source losses are unwelcome, even though leveraged lease transactions are designed to show losses for tax purposes.

In the case of railroad rolling stock, there is some relief from this problem. Section 861(e) of the Internal Revenue Code provides that income from leases of railroad rolling stock leased to domestic railroad companies be treated as income from sources within the United States if the use of the rolling stock is expected to be within the United States. That requirement is satisfied if the only use outside of the United States is in Canada or Mexico on a temporary basis, which is not expected to exceed 90 days in any taxable year.

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57. Lease transactions are usually designed to produce tax losses in the early years, when accelerated cost recovery deductions and interest deductions for acquisition debt exceed the rental income. These transactions are tax shelters for large corporate taxpayers.

58. I.R.C. § 22901 (1988).

Thus the foreign source income and loss problem can be disregarded for most leases involving railroad equipment in interchange service, even though there may be occasional use in Canada or Mexico. But for section 861(e) to be applicable, the lessee must be "a domestic common carrier by railroad or a corporation which is controlled, directly or indirectly, by one or more such common carriers." Thus a lease to a private car line would not have the benefit of section 861(e), unless the private car line is owned or controlled by a railroad or railroads.

As for autoracks owned and financed separately from the flat cars on which they are erected, the applicability of section 861(e) turns on the meaning of "railroad rolling stock." That is not defined in the regulations for section 861; another Treasury regulation, section 1.48-1(g), defining rolling stock for certain purposes of sections 38 and 48 of the Internal Revenue Code, speaks of "locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels" that are included in a railroad's equipment accounts. The part about wheels suggests that highway trailers would be included, but it is more difficult to make a case for containers and autoracks.

There is more to the foreign tax credit than that, of course. There are some very interesting problems relating to the allocation of items of expense to sources within and without the United States, particularly the interest expense in leveraged lease transactions.

B. Double Dips

Different nations have different notions of the distinction between a lease and a secured loan. In the United States, that distinction is based on the economic substance of the transaction.[59] In some other countries, particularly those with a civil code heritage, there may be greater reliance on form. And even in those countries that look to the economic substance of the transaction, the measures may be different from ours.

These differences make possible a sort of arbitrage. If an equipment financing transaction across international boundaries, styled as a lease, is treated as such in the lessor's country but regarded as a secured loan in the lessee's country, then the lessor would be regarded as the owner of the equipment in its home country, and the nominal lessee would be regarded as the owner of the equipment in its home country. Thus there can be two owners of the same equipment, and two sets of tax benefits of ownership—depreciation deductions or whatever—available for the same

59. Helvering v. Lazarus & Co., 308 U.S. 252 (1939); *see* Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Rul. 55-540, 1955-2 C.B. 39; *see generally* ASSET FINANCING, *supra* note 18, at 493; William A. Macan, IV & Richard L. Umbrecht, TAX ASPECTS OF EQUIPMENT LEASING, EQUIPMENT LEASING—LEVERAGED LEASING 313 (Bruce E. Fritch et al. eds., 3d ed. 1988).

equipment. Such a double-dip of tax benefits can substantially reduce the financing cost of equipment for which such transactions are possible. Cross-border lease financing of aircraft is quite common around the globe.[60]

Needless to say, tax authorities are not entirely enthusiastic about the effect on the national revenues of such practices. In the case of cross-border leasing of equipment for use in the United States, the domestic tax effects are nil, because someone in the United States would be entitled to the accelerated cost recovery deductions for the equipment in any case. Thus the Internal Revenue Service has not actively opposed the practice,[61] and indeed, another government agency, the Federal Aviation Administration, has adopted specific guidelines to accommodate cross-border leases.[62]

But in the home country of a lessor that has leased equipment into another country, the tax benefits are there to reduce tax revenues but the equipment is not there to increase productive capacity. Thus tax authorities in the country on the "lessor" side of a transaction do not favor cross-border leasing, unless they perceive some benefit to that country. If the equipment subject to the lease, or significant parts of that equipment, are manufactured in the lessor's country, then tax authorities can look upon the transaction as a form of export support, and give their blessing (or withhold objections). Consequently, most cross-border transactions involve a lease from the country where the equipment is built into the country where it is used.[63]

This hardly seems relevant for railroad equipment financing, because railroad cars and locomotives used in the United States are built here. But electric locomotives have been imported (and financed with cross-border leases), and new generations of locomotives will have traction motors and other equipment originating in Europe. In addition, almost all public transit equipment—subway cars, commuter cars and light-rail cars—are manufactured by foreign builders, although assembly often is done in the United States. Thus the home countries of the manufacturers of this equipment and components would be potential hosts for cross-border transactions. Finally, Japanese cross-border leasing remains available regardless of the origin of the equipment or its components.[64]

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60. *See* Richard S. Koffey & Richard L. Umbrecht, *Japanese Cross-Border Leasing into the United States*, 43 TAX LAW. 149 (1989).

61. *But see* Ronald Coleman, 87 T.C. 178 (1986), aff'd, 833 F.2d 303 (3d Cir. 1987).

62. Treatment of Leases with an Option to Purchase, 55 Fed. Reg. 40,502 (1990); *see also Aircraft Finance*, *supra* note 3, at 1042.

63. An exception is Japan, which has permitted its taxpayers to take the benefits of equipment ownership for equipment leased to other countries, but not manufactured in Japan. *See* Koffey & Umbrecht, *supra* note 60.

64. *See* Koffey & Umbrecht, *supra* note 60.

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C. *Foreign Sales Corporations*

The current need to rebuild railroads in many countries of the world suggests new vigor in the export market for American railroad equipment, particularly locomotives. Cross-border lease transactions in the outbound direction can be designed to employ tax-oriented techniques to reduce financing costs for the ultimate user in a foreign country. The conventional type of double-dip is not possible: tax authorities in the United States take perhaps the strictest view in the world of what constitutes a lease, so that it has not been possible to design a lease from an American lessor to a foreign lessee that would be treated as a lease under U.S. tax rules and a secured loan under foreign rules, creating two tax owners. Further, if equipment is used predominantly outside of the United States by a foreign lessee, the most favorable accelerated cost recovery deductions are not available.[65]

Comes now the FSC, the Foreign Sales Corporation. This is a tax-incentive for export sales; the special benefits of the FSC are available for lease transactions as well as sales. A Foreign Sales Corporation, owned by an American corporation but organized outside the United States,[66] can exclude from its taxable income 16% of certain qualified export income (called "foreign trade income") from a transaction in which the FSC buys export property from a related supplier and sells or leases the property to an unrelated buyer or lessee, or acts as a commission agent to assist a related company in selling or leasing export property to an unrelated buyer or lessee.[67] A FSC can also exclude from its taxable income 32% of its rental income from equipment, purchased from an unrelated entity, and leased to an unrelated foreign lessee.[68] This income can be transferred to the parent corporation without additional tax under the dividends-received deduction.

Airline financers have adapted the FSC to reduce the cost of leasing

65. Under the accelerated cost recovery system, railroad equipment (other than tank cars) is regarded as "7-year property," and can be depreciated over that period to a zero salvage value using the 200% declining balance method. I.R.C. § 168(b) (1988). For equipment used predominantly outside of the United States, the depreciation deduction is determined by using the straight-line method over the class life, which is a longer period than the recovery period under I.R.C. § 168(a). I.R.C. § 168(g) (1988). There is an exception for railroad rolling stock "used within and without the United States" belonging to a domestic regulated carrier, or to another United States taxpayer if the rolling stock is not leased to foreign persons for more than 12 months in a 24-month period. I.R.C. § 168(g)(4)(B) (1988). If equipment is leased to an entity other than a United States taxpayer, the "recovery period" (the depreciation period) cannot be less than 125% of the lease term. I.R.C. § 168(g)(3)(A) 1988).

66. Usually Barbados, Bermuda, or the U.S. Virgin Islands.

67. I.R.C. §§ 921-27 (1988); *see also* Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., Explanation of the Technical Corrections to the Tax Reform Act of 1984 and other Recent Tax Legislation 178 (1987).

68. *Id.*

aircraft to be used predominantly outside of the United States. The first technique, called a "commission FSC," has been used for leases of aircraft both to foreign lessees and to domestic lessees for use on foreign routes.[69] The lease structure is straightforward: a lessor, a United States taxpayer, leases equipment to a foreign user (or to a domestic user for foreign routes). The lessor leverages the transaction by borrowing most of the purchase price of the equipment from institutional lenders on a non-recourse basis, that is, the lenders agree to look only to the stream of rent payments for debt service. The lessor organizes a subsidiary Foreign Sales Corporation, and up to 23% of the rental income is allocated to the FSC as a commission for arranging the transaction.[70]

Lease transactions, particularly leveraged lease transactions, are designed to show tax losses in the early years, due to the allowances for depreciation (or accelerated cost recovery) of the leased equipment and for interest on the acquisition debt exceeding the rental income. Thus a commission FSC may not have foreign trade income subject to the exclusion until the later years of the lease. Losses in the early years can also cause problems with the foreign tax credit.[71]

In order to enhance the yield from a commission FSC lease transaction, financers look for ways to separate the debt from the lease income. Usually, the interest expense for non-recourse debt must be allocated to the income generated by the property acquired with the debt. If that interest can be allocated by the lessor to general indebtedness and not set off against the rental income, more of the rental income would be available for the 15% exclusion. Another technique to enhance yields is the use of a short lease term, to shorten the depreciation period,[72] and a long debt term, to spread out the debt service.

While these techniques can be regarded as aggressive, they are not thought to be offensive because the result is a lower financing cost for equipment exported from the United States. The commission FSC can be used for domestic railroads with lines outside of the United States, for foreign railroads, and for private cars used outside of the United States.

Exclusion of 32% of income from taxes is better than exclusion of 16% of income, so financers have developed the "ownership" FSC transaction to lease equipment directly. In these transactions, the Foreign

69. The depreciation deductions are more favorable for aircraft registered with the Federal Aviation Agency and operated "to or from the United States" or "under contract with the United States." I.R.C. § 168(g)(4)(A) (1988).

70. To give credence to this, some of the negotiations must take place where the FSC is organized. *See Aircraft Finance, supra* note 3, at 1042.

71. *See* discussion *supra* part IIIB.

72. If equipment is leased to a foreign entity or an tax-exempt entity, the recovery period for depreciation deductions cannot be less than 125% of the lease term. I.R.C. § 168(g)(3)(A) (1988).

Sales Corporation itself purchases the equipment and leases it to a foreign user. In order to obtain the most favorable yield, however, it is necessary to employ some of the same strategies as in the commission FSC: separation of the debt service from the rental income, and shortening the lease term to enhance the depreciation deductions.

Separating the rental income from the debt is a major challenge in these transactions. The Foreign Sales Corporation owns the equipment and is the lessor under the lease; but it cannot be the borrower under the acquisition debt: if so, the interest would be deducted from the rent income, reducing (or even eliminating) the income for which the 32% exclusion is available, and destroying the yield from the transaction. In order to overcome this, the corporation that owns the FSC borrows the money, entering into the acquisition debt, and injects the loan proceeds into the FSC as capital. Thus the FSC has rental income subject to the exclusion without interest deductions, and the parent of the FSC has interest available to deduct from other income.

The catch, however, is that the borrower is the parent of the FSC, not the FSC itself, and that parent is not the owner of the equipment and cannot grant a security interest in the equipment to support non-recourse debt. The lenders in these transactions are asked to make the loan without a security interest in the equipment. Instead, the lenders receive a pledge of the stock of the Foreign Sales Corporation. This is enough of a departure from the traditional structure of a leveraged lease transaction to chill the enthusiasm of lenders, unless both the ultimate lessee and the lessor are quite credit-worthy.

Purveyors of ownership FSCs use the same yield enhancement technique as the commission FSCs involving leases to foreign entities: the lease term is shortened to enhance the depreciation deduction, while the term of the debt is much longer, perhaps twice the initial lease term. At the expiry of the initial lease term, the lessee must either purchase the equipment or arrange a replacement lease with payments sufficient to discharge the debt and preserve the lessor's yield. This is called a "Pickle" lease, because the Internal Revenue Code provisions establishing the depreciation period for equipment leased to entities that do not pay United States income taxes—125% of the lease term—were installed by the amendments sponsored, in part, by Congressman Pickle.[73]

An ownership FSC can be used to finance railroad equipment manufactured in the United States and used in foreign countries. Canada and Mexico are foreign countries.

The accelerated "Pickle" lease, developed in the context of FSC

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73. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 31, 98 Stat. 494, 509 (1984).

transactions, has also been used for sale-leaseback financing by American investors of railroad equipment in foreign countries.

IV. Mexican Interchange

Financers of railroad equipment used in Canada (whether directly by Canadian railroads or through interchange with U.S. railroads) have the comfort of a central recording statute for interests in railroad equipment, section 90 of the Railway Act.[74] This is quite like the federal recording statute in the United States, in that this central filing is "valid against all persons" and there is no need for any local filing or perfection of security interests.[75]

Mexico has no such central filing procedure. This has not been regarded as a significant problem in the past, although the Ferrocarriles Nacionales de Mexico (The National Railways of Mexico), the government entity that operates most of the railroad mileage in Mexico, participates in the equipment interchange system of the Association of American Railroads. Thus any railroad rolling stock placed in interchange service in North America could, at some time or other, be used to carry goods to Mexico and be operated over Mexican trackage.

The current development of a free trade agreement with Mexico offer the prospect of significant increases in rail traffic between Mexico and the United States. Efficient handling of this traffic suggests equipment interchange, perhaps even run-through service. But the parties who finance that equipment like to have their interests in the equipment protected by some form of perfection or public recordation. Insist on it.

The only system of "perfection" now available in Mexico is registry with the public registries of property and commerce, which exist in the Federal District and in every major city and area. Each property registry covers only local real property, but the laws of the Federal District and of most state civil codes classify rolling stock as "immovable," or real property,[76] so interests in railroad cars could be registered in those property registries.[77] But that is not now done: the process would involve translation of the documents into Spanish, perhaps conversion into civil code forms, engaging local lawyers, and inevitable procedural delays.

Mexican lawmakers have never seen the need for a central registry for recordation of interests in railroad rolling stock, like the ICC registry or that maintained by the Registrar General of Canada. The Mexican railway

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74. R.S.C., ch. R-3, § 90. Formerly ch. R-2, § 86; *see also Railroad Equipment Financing*, *supra* note 1, at 98.

75. *See* 49 USC § 11303 (1988).

76. *E.g.*, C.C.D.F. Art. 740 (X).

77. L.V.G.C., Art. 93.

system is run by a government agency, created in accordance with the Mexican Constitution and a special organic law[78], and the railways' property cannot be levied against for execution.[79] There is no need to protect rights of creditors secured by interests in railroad rolling stock, because there aren't any such creditors in Mexico. The only significant private interests in railroad rolling stock would be those of foreign owners and creditors, and why should Mexico provide a registry for them?[80] When the question comes up, Mexican counsel usually advise that the courts will generally apply United States law in determining the ownership of cars from the United States and will give effect to security interests validly created abroad.[81]

For equipment creditors, this advice is adequate for the usual transaction involving hundreds or even thousands of railcars in domestic interchange service, because only a few of those cars might be in Mexico at any given time. But in a transaction involving locomotives for a railroad with connections into Mexico, or for equipment that might be dedicated to service Mexican traffic, financing parties may want more concrete assurances.

We are unlikely to see Mexico adopt a central system for recordation of interests in railroad equipment, like the U.S. and Canadian systems. But a more realistic hope is the adoption of a bilateral treaty providing for international recognition of interests in railroad equipment.

The model for this would be the Convention on International Recognition of Rights in Aircraft, adopted in 1948 in Geneva.[82] The United States and Mexico are parties to this multilateral treaty, although Mexico has made a reservation to certain terms. This convention provides for international recognition of rights in aircraft that have been constituted in accordance with the law of the nation of registry of the aircraft. Thus, in the case of an aircraft registered in the United States, recordation of interests in that aircraft with the FAA under section 503 of the Federal Aviation Act[83] serves to protect financers of the aircraft in the 51 other nations that have adopted the convention.

Of course, railroad cars are not "registered" like aircraft. But a close-

78. L.O.F.N.M. (1985).

79. *Id.*, Art. 18.

80. There are a few hundred private cars in Mexico, not enough to create any pressure for special legislation to facilitate financing. Privatization of the Mexican National Railway, that is, sale of the railway to private investors, has been mentioned but does not appear to be in any way imminent.

81. C.C.D.F. Art. 13 (IV).

82. 4 U.S.T. 1830, T.I.A.S. No. 2847, 310 U.N.T.S. 151. *See generally* ASSET FINANCING, *supra* note 18, at 266; *Aircraft Finance*, *supra* note 3 at 1054.

83. 49 U.S.C. app. § 1403 (1988); *see generally* ASSET FINANCING, *supra* note 18, at 251; *Aircraft Finance*, *supra* note 3, at 1040.

enough equivalent is found in the system of reporting marks identifying car owners promulgated by the Association of American Railroads. A bilateral treaty could be based on recognition of the laws of the nation of domicile of the entity, railroad company or otherwise, whose AAR reporting marks are on the equipment.

Such a treaty would provide complete coverage, for railroad equipment financers, in North America. The integrity of the system is assured by the track gauge: the tracks in the southern part of Mexico and the adjoining central American countries are narrow gauge, so standard-gauge equipment cannot escape that way.

V. Recommendations

We can distill from the recent airline bankruptcy cases and aircraft financing practice some guidelines for railroad equipment financing, to be considered along with the recommendations published earlier:[84]

1. A railroad company should make financing arrangements for rolling stock or locomotives before delivery and payment to the builder, or interim arrangements must be made in contemplation of the ultimate financing arrangements. Otherwise, the protection of section 1168 of the Bankruptcy Code may be lost to the ultimate financers, and with it, the most favorable financing terms.

2. A debt financing of railroad rolling stock or locomotives should adhere to the rules for "purchase money security interests" under Section 9-107 of the Uniform Commercial Code, in order to assure the availability of the protection of section 1168 (and, incidentally, to preserve the ability to issue equipment obligations under the exemption from registration available under section 3(a)(6) of the Securities Act of 1933).

3. If a lease financing transaction is planned, and the transaction would not qualify as a "purchase money security interest" if it is ultimately determined to be a security agreement rather than a lease, the railroad should carefully examine the law governing the transaction on the point of the distinction between a lease and a security interest. In this regard, selection of a state that has adopted Article 2A of the Uniform Commercial Code is helpful. If the railroad's or the lessor's home state has not so adopted Article 2A, the equipment should be conveyed to an owner trust, established in an appropriate state, and that state's law selected to govern the transaction.

4. If railroad equipment with significant foreign content is to be financed, a cross-border lease from the country of origination of the equip-

84. *See generally Railroad Equipment Financing*, *supra* note 1, at 113.

ment should be examined for potential savings in financing cost arising out of tax benefits in that country.

5. Exporters of railroad equipment, and foreign users of U.S. manufactured equipment, should consider financing through a Foreign Sales Corporation.

6. The railroad industry and its financers should promote the establishment of a bilateral treaty with Mexico, or a multilateral North American treaty, regarding international recognition of rights in railroad rolling stock.