Railroad Equipment Financing

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TABLE OF CONTESTS

I. INTRODUCTION

Equipment obligations — obligations secured by rolling stock — are a unique and important means of access to the capital markets for the railroad industry. Because of a history of investment safety dating back to the last century, and certain important legal factors, railroad equipment obligations are accepted by the investment community when other credit windows may be closed to railroad companies. The rating agencies cus-

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tomarily rate equipment obligations in one of the three highest grades, even when other debt securities of the railroad are deep in speculative territory.

In the recent decade of deregulation and railroad consolidation, an equipment surplus has reduced the need for outside financing. But now the slack has been taken out, and the major trunk line carriers and the new regional railroads are going to the institutional finance market to finance new equipment acquisitions and major rebuilding programs.

The legal framework for this renewed financial activity, secured financing and finance leasing, has changed substantially since the last review of railroad equipment financing in the legal literature.[1] While the same issues are presented as in other types of secured financing and leasing, particularly aircraft financing,[2] the resolution of these issues is not always the same, and there are some curious practices used in railroad equipment financing, some justified and some not, that deserve explanation.

I shall first explain some of the peculiar forms of railroad equipment financing. Railroad equipment financing uses forms that were developed in antiquity, and despite the unification of personal property security devices under the Uniform Commercial Code, these old forms remain fixed by statute and tradition.

A particular element of the legal strength of railroad equipment obligations is derived from federal recordation statutes in both the United States and Canada. I shall examine these statutes and their relationship to state and provincial personal property security law.

Equipment obligations of railroad companies enjoy an exemption from the registration requirements of the Securities Act of 1933, and are generally free of other federal and state securities regulation schemes. I shall also examine the dimensions of this exemption.

The unique history of railroad equipment obligations includes special treatment in railroad reorganization. Section 1168 of the Bankruptcy Code, a provision much beloved by institutional investors, sets forth this special treatment. I shall review some limitations of that statute. And finally, I've presented a few specific recommendations for putting together railroad equipment financing transactions.

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1. Riordan & Duffy, *Lease Financing: A Discussion of Security and Other Considerations from the Institutional Lender's Point of View*, 24 BUS. LAW. 763 (1969); *see also* Adkins & Billyou, *Current Developments in Railroad Equipment Financing*, 12 BUS. LAW. 207 (1957).

2. *See* Kruft, *Leveraged Aircraft Leases: The Lender's Perspective*, 44 BUS. LAW. 737 (1989).

II. RAILROAD EQUIPMENT OBLIGATIONS

A. THE TRADITIONAL FORMS

Forms of railroad equipment obligations predate the law of personal property security, as expressed in Article 9 of the Uniform Commercial Code and the predecessor conditional sales acts and chattel mortgage acts.[3] Indeed, railroad equipment obligations were the first examples of personal property security devices, emerging in an era of legal hostility to such things, when the common law treated non-possessory interests in personal property as fraudulent.[4]

The Philadelphia plan equipment trust was the first form of railroad obligation, appearing in the early part of the nineteenth century as a means of financing canal boats.[5] The law at that time would not countenance mortgages of chattels, therefore in order to finance a canal boat, the canal company would lease the boat to a boatman, the boatman would pay regular rents for a stated period, and at the end of that period he could purchase the boat for a nominal amount. This arrangement was determined to be valid against third parties,[6] and the new railroad industry in Pennsylvania adopted this bailment-lease to finance equipment acquisitions, the railroad company being the lessee and the financing party being the lessor.[7]

The modern form, as it evolved a century later,[8] retained the bailment-lease but added a form of trust indenture, under which a trustee acted as owner and lessor for the benefit of a group of financing parties. The financing parties received equipment trust certificates, issued by the trustee, as evidence of their interest in the transaction; the railroad-lessee usually endorsed its guaranty on these certificates. Certificates were issued in serial maturities, and were entitled to "dividends" at a fixed rate. The rents covered the principal maturities and dividends, and at the end of the lease term the railroad-lessee became the owner of the equipment.

Equipment trust certificates acquired a reputation for investment safety over the years,[9] and institutional investors regularly purchased these securities for their fixed-income portfolios. They were sold by the railroads at competitive bidding, under the supervision of the Interstate Commerce Commission. The usual issue involved an advance "rent" to

3. *See generally* G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (1965).

4. Hamilton v. Russel, 5 U.S. (1 Cranch) 309 (1803); Twyne's Case, 3 Co. Rep. 80b, 76 Eng. Rep. 809 (Star Chamber, 1601); 13 Eliz. I, c.7 (1571). *See generally* M. RICE, ASSET FINANCING 65 (1989).

5. Montgomery, *The Pennsylvania Bailment Lease,* 79 U. OF PA. L. REV. 920 (1931).

6. Lehigh Coal & Nav. Co. v. Field, 8 Watts & Serg. 232 (Pa. 1844).

7. K. DUNCAN, EQUIPMENT OBLIGATIONS 16 (1924).

8. D. STREET, RAILROAD EQUIPMENT FINANCING 83 (1959).

9. *Id.* at 69; *see also* M. RICE, RAILROAD EQUIPMENT OBLIGATIONS 111 (1978).

cover 20% of the purchase price of the equipment, and during a term of fifteen years rents were calculated to cover equal annual payments of principal and semiannual payments of "dividends" on the certificates.

Under modern notions of the distinction between a security interest and a lease, whether by reference to the Uniform Commercial Code,[10] federal income tax considerations,[11] or accounting principles,[12] the lease in the Philadelphia plan is not a lease at all, but a disguised security interest. Even with this contrived structure, the railroad equipment trust has become enshrined in various statutes,[13] and is probably here to stay. The form was adopted for aircraft financing in the post war boom of commercial aviation,[14] and the equipment trust continues as a significant instrument of aircraft finance.

Because of an exemption from registration under the Securities Act of 1933,[15] railroad equipment trust certificates have no restrictions on distribution or resale and can thus be treated as publicly-offered securities. The private-placement counterpart has been the New York Plan "conditional sale."

A "conditional sale" is a device designed to accommodate the payment of the purchase price in installments, with the seller retaining an interest in the goods sold until satisfaction of the condition, full payment. The early appeal of the conditional sale was the retention of "title" in the seller. A railroad company usually was subject to a mortgage on the entire system, covering not only the land and right-of-way, but also the tracks, rolling stock, supplies, and all of the pieces that made up a functioning railroad. Such mortgages had after-acquired property clauses, so that new equipment coming into the hands of the road would become subject to the mortgage. A conditional sale, in which the vendor retained "title," was held by the Supreme Court to give the conditional vendor a claim superior to the lien of the mortgage.[16] Thus comforted, investors

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10. *See, e.g.*, Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of U.C.C. Section 1-201 (37) and Article 9*, 1973 DUKE L. J. 909.

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

12. FINANCIAL ACCOUNTING STANDARDS BOARD, Statement of Financial Accounting Standards No. 13, (Accounting for Leases 1976).

13. 11 U.S.C. § 1168 (1982 Supp. II & Supp. V. 1987); 15 U.S.C. § 77c(a)(6) (1982); 49 U.S.C. § 11303 (1982); N.Y. Banking L. § 235 (McKinney's 1971 & Supp. 1989), N.Y. Ins. L. § 1404 (McKinney's 1985 & Supp. 1989).

14. Adkins & Billyou, *Developments in Commercial Aircraft Equipment Financing*, 13 BUS. LAW. 199 (1958).

15. 15 U.S.C. § 77c(a)(6) (1982). The Securities Act of 1933, Pub. L. No. 22, ch. 38, 48 Stat. 74 (1933), as amended 15 U.S.C. §§ 77a-77aa (1982 & Supp. V. 1987), is herein sometimes referred to as the '33 Act.

16. Fosdick v. Schall, 99 U.S. 339 (1879); *see* G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 62 (1965).

were willing to advance funds against assignments of conditional sale obligations, and a major method of equipment financing emerged.

Conditional sales were validated by specific state legislation in the period 1881-1913.[17] But the principal impetus for their use as financing devices was a peculiar regulatory interpretation.

The Interstate Commerce Commission was given power to regulate the issuance of securities by rail carriers in the 1920 amendments to the Interstate Commerce Act,[18] long before the broader regulatory mechanism of the Securities Act of 1933[19] and related statutes was put in place. The securities regulation scheme vested in the ICC involved an approval process, whereby securities could not be issued unless and until the Commission approved the same — quite different from the registration and disclosure mechanism of the '33 Act.[20] As part of the approval process, the ICC would investigate how the proceeds of the issue of the securities were used and would pass on the offering price.[21] Ordinarily, the ICC required that competitive bidding be used in the sale of the securities.[22]

Thus, issuance of securities by railroad companies could be a cumbersome process. The definition of "security", however, in the Interstate Commerce Act was less broad than the definition in the '33 Act, and a loophole was soon found. In an early decision, the ICC took jurisdiction over the notes issued in an equipment financing, but not the conditional sale agreement that secured the notes.[23] So railroad lawyers developed a form of financing that used a conditional sale, with the payment obligation contained therein, without accompanying notes. The Interstate Com-

17. K. DUNCAN, EQUIPMENT OBLIGATIONS 155 (1924). These "recording statutes" often made specific reference to railroad rolling stock and some were limited to such equipment. A few of these statutes remain on the books: CAL. PUB. UTIL. CODE, § 7578 (West 1965); VT. STAT. ANN. tit. 30 § 1034 (1986). The recording statutes always required that the equipment be marked with the name of the owner or lessor; this established a tradition that is still observed, although a universal legend such as "Subject to a Security Interest Filed with the Interstate Commerce Commission" is usually used, to make it easier for the lads in the paint shop.

18. Transportation Act of 1920, § 439, Pub. L. No. 152, ch. 91, 41 Stat. 457, 494 (1920) (codified as amended, at 49 U.S.C. § 11301 (1982)).

19. Securities Act of 1933, *supra* note 15.

20. For a discussion of the differences between securities regulation under the Interstate Commerce Act and the Securities Act of 1933, *see* H.R. REP. No. 94-725, 94th Cong. 2d Sess. 64 (1975); *see also* 1 L. LOSS & J. SELIGMAN, SECURITIES REGULATION 166 (3d ed. 1989).

21. All consistent with the intent of Congress. *See* Railroad Comm'n of Calif. v. Southern Pacific Co., 264 U.S. 331, 347 (1924); Chicago South Shore & S.B. R.R. v. United States, 221 F. Supp. 106, 108 (N.D. Ind. 1963); *Ex Parte* 275, Expanded Definition of the Term "Securities", 348 I.C.C. 288, 290 (1975); I. SHARFMAN, THE INTERSTATE COMMERCE COMMISSION 189 (1931).

22. *Ex Parte* 158, *In re* Competitive Bidding in the Sale of Securities, 257 I.C.C. 129 (1944), *modified*, Atlantic Coast Line R.R. Competitive Bidding Exemption, 282 I.C.C. 513 (1952) *further modified*, *Ex Parte* 158, 307 I.C.C. 1 (1958).

23. Notes of Bangor & Aroostock R.R., 67 I.C.C. 533 (1921).

merce Commission confirmed that such conditional sale obligations were not "securities" as defined in the Interstate Commerce Act, and that it had no jurisdiction over their issuance.[24] Thereupon, the railroads used conditional sale financing for those transactions that were best privately placed, without the structural confinement that went along with the approval process for the equipment trusts.

When conditional sale financing, without the benefits and blessings of ICC regulation, became a major element of railroad debt, the Commission attempted to change its mind,[25] but was unsuccessful.[26]

There was a certain symmetry in the federal securities regulation scheme, however; because conditional sale obligations were not regulated by the Interstate Commerce Commission, the exemption from registration afforded by section 3(a)(6) of the Securities Act (as originally written) did not apply, and such obligations came under the scope of the '33 Act. Accordingly, the railroads and financial institutions used the section 4(2) exemption from registration for "private placements" in arranging these transactions, and conditional sale transactions became a significant element of railroad capital formation in the institutional private placement market.

Conditional sale financing of railroad equipment followed a consistent structure. The railroad company would contract with the equipment vendor to pay the purchase price of the equipment in installments, usually equal annual installments for fifteen years, with interest on the unpaid balance paid semiannually. The vendor would retain "title" to the equipment until the debt was discharged (with the advent of the Uniform Commercial Code, the notion of "title" was replaced by a security interest). The parties supplying the financing would appoint an agent, and the agent would pay the invested funds to the equipment vendor, taking an assignment of the conditional sale indebtedness and the rights under the conditional sale agreement. Thus the vendor was paid immediately upon delivery of the equipment, and the financing parties stepped in its shoes to collect the conditional sale indebtedness. The financing parties did not receive notes or any similar instrument by the railroad, but were issued certificates by the agent, as evidence of participation in the indebtedness.

The railroad equipment financing triad is completed by lease financing. Railroad equipment lends itself to leasing: railroad companies are accustomed to using equipment owned by others, and because rolling stock has a relatively long life, a fifteen-year transaction, the traditional

24. Lehigh Valley R.R. Conditional Sale Contract, 233 I.C.C. 359 (1939).

25. *Ex Parte* 275, Expanded Definition of the Term "Securities," 340 I.C.C. 817 (1972).

26. Association of American R.R. v. United States, 603 F.2d 953 (D.C. Cir. 1979).

term for a railroad equipment financing, would provide financing parties a significant residual value at the end of the term.

Full-payout finance leases had been used as early as 1949,[27] perhaps inspired by real estate sale-leasebacks developed in that era.[28] By the 1950's, leasing was recognized as a financing method for chattels as well as real property.[29] When tax incentives for investment in equipment — the investment credit and accelerated methods of depreciation — were introduced in the early 1960's, leasing took on major importance as a method of providing some of the benefits of these tax incentives to transportation companies that often did not have the tax liability to use them effectively. Instead of the user purchasing the equipment, another corporation needing shelter for taxes would acquire the assets and lease them to the user. This leasing corporation would reduce its own tax liability with the depreciation deductions and investment credit, and pass a portion of the benefits on to the equipment user in the form of reduced rents. The need of airline companies to finance new fleets of turbojet aircraft led to the development of leveraged leasing, in which the owner-lessor borrows most of the purchase price.[30] The railroad industry quickly adopted the structure, and many fortunes were made in brokering railroad equipment lease transactions.

Railroad leveraged lease transactions were shaped by the same forces that shaped straight debt financing. Because the prevailing railroad securities statute, section 20a of the Interstate Commerce Act, required ICC approval for a carrier to "assume any obligation or liability as lessee . . . in respect of the securities of any other person," it was felt in most legal quarters that the debt portion of a leveraged lease transaction should be in the form of a conditional sale agreement, not regarded by the Commission as a security, thus avoiding the need for ICC approval.[31] And so they were, involving a somewhat cumbersome documentary structure: a conditional sale agreement from the vendor to the owner-lessor, a lease to the railroad company, and an assignment of the conditional sale indebtedness to an agent for the debt participants. Very often the equity participant or participants, the owner of the equipment, would

27. D. STREET, RAILROAD EQUIPMENT FINANCING 124 (1959).

28. *See* Cary, *Corporate Financing Through the Sale and Lease-back of Property: Business, Tax and Policy Consideration*, 62 HARV. L. REV. 1 (1948).

29. *See* Steadman, *Chattel Leasing—A Vehicle for Capital Expansion*, 14 BUS. LAW. 523 (1959).

30. *See* Johntson, *Legal Aspects of Aircraft Finance*, 29 J. AIR L. & COM. 161 (Part I), 299 (Part II) (1963); Lambert, *Survey of Domestic and International Aspects of Aircraft Equipment Financing*, 18 BUS. LAW. 627 (1963).

31. This view was not universally held, and many leveraged lease transactions have been done with notes, with no apparent ill effect. No one seems to have been concerned that the lease itself would be regarded as a security.

use a trust as an ownership vehicle, involving another instrument and another party. And all of the financing parties and the railroad would usually join in a participation agreement of some sort, setting up closing conditions and picking up odds and ends of covenants and agreements. Much paper, much lawyering.

B. Private Car Lines

Railroad equipment financing is not confined to equipment owned by or leased to railroads. Railroads also move commodities in "private cars," cars owned by others. Shippers often own rolling stock designed for the special needs of their commodities, and independent entities, called "private car lines," maintain fleets of equipment for short-term lease to railroad companies and shippers. These private cars are a major portion of the nation's fleet of railroad rolling stock, and the financing of this equipment is a major capital market.

The securities regulation aspects of railroad company equipment obligations do not apply to the obligations of private car lines. These lines are not regulated carriers,[32] and are not covered by the scheme of railroad regulation embodied in the Interstate Commerce Act and the successor provisions of the Transportation Code.[33] Nevertheless, the forms used for financing equipment by railroads have been adopted for financing private cars, not because the law requires it, but because tradition suggests it. Thus private car line equipment financers often use the equipment trust as the security instrument, and they sometimes employ conditional sales.

The danger of this practice is that the investors may assume that the legal characteristics of these devices is independent of the nature of the obligor, and may disregard important differences in treatment under the securities laws, bankruptcy laws, and some other relevant areas of the law. The distinction between railroad companies, on one hand, and private car lines and other types of obligors, on the other hand, must always be kept in mind in reviewing and applying legal principles to equipment obligations.

III. Perfection of Security Interests

Railroad equipment financing (and financers) have the benefit of a comprehensive federal statute covering recordation of interests in such equipment. Because it pre-dates the Uniform Commercial Code, the operation of this statute does not depend on that feature of state law; yet the

32. General American Tank Car Corp. v. El Dorado Terminal Co., 308 U.S. 422 (1940); Ellis v. I.C.C., 237 U.S. 434 (1915).

33. 49 U.S.C. § 10101-11916 (1982 & Supp. IV 1986).

draftsmen of the secured transactions article of the Uniform Commercial Code have accommodated the federal statute by treating it as the method of filing to perfect a security interest, in a singularly successful marriage of federal and state law.

The railroad equipment recording statute was first promulgated as section 20c of the Interstate Commerce Act.[34] DeForrest Billyou of the New York bar proposed the statute in 1951[35] to remedy the problem of compliance with the conditional sales acts and railroad recording statutes of the various states.[36] The interchange of equipment among the railroads of North America had made recording of interests in railroad rolling stock under state statutes both impractical and inadequate.[37]

Section 20c was inspired by section 503 of the Civil Aeronautics Act,[38] the provision for federal recordation of interests in aircraft. The railroad statute created a system of central filing with the Interstate Commerce Commission, and referring to the forms of financing prevailing at the time — mortgages, leases, equipment trust agreements, and conditional sales agreements — decreed that once such instruments were recorded with the Commission, they would be "valid and enforceable against all person . . . ."[39]

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34. Pub. L. No. 556, ch. 881, 66 Stat. 724 (1952).

35. Billyou, *Federal Railroad Equipment Legislation*, 64 HARV. L. REV. 608 (1951).

36. *See generally* K. DUNCAN, EQUIPMENT OBLIGATIONS 97, 155 (1924).

37. S. REP. No. 1676, 82d Cong., 2d Sess. 3 (1952).

38. Pub. L. No. 706, ch. 601, 52 Stat. 973, 1006 (1938); reenacted in 1958 as section 503 of the Federal Aviation Act, Pub. L. No. 85-726, 72 Stat. 731, 772 (1958); 14 U.S.C. § 1403 (1982 & Supp. IV 1986). *See* Adkins & Billyou, *Developments in Commercial Aircraft Equipment Financing*, 13 BUS. LAW. 199 (1958).

39. Sec. 20c. Any mortgage, lease, equipment trust agreement, conditional sales agreement, or other instrument evidencing the mortgage, lease, conditional sale, or bailment of railroad cars, locomotives, or other rolling stock, used or intended for use in connection with interstate commerce, or any assignment of rights or interest under any such instrument, or any supplement or amendment (including any release, discharge, or satisfaction thereof, in whole or in part), may be filed with the Commission, provided such instrument, assignment, supplement or amendment is in writing, executed by the parties thereto, and acknowledged or verified in accordance with such requirements as the Commission shall prescribe; and any such instrument or other document, when so filed with the Commission, shall constitute notice to and shall be valid and enforceable against all persons including, without limitation, any purchaser from, or mortgagee, creditor, receiver, or trustee in bankruptcy of the mortgagor, buyer, lessee or bailee of the equipment covered thereby, from and after the time such instrument or other document is so filed with the Commission; and such instrument or other document need not be otherwise filed, deposited, registered or recorded under the provisions of any other law of the United States of America, or of any State (or political subdivision thereof), territory, district or possession thereof, respecting the filing, deposit, registration or recordation of such instruments or documents. The Commission shall establish and maintain a system for recordation of each such instrument or document filed pursuant to the provisions of this section, and shall cause to be marked or stamped thereon, a consecutive number, as well as the date and the hour of such recordation, and shall maintain, open to public inspection, an index of all such instruments or documents, including any assignment, amendment, release, discharge or satisfaction thereof, and shall record, in

Section 20c served the railroad industry and the financial community faithfully for many years; its terms were so unequivocal that no court was asked to construe it.

The Interstate Commerce Act, as a whole, was regarded as a terrible mess, however, and in 1976 a joint project of the Law Revision Counsel of the House of Representatives, the Interstate Commerce Commission, and the Department of Transportation was commenced to revise the Interstate Commerce Act as part of a new transportation code. Section 20c sustained some damage in passing through this legislative gauntlet. Its two long sentences were chopped into nine shorter ones, as it was recodified as new section 11303 of Title 49, United States Code:

> (a) A mortgage (other than a mortgage under the Ship Mortgage Act, 1920), lease, equipment trust agreement, conditional sales agreement, or other instrument evidencing the mortgage, lease, conditional sale, or bailment of railroad cars, locomotives, or other rolling stock or vessels, intended for a use related to interstate commerce may be filled with the Interstate Commerce Commission. An assignment of a right or interest under one of those instruments and an amendment to that instrument or assignment including a release, discharge, or satisfaction of any part of it may also be filed with the Commission. The instrument, assignment, or amendment must be in writing, executed by the parties to it, and acknowledged or verified under Commission regulations. When filed under this section, that document is notice to, and enforceable against, all persons. A document filed under this section does not have to be filed, deposited, registered, or recorded under another law of the United States, a State (or its political subdivisions), or territory or possession of the United States, related to filing, deposit, registration, or recordation of those documents. This section does not change the Ship Mortgage Act, 1920.
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> (b) The Commission shall maintain a system for recording each document filed under subsection (a) of this section and mark each of them with a consecutive number and the date and hour of their recordation. The Commission shall maintain and keep open for public inspection an index of documents filed under that subsection. That index shall include the name and address of the principal debtors, trustees, guarantors, and other parties to those documents and may include other facts that will assist in determining the rights of the parties to those transactions.[40]

The drafters of the new code deserve credit for creating a crisper, more easily comprehended statute. But in the search for efficiency, a few missteps were made.

The first of the new, shorter sentences has a reference to "vessels."

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such index the names and addresses of the principal debtors, trustees, guarantors, and other parties thereto, as well as such other facts as may be necessary to facilitate the determination of the rights of the parties to such transactions.

Id. Pub. L. No. 556, ch. 881, 66 Stat. 724 (1952).

40. Pub. L. No. 95-473, 92 Stat. 1337, 1430 (1978).

This is a result of combining old section 323[41], covering interests in vessels used by regulated carriers, with section 20c. They were originally written in similar terms, so that combining the two provisions seems quite sensible. Except that old section 323 was limited to vessels used by water carriers subject to regulation by the Interstate Commerce Commission, and new section 11303 speaks of "vessels, intended for a use related to interstate commerce . . . ." Quite different, and considerably broader, for only a minority of interstate marine commerce was handled by regulated carriers. This broad coverage had been specifically rejected by Congress in enacting the original section 323.[42]

The new fourth sentence is the heart of the statute: "When filed under this section that document is notice to, and enforceable against, all persons." The succinct phrase "all persons" is regarded by the drafters of the new code as being more inclusive than the litany "all persons including, without limitation, any purchaser from, or mortgagee, creditor, receiver, or trustee in bankruptcy of, the mortgagor, buyer, lessee, or bailee of the equipment covered thereby."[43] The question is, would a court reach the same conclusion? For the retention of the phrase "any purchaser from" would have made clear that the holder of an interest recorded under the new section 11303 would prevail over a buyer in the ordinary course of business. This is not the case under section 503 of the Federal Aviation Act relating to interests in aircraft, a statute which refers simply to "all persons."[44] Courts consistently favor buyers in the ordinary course of business over holders of security interests recorded under that federal statute.[45]

The deletion of the reference to "trustee in bankruptcy" is equally troublesome. Those are strong words, giving an equipment creditor rights in bankruptcy that it otherwise might not have. The deletion is especially perplexing when one considers section 337(a) of the law creating the new Bankruptcy Code,[46] which was passed by Congress a few weeks after the revisions to the Interstate Commerce Act.[47] This section would have amended the reference to bankruptcy in section 20c to speak of "a case under Title 11 of the United States Code," had it still been there to amend. This specific reference reinforces the notion that the drafters of the Bankruptcy Code were aware of this special language, and

41. Pub. L. No. 90-586, 82 Stat. 1149 (1968).

42. H.R. REP. NO. 90-1932, 90th Cong., 2d Sess. (1968).

43. H.R. REP. NO. 95-1395, 95th Cong., 2d Sess. 153 (1978).

44. 14 U.S.C. § 1403 (1982 & Supp. IV 1986).

45. *E.g.*, Idabel National Bank v. Tucker, 544 P.2d 1287 (Okla. App. 1975).

46. Pub. L. No. 95-598, 92 Stat. 2549 (1978).

47. On November 6, 1978. The revisions to the Interstate Commerce Act were passed on October 17, 1938.

intended to preserve special rights for railroad equipment creditors (although this does seem inconsistent with elaborate bankruptcy code provisions for automatic stay and adequate protection).

There is some solace for equipment creditors in section 3 of the law amending the Interstate Commerce Act, which states that the new provisions "may not be construed as making a substantive change in the laws replaced,"[48] and in the legislative history that tells us that the objective of the revision was to restate the Interstate Commerce Act and related laws in comprehensive form, without substantive change.[49] The Law Revision Counsel duly opined to Congress that he was satisfied that the new law restated existing law accurately without substantive change.[50] (Perhaps that is close enough for government work). At least one court has ignored the revised law and looked to the original words of the Interstate Commerce Act to decide a close question.[51]

In one respect, however, the drafters of the revised Interstate Commerce Act were true to their word: if they were tempted to make reference to the contemporary and more general term "security interest" instead of the references to antique forms, mortgages and conditional sales, they successfully resisted. For unlike section 503 of the Federal Aviation Act, covering interests in aircraft, and section 11304 of Title 49, Transportation, covering interests in equipment used by regulated motor carriers, section 11303 does not specifically cover the generic form of security interest so carefully constructed by Professor Gilmore and the other authors of the secured transactions article of the Uniform Commercial Code. And so to be safe, the creator of a railroad equipment obligation must cast the words in the form of a mortgage, lease, equipment trust agreement, or conditional sale agreement. It is possible, of course, that a generous court would give a broad interpretation to the statute in order to protect an interest under an Article 9 security agreement, and such an interpretation would be quite justified, but if a court has ever been generous to a secured party it has escaped attention.[52]

These complaints notwithstanding, section 11303 of Title 49 is a very comprehensive and useful statute. It quite clearly covers leases, something that the filing provisions of Article 9 of the Uniform Commercial Code do not.[53] It quite clearly covers assignments, eliminating a problem that

48. 92 Stat. 1337, 1446 (1978).

49. H. REP. No. 95-1395, 95th Cong., 2d Sess. 4 (1978).

50. *Id.*

51. Association of American R.R. v. United States, 603 F. 2d 953 (D.C. Cir. 1979).

52. *See e.g.*, Clark, *Secured Transactions*, 43 BUS. LAW. 1425 (1988).

53. The recently promulgated Article 2A-Leases of the Uniform Commercial Code does not provide for filing or recording leases of goods, except in the case of goods that may become fixtures. American Law Institute, National Conference of Commissioners on Uniform State Laws, Article 2A. Leases, 1987 Official Text with Comments; *See also* Symposium, *Article 2A of the*

has come up under the correlative aircraft provision, section 503 of the Federal Aviation Act.[54] It is not limited in its coverage to regulated railroads, but includes railroad equipment owned or used by shippers and private car lines (even though the Interstate Commerce Commission originally thought that it did not).[55] In the only reported court test, it received a passing grade.[56]

The lack of judicial gloss is not a major problem. In the case of the parallel federal statute for interests in aircraft, section 503 of the Federal Aviation Act,[57] it is now well settled that the interstices of the federal law are to be filled by reference to the applicable state law.[58] And the draftsmen of the Uniform Commercial Code clearly had that in mind.[59] The Code treats these federal statutes as recording statutes, providing a method of filing,[60] and exempts from the application of Article 9 "a security interest subject to any statute of the United States, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property . . . ."[61] The words "to the extent" provide the federal-state interface, the Uniform Commercial Code picking up where the United States Code stops.[62]

The recordation procedure at the Interstate Commerce Commission is covered by relatively uncomplicated regulations.[63] The complete document is recorded with the Commission, and the document must be accompanied by a letter of transmittal in a certain form. This letter contains basic information regarding the names of the parties and the description of the equipment, similar to a Uniform Commercial Code financing state-

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Uniform Commercial Code, 39 ALA. L. REV. 559 (1988). *See* Bayer, *Personal Property Leasing: Article 2A of the Uniform Commercial Code*, 43 BUS. LAW. 1491 (1988).

54. Feldman v. Philadelphia Nat. Bank, 408 F. Supp. 24 (E.D. Pa. 1976); *but see* Feldman v. Chase Manhattan Bank, N.A., 368 F. Supp. 1327 (S.D.N.Y. 1974), *rev'd on other grounds*, 511 F.2d 468 (2d Cir. 1975); and Feldman v. First National City Bank, 368 F. Supp. 1333 (S.D.N.Y. 1974), *rev'd on other grounds*, 511 F.2d 460 (2d Cir. 1975).

55. *See* Billyou, *The Federal Railroad Equipment Recording Statute*, 20 I.C.C. PRAC. J. 216 (1952).

56. *In re* Auto Train Corp., 9 Bankr. 207 (Bankr. D.C. 1981).

57. 14 U.S.C. § 1403 (1982 & Supp. IV app. 1986).

58. Philko Aviation v. Shacket, 462 U.S. 406 (1983); Aircraft Trading & Services, Inc. v. Braniff, Inc., 819 F.2d 1227 (2d Cir.) cert. denied 484 U.S. 856 (1987).

59. GILMORE, *supra* note 3, at 401 (1965).

60. U.C.C. § 9-302(3), (4) 1972.

61. *Id.* at § 9-104.

62. The 1972 revisions to Article 9 of the Uniform Commercial Code have been adopted in 49 of the 50 states and the District of Columbia. The remaining state, Vermont, continues to use the 1962 version, which excludes from the coverage of Article 9 "an equipment trust covering railway rolling stock." U.C.C. § 9-104(e) (1962). *Id.* § 9-104 comment 5; *see also* GILMORE, *supra* note 3, at 430.

63. 49 C.F.R. § 1177 (1988).

ment, and provides guidance to the Commission staff for indexing the recorded documents.

The indexing system, however, is not altogether satisfactory. This system is patterned after the grantor-grantee index typically used for real estate records. Unlike the system of records of interests in aircraft maintained by the Federal Aviation Administration in Oklahoma City,[64] there is no index by car number. Car numbers are assigned by individual railroads and private car lines, not by the ICC, and there is no system of registration by car number as there is at the FAA for aircraft "tail" numbers.[65] A knowledge of railroad genealogy is necessary to track equipment through the many mergers, and railroad companies are not always fastidious about filing statements of new numbers when car numbers are changed to accommodate mergers or when the equipment is rebuilt. Thus a search of Interstate Commerce Commission records cannot be undertaken with a high level of confidence that every document recorded in respect of a given unit will be found.

Because of the these circumstances, in a refinancing of railroad rolling stock it is best for the new financing parties to take the interest in the equipment from the parties to the existing financing. An assignment of an existing lease or debt instrument, coupled with a renewal and amendment, may give the new financing parties the priority position of the original financing, whereas a release of the old interest and establishment of a new interest raises the question of intervening interests that may not have been found in a search.[66] In the refinancing of a lease transaction, a useful technique is the conditional sale from the original owner-lessor to the new owner-lessor, with an assignment to the new debt financing parties, and an amendment of the existing lease. This provides a debt instrument in one of the forms required by section 11303.

A. PERFECTION IN CANADA

The rails of Canadian railroads are 4' 8 1/2" apart, just as in the United States, and the Canadian railroads participate in the equipment interchange system of the Association of American Railroads. Thus rail-

64. *See* 14 C.F.R. § 49 (1988).

65. *See* 14 C.F.R. § 47 (1988).

66. This is not to say that it would work in all cases. Section 9-312 (7) of the Uniform Commercial Code gives future advances the same priority as the first advance under a particular security interest. But there is a question of the fairness to other creditors of permitting this priority when the original security agreement does not contemplate such advances, in circumstances where the agreement itself is recorded, not just a financing statement. If a court chooses to use real property transactions as an analogy, there is room for doubt. *See* G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW 883 (1985). Thus a refinancing party cannot depend on the effectiveness of acquiring the old priority position from the original financing party, but it is better to do it than not to.

road rolling stock, put into service and financed in the United States, may cross the border to Canada from time to time.

In most transactions, this is of little consequence. In a transaction covering 500 or 1000 units the cars will become scattered, and an occasional trip to Canada by some of those does not represent significant risk. However, some U.S. railroad companies have lines in or through Canada or significant equipment interchange with Canadian roads, increasing the proportions of the problem. Worth special attention are locomotive transactions with railroads on the northern border that have trackage in Canada, because each locomotive represents significant value.

Canada has a national recording statute, section 86 of the Railway Act of Canada:

> (1) Any instrument or copy of an instrument evidencing the lease, sale, conditional sale, mortgage or bailment of rolling stock located, moving or running on or over the lines of track of a company, or the amendment, assignment or discharge thereof, that is executed by the party or parties thereto, may be deposited in the office of the Registrar General of Canada, within twenty-one days from the execution thereof, and no instrument so deposited need be otherwise deposited, registered or filed under any law respecting the deposit, registration or filing of instruments affecting real or personal property, and on the execution and deposit of any such instrument as aforesaid, the same is valid against all persons.[67]

Section 86 has the same reference to traditional forms and the same notion of validity against "all persons" as the American statute. A difference to be kept in mind is the twenty-one day limit — if the documents are not deposited on time, they must be re-executed and sent up to Ottawa again.

Historically, section 86 only covered equipment leased, conditionally sold, or bailed to a railway company, leaving interests in equipment of private car lines to provincial law. (The reference in the statute to "company" is limited to railway companies.)[68] In 1982, section 86 was amended to its current form, ostensibly closing this gap. However, some Canadian counsel are not convinced that the national government has such authority; section 86 is only possible because of a provision in the Canadian constitution giving the national government jurisdiction over railway matters.[69] And there is the question of the effectiveness of such deposit when rolling stock is on private tracks, on the property of a shipper or receiver.

Thus Canadian counsel should be consulted in all financings involving significant amounts of equipment on Canadian tracks. In some cir-

67. CAN. REV. STAT. ch. R-2, § 86.
68. Railway Act, § 2(1), CAN. REV. STAT. C.234, § 1.
69. Advice of Michael Alvarez of the District of Columbia bar.

cumstances counsel may advise filing under one or more of the provincial statutes, personal property security acts in Manitoba, Ontario, Saskatchewan, and the Yukon territory,[70] and conditional sales acts in the remaining provinces[71] (except Quebec[72]).

IV. FEDERAL REGULATION

Equipment obligations of railroad companies enjoy a special exemption from securities regulation, a curious situation that can only be understood through an examination of the history of railroad securities regulation.

The first federal foray into securities regulation involved railroad securities. Securities manipulation in the railroad industry is the stuff of legend.[73] At the beginning of the twentieth century, the bloated capital structure of American railroads resulting from decades of stock watering was a problem of national proportions.[74] Following the recommendation of a special presidential commission chaired by Arthur T. Hadley, President of Yale University,[75] Congress, by section 439 of the Transportation Act of 1920,[76] added securities regulation to the powers of the Interstate Commerce Commission over railroad carriers.

Thus when the Securities Act of 1933[77] was passed, regulation of railroad securities was already in the hands of the patriarch of the independent regulatory agencies. Accordingly, an exemption from registration of securities under the new law was afforded to the railroad industry by section 3(a)(6) of the '33 Act.[78] That exemption spoke of securities subject to the approval of the Interstate Commerce Commission, so whatever was not covered by one act was covered by the other. Very neat. When motor carrier securities were brought under Interstate Commerce Commission regulation, the section 3(a)(6) exemption was enlarged to suit.[79] Also very neat.

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70. MAN. REV. STAT. ch. P-35 (1987); ONT. REV. STAT. ch. 375 (1980); SASK. STAT. ch. P-6.1 (1979-1980); YUK. ORD. ch. 20 (1980(2d)).

71. ALTA. REV. STAT. ch. C-21 (1980); B.C. REV. STAT. ch. 373 (1979); N.B. REV. STAT. ch. C-15 (1973); NFLD. REV. STAT. ch. 56 (1970); N.S. REV. STAT. ch. 48/C-30 (1967); P.E.I. REV. STAT. ch. C-16 (1974).

72. QUE. REV. STAT. art. 1980.

73. *See, e.g.*, M. JOSEPHSON, THE ROBBER BARONS (1934).

74. *See* BONBRIGHT, RAILROAD CAPITALIZATION 13, 156 (1920).

75. H.R. DOC. NO. 256, 62d Cong., 2d Sess. (1911).

76. Note 18, *supra*. For the history and purposes of this statue, see authorities cited at note 21, *supra*.

77. Securities Act of 1933, Pub. L. No. 22, ch. 38, 48 Stat. 74 (1933).

78. *Id.* 48 Stat. 76.

79. Pub. L. No. 255, ch. 498, 49 Stat. 543, 557 (1935).

Then came the Northeast railroad apocalypse in the 1970's.[80] Shortly after the collapse of the Penn Central and the adjoining roads, a Congressional staff report concluded that regulation of railroad securities had not been adequate under the existing statutory scheme.[81] Proposals were advanced to eliminate the section 3(a)(6) exemption from registration for carrier securities, so that there would be dual regulation by both the Securities and Exchange Commission to reinforce the regulation of the ICC.[82] Hearings were held, testimony was taken,[83] bills were proposed,[84] and legislators were lobbied. A provision to eliminate the exemption from the '33 Act was carried along with the legislative process leading to the Regional Rail Reorganization Act of 1973, but was deleted in the final version reported by the committee of conference.[85] Eventually section 3(a)(6) of the '33 Act was amended by section 308 of the Railroad Revitalization and Regulatory Reform Act of 1976.[86]

The revised section 3(a)(6) preserved the exemption for motor carrier securities, but eliminated the exemption for railroad securities — almost. While railroad equity securities, mortgage bonds, and the like would no longer be exempt from the registration requirements of the '33 Act, an exemption was continued for "any interest in a railroad equipment trust." This was reasonable, because railroad equipment trusts had an excellent record of investment safety from the beginning of the century right through the current crisis,[87] and the regulation of railroad equipment trusts by the Interstate Commerce Commission was quite satisfactory,[88] at least for investors.

But the statute goes on to define an "interest in a railroad equipment trust" as "any interest in an equipment trust, lease, conditional sales contract, or other similar arrangement entered into, issued, assumed, guaranteed by, or for the benefit of, a common carrier to finance the acquisition

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80. *See generally* NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, THE GREAT RAILWAY CRISIS (1978); R. SOBELL, THE FALLEN COLOSSUS (1977).

81. STAFF OF HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, INADEQUACIES OF PROTECTION FOR INVESTORS IN PENN CENTRAL AND OTHER ICC REGULATED COMPANIES, 92d Cong., 1st Sess. (1971).

82. H.R. 12128, 92d Cong.; H.R. 9810, 93d Cong.

83. *Northeastern and Midwestern Railroad Transportation Crisis, Hearings on S. 2188 and H.R. 9142 Before the Surface Transportation Subcommittee of the Senate Commerce Committee*, Ser. No. 93-8, 93d Cong., 1st Sess. 996 (1973).

84. H.R. 9142, § 911, 93d Cong.; H.R. 10979, § 201, 94th Cong.

85. S. REP. NO. 93-601, 93d Cong., 1st Sess. (1973); H.R. REP. No. 93-744, 93d Cong., 1st Sess. (1973).

86. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976).

87. M. RICE, RAILROAD EQUIPMENT OBLIGATIONS 111 (1978); D. STREET, RAILROAD EQUIPMENT FINANCING 69 (1959).

88. *Hearings*, *supra* note 83, at 996.

of rolling stock, including motive power."[89] This expands the exemption to types of financing that the Interstate Commerce Commission had not been regulating — conditional sales and leases.[90]

The explanation for this loophole is that, at the time of passage, it was not regarded as such. When H.R. 10979, the bill that embodied this language, was reported out of committee,[91] the Interstate Commerce Commission had concluded a proceeding expanding the scope of its securities regulation activities to cover conditional sale agreements and other types of non-negotiable obligations.[92] So all types of equipment obligations of railroad companies (except some leases) that were exempted from the registration requirements of the '33 Act by the new section 3(a)(6) language came under the securities regulation jurisdiction of the Interstate Commerce Commission.

But the ICC's expanded jurisdiction over carrier obligations survived only briefly. The Association of American Railroads and motor carrier interests appealed the action of the ICC and prevailed.[93] The court determined that the earlier, narrow construction of the term "securities" in the Interstate Commerce Act was correct, that conditional sale agreements and other noteless forms of financing were not subject to ICC jurisdiction, and that any expansion of this jurisdiction would require legislative action.[94]

Legislative action to expand the jurisdiction of the Interstate Commerce Commission was not forthcoming. Deregulation was in fashion. In 1982, Commission jurisdiction over motor carrier securities was eliminated,[95] and the section 3(a)(6) exemption from registration for motor carrier securities under the '33 Act was eliminated in the same statute. Thus motor carrier securities no longer have special treatment, and are regulated under the '33 Act as any other securities.

Conditional sale and lease obligations of railroad companies continued unregulated at the federal level.[96]

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89. Railroad Revitalization And Regulatory Reform Act of 1976, *supra* note 86 § 308; 15 U.S.C. § 77c(a)(6) (1982).

90. Lehigh Valley R.R. Conditional Sale Contract, *supra* note 24.

91. Date of report, December 12, 1975.

92. *Ex Parte no. 275*, Expanded Definition of the Term "Securities,"348 I.C.C. 288 (1975); I.C.C. ANN. REP. 288 (1975) 90 I.C.C. ANN. REP. 16.

93. Association of American Railroads v. United States, 603 F.2d 953 (D.C. Cir. 1979).

94. *Id.* at 966.

95. Bus Regulatory Reform Act of 1982, Pub. L. No. 97-261, § 19, 96 Stat. 1102, 1121 (1982).

96. The current relevant language of section 3(a) of the Securities Act of 1933 is as follows:

> Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> (6) Any interest in a railroad equipment trust. For the purposes of this paragraph "any interest in railroad equipment trust" means any interest in an equipment trust,

The deregulation fever then infected the Interstate Commerce Commission. In 1985, citing "the congressional policy to relax regulatory oversight where feasible,"[97] the Commission unilaterally abandoned most of its securities regulatory functions. In *Ex Parte No.* 397 the Commission amended its regulations to exempt from the operation of 49 U.S.C. § 11301 (the Commission's securities regulation statute) the issuance of securities by, *inter alia*, Class II and III railroads and "any rail carrier, regardless of size, issuing equipment trust certificates."[98] An exemption for other securities is available to a Class I railroad must file an annual notice of securities proposed to be issued in the succeeding two years.[99]

In order to respond to concerns that state regulatory agencies would attempt to plug this loophole, the Commission expressed the view that the granting of an administrative exemption would not diminish the Commission's underlying statutory authority, and that any state regulatory jurisdiction is pre-empted by the Commission's exclusive statutory jurisdiction.[100]

Thus equipment obligations of railroad companies are exempt from the registration requirements of the Securities Act of 1933, and are effectively exempt from the requirement for approval by the Interstate Commerce Commission. State "blue sky" laws ordinarily have an exemption for railroad equipment obligations, in deference to the federal regulatory scheme, and thus there is no state registration requirement either.

In constructing an equipment transaction, the language of the relevant statute must always be kept in mind. The section 3(a)(6) exemption from the registration requirements of the '33 Act speaks of transactions "to finance the acquisition of rolling stock, including motive power."[101] Thus a refinancing of currently-owned equipment would not have the ben-

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lease, conditional sales contract, or other similar arrangement entered into, issued, assumed, guaranteed by, or for the benefit of, a common carrier to finance the acquisition of rolling stock, including motive power.

15 U.S.C. § 77c (1982).

97. *Ex Parte no.* 397, Exemption of Railroads from Securities Regulation Under 49 U.S.C. 11301 (1985) 1 I.C.C. 2d 915 (1985).

98. *Id.*, *see also* 49 C.F.R. § 1175 (1988).

99. 49 C.F.R. § 1175.2 (1988). A Class I railroad is one with annual operating revenues of $50,000,000 or more; 49 C.F.R. § 1201 (1987).

100. *Ex Parte no.* 397, *supra* note 97, citing Schwabacher v. United States, 334 U.S. 182, 197 (1948), and Laird v. I.C., 691 F.2d 147, 152-53 (3d Cir. 1982), *cert. denied*, 461 U.S. 927 (1983). *See* 49 U.S.C. § 11301(b)(1). Section 402(a)(6) of the Uniform Securities Act, (the "blue sky" law in effect in twenty-one states), provides a specific exemption from state registration and filing provisions for securities "issued or guaranteed by any railroad . . . subject to the jurisdiction of the Interstate Commerce Commission." Other state blue sky laws have similar exemptions.

101. 15 U.S.C. § 77c(a)(6) (1982).

efit of the exemption. This language can cause problems with the usual rolling stock acquisition and financing practices of railroad companies. Railroad equipment is purchased and financed in large quantities, hundreds of cars at a time. But they cannot be manufactured and delivered all at once. An order is placed, the units are built, and then delivered to the railroad as they come out the factory door. The railroad pays cash, and then, when a sufficient number of units have been delivered to justify a financing, an equipment trust financing is arranged and the group of equipment is conveyed to the trustee. Often the timing of the financing is related to conditions in the money market. This practice is so common that railroad system mortgages usually have a provision to exclude from the lien of the mortgage rolling stock owned by the railroad for less than a year, so that such equipment trust financings can be arranged without obtaining a release from the mortgage trustee.

In order to keep from stretching the meaning of the words "to finance the acquisition of rolling stock" too far, the railroad company should ensure, by appropriate resolutions, that the connection between the acquisition of the equipment and the financing is established and maintained. Better yet, the financing should be arranged before equipment deliveries commence, or arrangements should be made with the manufacturer for delivery of the equipment under short-term "interim user agreements" or other lease arrangements, so that the manufacturer remains the owner until the financing is in place. This problem of the nexus between the acquisition and the financing also arises in connection with section 1168 of the bankruptcy code,[102] a very important provision in railroad equipment financing which is addressed below.

But the most important limitation to keep in mind is that the section 3(a)(6) exemption only relates to obligations of common carriers. Equipment obligations of private car lines are subject to the '33 Act, which requires registration if another exemption, such as the section 4(2) "private placement" exemption, is not available.

While the section 3(a)(6) exemption provides relief from the requirement for a formal registration procedure and prospectus, it does not relieve the requirement for candor in offering materials. The remedies of section 12 of the '33 Act are available if any communication used in the offering "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. . . ." *Id.* And the prohibition against fraud in section 17 applies notwithstanding the exemption. Thus any offering circular or other materials prepared in con-

102. 11 U.S.C. § 1168 (1982).

nection with an offering under the section 3(a)(6) exemption must be done with care and diligence.

A. Legal Investment Laws

Railroad equipment obligations are often the subject of specific provisions in state laws regarding the investments permitted to savings banks, insurance companies, and fiduciaries — not in the nature of restrictions, but rather, special accommodations. At one time, particularly in the New England states, these legal investment laws were quite particular, describing the types of securities permitted and sometimes providing for a "legal list" to be kept by a state agency. Railroad equipment obligations were usually specifically mentioned in these statutes, and sometimes particular requirements for the terms of these obligations were set out.

There has been a recent trend towards liberalization of these laws, dropping the specific requirements for a more general standard or the "prudent man rule."[103] But New York retains specific language,[104] both for savings banks and insurance companies.[105] The legal investment laws for insurance companies in New York are particularly important, because all insurance companies licensed to do business in the Empire State must comply therewith.[106] Designing an equipment trust financing to comply with these provisions is not particularly difficult, but they must be kept in mind to avoid inadvertently limiting the market for the financing.

Some legal investment laws are pegged to ratings by recognized independent rating agencies, usually permitting investment in debt securities that are rated "investment grade," or in one of the three highest rating grades. (Both Moody's and Standard & Poor's characterize the four highest grades as "investment grade.") Rating agencies customarily have rated railroad equipment obligations having typical characteristics — 15-year maximum maturity, financing of not more than 80% of equipment cost, and the protection of section 1168 of the Bankruptcy Code — not lower than the third highest grade, even if the senior debt of the railroad is rated substantially lower.

B. Section 10 of the Clayton Act

An often forgotten federal statute is section 10 of the Clayton Act,[107] an antitrust law with criminal penalties. It prohibits transactions between

103. *E.g.*, Mass. Gen. L. ch. 167E, F (West 1984 & Supp. 1989). For the prudent man rule, *see also* Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830).

104. N.Y. Banking Law, § 235, subdiv. 7 (McKinney's 1971 & Supp. 1989).

105. N.Y. Ins. Law, § 1404 (McKinney's 1985 & Supp. 1989).

106. N.Y. Ins. Law, § 1413(a) (McKinney's 1985 & Supp. 1989).

107. 15 U.S.C. § 20 (1982).

common carriers and other entities with common officers or directors, unless the transaction is done pursuant to competitive bidding under the regulations of the Interstate Commerce Commission.[108]

Transactions between a railroad company and wholly-owned subsidiary are usually thought of as not raising the prospect of criminal prosecution, if the economic effect is a wash.[109] But the question of interlocking directorates with other parties can present a very real problem, and the question must be asked at the beginning of a transaction. Here again, the statute is limited to common carriers, and private car line transactions do not have this problem.

C. *BANKRUPTCY*

Secured transactions are subject to the automatic stay in bankruptcy proceedings, and payments on the obligation may be limited for a time to a measure of "adequate protection," instead of the payments specified in the contract. Thus in the eyes of institutional investors, a critical element of railroad equipment obligations is the special protection in bankruptcy afforded by section 1168 of the Bankruptcy Code:

> (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 date of the order for relief under this chapter, the trustee, subject to the court's approval, agrees to perform all obligations of the debtor that become due on or after such date under such security agreement, lease, or conditional sale contract, as the case may be; and
>
> (2) any default, other than a default of a 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 is cured before the expiration of such 60-day period; and
>
> (B) that occurs 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

108. 49 C.F.R. § 1010 (1987).

109. Cleary v. Chalk, 488 F.2d 1315 (D.C. Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

(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.[110]

The legal lore of this provision is closely related to the similar provision for aircraft, section 1110,[111] which has been the subject of much learned comment, some very good,[112] some not.[113] To consider the effect of these provisions, we should get it right from the horse's mouth, the comments of the House of Judiciary Committee, the drafters of the Bankruptcy Code, on section 1110:

> This section, to a large degree, preserves the protection given lessors and conditional vendors of aircraft to a certificated air carrier or of vessels to a certificated water carrier under section 116(5) and 116(6) of present chapter X. It is modified to conform with the consolidation of chapters X and XI and with the new Chapter 11 generally. It is also modified to give the trustee in a reorganization case an opportunity to continue in possession of the equipment in question by curing defaults and by making the required lease or purchase payments. This removes the absolute veto power over a reorganization that lessors and conditional vendors have under past law, while entitling them to protection of their investment.
>
> The section overrides the automatic stay or any power of the court to enjoin taking of possession of certain leased, conditionally sold, or liened equipment, unless the trustee agrees to perform the debtor's obligations and cures all prior defaults (other than defaults under ipso facto or bankruptcy clauses) within 60 days after the order for relief. The trustee and the equipment financer are permitted to extend the 60-day period by agreement. During the first 60 days, the automatic stay will apply to prevent foreclosure unless the creditor gets relief from the stay.

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110. 11 U.S.C. § 1168 (1982).

111. The first part of 11 U.S.C. § 1110 is similar to 11 U.S.C. § 1168:

> 1110. Aircraft equipment and vessels
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> (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, aircraft, aircraft engines, propellers, appliances, or spare parts, as defined in section 101 of the Federal Aviation Act of 1958 (49 U.S.C. 1301), or vessels of the United States, as defined in subsection B(4) of the Ship Mortgage Act, 1920 (46 U.S.C. 911(4)), that are subject to a purchase-money equipment security interest granted by, leased to, or conditionally sold to, a debtor that is an air carrier operating under a certificate of convenience and necessity issued by the Civil Aeronautics Board, or a water carrier that holds a certificate of public convenience and necessity or permit issued by the Interstate Commerce Commission, as the case may be, 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. . . .

The remaining subparagraphs are identical to those of section 1168. 11 U.S.C. § 1110 (1982).

112. Sheneman, *Equipment Leasing Under the Bankruptcy Code* 828, in EQUIPMENT LEASING—LEVERAGED LEASING 739 (B. FRITCH, A. REISMAN AND I. SHRANK, eds., 3d ed. 1988); Gerstell and Hoff-Patrinos, *Aviation Financing Problems under Section 1110 of the Bankruptcy Code*, 61 AM. BANKR. L. J. 1 (1987).

113. Goldman, Album and Ward, *Repossessing the Spirit of St. Louis: Expanding the Protections of Sections 1110 and 1168 of the Bankruptcy Code*, 41 BUS. LAW. 29 (1985).

> The effect of this section will be the same if the debtor has granted the security interest to the financer or if the debtor is leasing equipment from a financer that has leveraged the lease and leased the equipment subject to a security interest of a third party.[114]

The history of section 1168 goes back to the reorganization of the Chicago, Rock Island and Pacific Railway in the 1930's. The legal traditions of the time had given effect to the title-retention features of equipment trust and conditional sales agreements to protect equipment creditors in equity receiverships. Equipment obligations had been honored, for the most part, through various periods of economic distress in the industry,[115] and equipment obligations had consequently been regarded as investment vehicles of very low risk. In the Rock Island proceeding, payments on equipment obligations were suspended, an extraordinary event. When the issue was litigated, the Supreme Court determined that secured creditors could be enjoined from recovering collateral if such recovery would delay or obstruct the reorganization.[116] A revolting development, to be sure.

The courts having been found unsympathetic to equipment creditors, relief was sought in the legislature. As part of a rearrangement and simplification of section 77 of the Bankruptcy Act (section 77 covered railroad reorganizations) in 1935,[117] Congress added a sentence to the end of section 77(j):

> The title of any owner, whether as trustee or otherwise, to rolling-stock equipment leased or conditionally sold to the debtor, and any right of such owner to take possession of such property in compliance with the provisions of any such lease or conditional sale contract, shall not be affected by the provisions of this section.[118]

It is clear from the legislative history of this provision that it was intended to preserve what was regarded as an existing right of equipment creditors, and that such right was crucial to the continued access of the railroads to the capital markets.[119]

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114. H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 405 (1977). The comments on section 1168 (section 1166 of H.R. 8200) are brief, citing the parallel section 1110. *Id.* at 423. The two provisions are generally treated in the legislative history as involving the same issues. *Id.* at 238.

115. Street, *supra* note 27.

116. Continental Ill. Nat. Bank. & Trust Co. v. Chicago, R.I. & P. Ry., 294 U.S. 648 (1935).

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

118. *Id.*, 49 Stat. 922.

119. H.R. Doc. No. 89, 74th Cong., 1st Sess. (1935); Hearings before the committee on the Judiciary on H.R. 6249, 74th Cong., 1st Sess. 60 (1935) (statement of Coordinator's Counsel); *id.* at 79; S. REP. NO. 1336, 74th Cong., 1st Sess. 5 (1935). A statement in the House Judiciary Committee report summarizes the views at the time:

> Under the present provisions of section 77, there is doubt whether the trustee under the typical equipment-trust agreement is entitled to the possession of the property insured by the terms of the agreements, it having been urged in some of the pending cases that, under the provisions of section 77, the equipment-trust arrangement must

Access to capital was important in other transportation industries, too. Special protective provisions for equipment obligations of airline companies and water carriers were later added to the Chapter X reorganization provisions of the Bankruptcy Act. These followed the language of the last sentence of section 77(j), including the references to title retention devices—conditional sales and leases.[120] When the bankruptcy laws were overhauled in the '70s,[121] the affected industries and the investment community made it perfectly clear to the drafters of the new law that such provisions were essential, and that financing of transportation equipment could not continue without them.[122]

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be treated as an ordinary mortgage. If this were done, the investors in the trusts would, consequently, be deprived of the preference intended to be preserved to them by the terms of the agreements, which in form and substance are generally in the nature of contracts of conditional sale. In view of the necessity of readily financing purchases of equipment at a time when the development of the transportation art is providing new forms of equipment, particularly in the passenger field, of which, in interests of efficiency and economy, the carriers should be able to avail themselves, and because after a depression the carriers are usually required to make large expenditures for equipment in order to accommodate the improved traffic, your committee is of the opinion that any doubt should be removed with reference to the validity of the equipment trust as a means of financing equipment purchases.

H.R. REP. NO. 1283, 74th Cong., 1st Sess. 4 (1935).

120. Section 116(5) was added in 1957:

> Notwithstanding any other provisions of Chapter X, the title of any owner, whether as trustee or otherwise, to aircraft, aircraft engines, propellers, appliances, and spare parts (as any of such are defined in the Civil Aeronautics Act of 1938, as now in effect or hereafter amended) leased, subleased, or conditionally sold to any air carrier which is operating pursuant to a certificate of convenience and necessity issued by the Civil Aeronautics Board, and any right of such owner or of any other lessor to such air carrier to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of this chapter if the terms of such lease or conditional sale so provide.

Pub. L. No. 85-295, 71 Stat. 617 (1957); *see* S. REP. NO. 1032, 85th Cong., 1st Sess. (1957); H.R. REP. NO. 944, 85th Cong. 1st Sess. (1957).

Section 116(6) followed in 1968:

> (6) Notwithstanding any other provisions of this chapter, the title of any owner, whether as trustee or otherwise, to vessels (as the term is defined in the Ship Mortgage Act, 1920, as now in effect or hereafter amended) leased, subleased, or conditionally sold to any water carrier which holds a certificate of public convenience and necessity or permit issued by the Interstate Commerce Commission, and any right of such owner of any other lessor to such water carrier to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of this chapter if the terms of such lease or conditional sale so provide.

Pub. L. No. 90-586, 82 Stat. 1149 (1968); *see* H.R. REP. No. 90-1932, 90th Cong., 2d Sess. (1968).

121. Pub. L. No. 95-598, 92 Stat. 2549 (1978); 11 U.S.C. §§ 101-151326 (1982 & Supp. V 1987).

122. The vigor of the lobbying effort is evidenced by this comment of the House Judiciary Committee: "Whether or not there was an initial need for these provisions, their existence has become largely addicting to the financing industry, and now the industry claims it would simply cease financing of the relevant equipment if the protections were removed." H.R. REP. NO. 95-595, *supra* note 114, at 239.

Thus it was the intention of the drafters of the Bankruptcy Code to preserve the traditional rights of equipment creditors to move against the collateral, but with modifications to accommodate the "joint interests of the equipment financers and of the integrity of the bankruptcy laws and the reorganization process."[123] Hence the provisions giving the bankruptcy trustee the right to retain possession of the equipment by agreeing within a certain period to perform the obligations under the financing agreement.[124]

The drafters of section 1168 also wished to respond to changes in personal property security law since 1935. The conditional sale and the lease for security embodied in the equipment trust had been supplanted (but not replaced) by the unified, generic form of security interest under Article 9 of the Uniform Commercial Code. To avoid forcing equipment financing transactions into outmoded forms, reference was made in the new legislation to "security interests."[125] The Bankruptcy Code provided its own definition for this term,[126] but it is clear that it is founded on the Uniform Commercial Code creature.[127]

In order to avoid the broad scope of the term "security interest," which would include general mortgages, the words of limitation "purchase money" were added, to include "only security interests that were granted to finance the acquisition of the covered equipment."[128] These words have caused some anxiety in connection with sale-leasebacks of aircraft, because such financing seemed inconsistent with the legislative intent even though the reference to leases in the statute is not qualified by the term "purchase-money."[129] The consensus of current comments, however, is that the statute means what it says, and such concerns are not justified.[130]

The words "purchase-money" must also be considered in connection with the practice of railroad companies to accept delivery of equip-

123. H.R. REP. NO. 95-595, *supra* note 114, at 239.

124. It has been the custom to provide for such rights of bankruptcy trustees in the default provisions of railroad equipment obligations, because reorganization of railroad companies is a not uncommon procedure, and it is thought better to have the equipment obligations ride through the organization (so long as payments were kept current) rather than to repossess and sell the collateral. This has not been the custom in aircraft equipment obligations, however. Aircraft equipment obligations always had *ipso facto* bankruptcy default clauses, declaring bankruptcy or insolvency an immediate event of default. They still do, even though such clauses are ineffective under the Bankruptcy Code. 11 U.S.C. §§ 363(1), 365(e); *see* H.R. REP. NO. 95-595, *supra* note 114, at 346, 348.

125. H.R. REP. NO. 95-595, *supra* note 114, at 240.

126. 11 U.S.C. § 101 (1982).

127. H.R. REP. NO. 95-595, *supra* note 114, at 239; 314.

128. *Id.* at 240.

129. Goldman, Album and Ward, *supra* note 113.

130. Sheneman, *supra* note 112; Gerstell and Hoff-Patrinos, *supra* note 112.

ment and pay for it as it comes from the manufacturer, and later to subject a group of this equipment to an equipment trust financing. (This practice also relates to the section 3(a)(6) exemption from registration under the '33 Act, discussed above.) The references to lessor and lease in section 1168 should be interpreted broadly enough to encompass the nominal lessor and the bailment-lease embodied in the traditional Philadelphia plan equipment trust, if the court is sensitive to the traditions of equipment obligations and the legislative history of that section of the Bankruptcy Code.[131] Nevertheless, the parties to an equipment trust agreement should ensure that there is a very clear connection in the record between the acquisition of the equipment and the financing. The best course of action is the arrangement of the financing before the first unit of equipment is delivered, but failing that, interim financing in contemplation of the "permanent" financing should be satisfactory. At a minimum, the corporate resolution authorizing the purchase of the equipment should speak of the ultimate financing arrangements.

The purchase-money limitation also affects transactions to finance the rebuilding of railroad equipment. Rebuilding can range from fumigating the weevils to work of such magnitude that a unit will be given a new date by the Association of American Railroads for the purposes of car hire charges.[132] But it would take a great semantic stretch to treat rebuilding as acquisition, no matter what the content of new parts. Thus it cannot be assumed that a debt financing to cover the cost of rebuilding equipment already owned by a railroad company would be covered by section 1168.

What is a railroad to do? The purchase of rebuilt equipment does no violence to the language or intention of section 1168, so a railroad could trade in its hulks for others in the inventory of the rebuilder, have the rebuilding done to its order, and then purchase the rebuilt equipment and finance the purchase. If the railroad contemplates doing the rebuilding in its own shops, the hulks would have to be the property of someone else, that someone else would contract with the railroad for the rebuilding, and the railroad would acquire the rebuilt cars after rebuilding is complete. Because much of the proceeds of the financing goes back to the railroad to cover the costs of rebuilding, there might be doubt in some minds about meeting the purchase-money test. But here we can look to railroad tradition. Since the beginning of railroading, rolling stock has often been built in a railroad's own shops. During construction, the cars would be

131. It is clear from the legislative history of the last sentence of section 77(j) that the drafters thereof understood that the leases embodied in the contemporary equipment trust agreements, and referred to in the legislation, were bogus and ". . . in form and substance are generally in the nature of contracts of conditional sale." H.R. REP. NO. 1283, 74th Cong., 1st Sess. 4 (1935).

132. Car hire charges, the amounts railroad companies pay one another for the use of rolling stock, are an inverse function of the age of the railroad car.

owned by an individual, usually a company employee. Upon completion of construction, an equipment trust financing would be arranged, and the individual would convey the equipment to the trustee. No one ever doubted that such a transaction would have the protection of the last sentence of section 77(j) of the Bankruptcy Act.

If a railroad proposes to do the rebuilding of its own hulks, or have its own hulks rebuilt on the outside, it may be asking too much of tradition and usage to assure the protection of section 1168 in a debt financing. A better approach would be a sale and leaseback, relying on the express words of the statute that protect lessors and leases. This should not offend even those who look askance at sale and leaseback transactions, for the proceeds of the financing are surely being used to increase the traffic capacity of the railroad. Which is what the drafters of that sentence had in mind in 1935.[133]

V. AUTORACKS

A major factor in the economic performance of American railroads is the movement of automobiles to market. The necessary efficiency is achieved with special autorack cars — flat cars with two or three level racks, often with a metal skin, to carry new cars and small trucks.

While an autorack car may have the look of a single unit, such a car is actually two separate things, mechanically and legally — the flat car and the autorack placed on it. Autoracks are like buildings, in that they are attached to the surface that they stand on and depend on it for support — but that surface usually belongs to someone else, and it moves.

Autoracks represent considerable investment — more than the flat cars on which they are erected — so they are often the subject of a financing. Sometimes alone, more often with other equipment types, never with those flat cars. Such a financing involves some special considerations.

Section 1168 of the Bankruptcy Code specifically covers autoracks, speaking of "rolling stock equipment or accessories used on such equipment, including superstructures and racks. . . ."

Section 11303 of the Transportation Code, the federal law provision for the recordation of interests in railroad equipment with the Interstate Commerce Commission, does not. This statute speaks only of "railroad cars, locomotives, or other rolling stock. . . ."

That is not terrible. Autoracks are certainly mobile goods, and the filing of a financing statement describing that collateral in the state where the debtor (and the lessee, in a lease transaction) has its chief executive

133. *Supra* note 119.

office will perfect a security interest in the racks in every state (including Louisiana, after January 1, 1990). Because a railroad company would fit the definition of a "transmitting utility," continuation statements need not be filed to continue the effectiveness of the financing statements after five years. But, *nota bene*, private car lines and equity participants are not transmitting utilities, and continuation statements must be filed every five years to maintain the perfect status of a security interest against such entities.

The federal statute in Canada covering interests in railroad equipment, section 86 of the Railway Act, speaks only of rolling stock, so like the American statute, it is of no use for autorack financing. The filing provisions of provincial law would have to be used.

Also limited to rolling stock is the exemption from the registration requirements of the Securities Act of 1933, expressed in section 3(a)(6) thereof.

VI. RECOMMENDATIONS

The arrangement and documentation of a railroad equipment financing should proceed just as any other secured transaction covered by Article 9 of the Uniform Commercial Code, or any other lease by reference to contract and personal property lease law (and Article 2A of the Uniform Commercial Code when, if, and as it is adopted). But there are these points to keep in mind.

1. Railroad equipment obligations, whether leases or secured transactions, and assignments thereof, must be recorded with the Interstate Commerce Commission pursuant to 49 U.S.C. § 11303, and the regulations at 49 C.F.R. § 1177. That statute does not accommodate generic Article 9 security interests, and a conditional sale, chattel mortgage, or equipment trust must be used as a debt instrument. The statute is not limited to obligations of common carrier railroads, and all obligations relating to railroad rolling stock, regardless of the user or owner, must be recorded under the statue.

2. In many other respects, the equipment obligations of railroad companies and the railroad equipment obligations of other entities are governed by different statutes. The distinction between these two separate families of obligations should be observed in analysis, drafting, and implementation of a transaction.

3. Obligations of railroad carriers used to acquire rolling stock and locomotives are exempt from the registration under the Securities Act of 1933, need not be approved by the Interstate Commerce Commission under 11 U.S.C. § 11301, and are exempt from the registration and filing provisions of state blue-sky laws. The custom of placing these obliga-

tions only with institutional investors should be continued so as not to betray the confidence of Congress in the integrity of these obligations and the issuance thereof. An offering circular should be prepared and used in the same circumstances that a prospectus would be used for issues registered under the '33 Act keeping in mind the civil liabilities for untrue statements and omissions of material facts set forth in section 12 and the prohibition against fraud of set forth in section 17 of that Act.

4. Railroad equipment obligations of private car lines, shippers, and other entities not regarded as railroad companies are not exempt from the registration requirements of the '33 Act, and if an exemption from registration under section 4(2) of that act is not available, such obligations must be registered.

5. The requirements of the legal investment laws, particularly those for the state of New York, should be observed.

6. The possibility of interlocks between officers and directors of the parties to a financing involving a railroad company should be searched out at the beginning of a transaction, to avoid conflict with the restrictions of section 10 of the Clayton Act.

7. Equipment obligations issued by railroad companies should have a clear connection between the acquisition of the equipment and the financing, if the benefits of section 1168 of the Bankruptcy Code are to be available to the financing parties.

8. Section 1168 of the Bankruptcy Act does not apply to entities other than railroad companies, and such obligations will be subject to the usual rules for automatic stay and adequate protection of secured transactions or the rules for unexpired leases under the Bankruptcy Code.

9. Transactions to finance the rebuilding of equipment must be carefully constructed to obtain the protection of section 1168 of the Bankruptcy Code. The structure of a transaction should be established before rebuilding commences.