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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW  
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STUDY GROUP FOR THE PREPARATION OF  
UNIFORM RULES ON CERTAIN INTERNATIONAL ASPECTS  
OF SECURITY INTERESTS IN MOBILE EQUIPMENT

COMMENTS

by Mr Thomas J. WHALEN

to the Memorandum by Professor R.C.C. Cuming  
on a proposed Unidroit Convention on Security Interests  
in Mobile Equipment

Rome, February 1994

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Memorandum of Comments  
of Thomas J. Whalen, dated February 7, 1994  
to the Memorandum of  
Professor Cuming dated November 5, 1993  
Relating to a Proposed Unidroit Convention on  
Security Interests in Mobile Equipment

Professor Cuming's Memorandum has served the very valuable purpose of highlighting many of the issues of convention coverage for the February 1994 meeting. Comments are offered here on certain sections of Professor Cuming's Memorandum, which are referred to in this submission by the subject topic and page number of his paper.

1. Who Can Benefit from the Convention, p.2

As Professor Cuming has stated, the beneficial purpose of this proposed convention is to "eliminate the more significant legal risks associated with financing on the security of mobile equipment". Scope, p. 2

Stated more broadly, lenders will be encouraged to finance the purchase of capital equipment, and distributors will be encouraged to enter into financing contracts if they know that the equipment may or will be transported to a country which will recognize and enforce their security interests in the equipment. As a consequence, trade will be encouraged because it will increase commercial predictability and reduce recovery risks.

A country which becomes a party to this convention pledges to adhere to its terms, which should, among other things, encourage investment in developing and transforming countries.

If this is its principal purpose, the convention itself must establish a legal regime which contains an enforcement mechanism implementing this objective. To give comfort and practical security to lenders, distributors and others, the convention must define carefully the interest it will recognize or create, and enforce. Accordingly, if at all possible, the convention and its enforcement provisions should be triggered at the moment the security interest is created, if the parties wish the convention to control. To the extent that coverage by the Convention must await a subsequent event, such as movement across a border, the certainty of the lender's position at the time of contract or finance structuring will be reduced.

If this regime is to be effective, the convention may need to displace or supersede some otherwise governing municipal law. The certainty provided by the enforcement provisions will be the convention's principal comfort to a foreign lender who will, more often than not, be seeking to enforce a right against a debtor-citizen of that convention state.

Thus, as Professor Cuming has suggested the efficacy of the convention usually will rest upon "the presence of the

equipment at the time of enforcement of the security interest against third parties or the debtor in a State that is party to the convention or that otherwise recognizes convention law as the applicable law." Scope p. 2.

2. Defining Scope, pp. 2-3

Professor Cuming states that "merely because a security agreement falls within the scope of the convention in that it provides for a security interest in mobile equipment, it does not follow that the rights arising under the agreement or third party rights acquired in the mobile equipment after the security interest arises are affected by the convention." Scope, p. 3. This proposition suggests that municipal law could trump or thwart convention remedies in certain circumstances, which may not be a desirable result.

One of the dilemmas presented is how to satisfy the test of internationality at the moment the security interest is created: how to bring the terms of the convention in effect before the equipment is moved across national borders, or in the event the equipment never moves across national borders.

It may also be necessary to consider that the convention should extinguish or grant a priority to a secured party which registers its security interest with the

international registry before or after the property moves across national borders, over any domestic pre-existing security interest, perfected under municipal law before it crossed national borders.

The policy answer to this conflict may be that any secured party who perfects its security interest in mobile equipment in a domestic transaction according to municipal law, should be on notice (after the convention is in effect) that the secured party should now also register its lien in the international registry to assure itself of the protections of the convention.

If this principle is accepted by the Study Group, the question must then be asked: what must happen to bring that security interest within the rights and remedies of the convention: for example, registration at the international registry, movement across national borders?

3. Types of Movables, pp. 3-6

Professor Cuming has detailed the problems of both defining too broadly the "equipment" to be covered by the convention, and defining too narrowly the "scope" by listing only specific equipment to be covered.

Keeping in mind the objectives to be achieved, it seems important that a third party, looking at the equipment wherever it is, should be on "notice" that this equipment may be covered by the convention, so the third party can check with the registry to determine whether there are any liens on the property.

The convention should not attempt to cover all mobile equipment, only "big ticket" items. In limiting convention coverage to "big ticket" items, say \$50,000 U.S. dollars or more, coverage could still be uncertain unless determined by the manufacturer's original price, which has some certainty and which is usually publicly available.

To avoid the definitional uncertainty of coverage which Professor Cuming fears, perhaps we should avoid coverage language such as "equipment of a kind that is generally taken by users from one state to another" -- notwithstanding the general agreement of both the Exploratory Group and the Study Group at its first meeting that this kind of definition was workable. It may be feasible to alter the proposed definition of Professor Cuming by (1) deleting the language "used by the debtor . . . in the State" and (2) adding to (a)(ii) "movable industrial equipment" having an original manufacturer's price in excess of \$50,000.

4. Collateral Other Than "Mobile Equipment", p. 6

Intangibles probably should not be covered by this convention, in the interest of simplicity and certainty.

Professor Cuming's discussion of "proceeds" suggests that the security interest created and governed by this convention should not attach to proceeds. The remedy of the secured party should solely be in the equipment itself. For the reasons detailed by Professor Cuming, for the convention to apply to proceeds or accounts subsequently assigned by the debtor, the convention creates complicated and perhaps unnecessary conflicts with municipal law.

Professor Cuming suggests as an alternative that it may be desirable to have convention remedies enforceable against proceeds if recognized under national law. On one hand, this could create different results in different convention States; it would invoke municipal law remedies to enforce Convention rights, and perhaps bring the convention into unnecessary conflict with municipal law. On the other hand, there may be no good reason to deprive the secured party of an interest it otherwise would have under local law as long as it does not interfere with the operation of the convention's rules.



We may wish to consider whether, in this convention, insurance should be considered "proceeds" to which a security interest created by the convention should attach. A lender should have security in the asset (while it exists). If it is destroyed, the lender should receive the insurance proceeds at least to the extent of the debt, "as his interest may appear", but not because of the convention, but because of a separate insurance contract. The lenders should protect themselves by contracting that they will be irrevocable payees of the insurance, in the event of destruction of the equipment. A convention provision covering insurance as "proceeds" may not be needed or desired.

5. The "Debtor" and the "Obligation Secured", p. 8-9

The focus of the convention should be on the property rather than on the debtor. Accordingly, there should be no difficulty in covering third party debt, where the definition of "debtor" includes the party whose property is offered as security for the debt.

6. Security Interest, p. 9

Whether the parties invoke the convention or not, third parties looking at a piece of convention-covered mobile equipment they want to buy should be protected by the enforcement provisions of the convention, if no liens are recorded against the equipment with the international registry.

7. Future Obligations and After-Acquired Equipment, pp. 8 and 10

To achieve simplicity it may also be desirable that the convention decline to cover "future obligations" or "after-acquired" property. However, coverage of these points is clearly possible, as Professor Cuming points out. To cover future obligations and after-acquired equipment, it would seem necessary to define what kind of notice is intended by registration with the international registry. Is it intended to give notice of "some undefined encumbrance" imposing upon the third party a duty to inquire? Or is it intended that the registration give notice of the full extent of the lien, with the result that any party giving credit in the face of such notice is subordinated to the extent of the registered lien?

9. Security Leases, pp. 11-15

Because of constantly developing new forms of security devices, there is a risk that "security interest" be so narrowly defined to exclude, for example, "finance leases" which are prevalent in aircraft and other equipment financings. Professor Cuming is correct that at least in the United States, in some factually close cases, it will be difficult to determine with certainty whether the transaction involves a true lease or a finance lease.

The indicia of a finance lease, as set forth in Professor Cuming's suggested Article, captures the major points U.S. courts have relied upon in deciding whether a lease is a finance lease or a true lease. The dilemma presented is that finance leases (and future innovative forms of asset based financing) should most certainly be encompassed in the convention. The Study Group seems in agreement on that point, when it agreed that a security interest should be defined from a "functional" viewpoint. At the same time, in close factual cases, as Professor Cuming points out, it may be difficult to identify the "lease" as a finance lease, as distinct from a "true lease.

Although beyond the present thinking of the Study Group, and somewhat beyond Professor Cuming's second approach, we

may wish to consider whether all leases should be covered by the convention. The convention would in effect protect the lessor's interest in the property (his ownership or "financing" interest). Thus, leases of convention-covered equipment could also be registered in the International Registry.

Whether the lessor is the true owner (in a true lease) or a financier in a finance lease such as is covered in the International Financial Leasing Convention, the remedies for the lessor on the default of lessee are similar: repossession and recovery of the asset; or sale of the asset, in the event of a financing, to make the lessor whole.

There may be difficult priority and other problems, but essentially the broad object will be realized if the registry puts the "world" on notice of the nature of the interest held by the lessee.

There are sound reasons against the expansion of this convention beyond "security interests" to include true leases, yet given the difficulties in defining "financial leases" which might be very complicated and alien to some states, it might be worthwhile to explore whether there is any benefit in including all leases of convention-covered equipment within the coverage of the convention.

8. The Security Agreement, p. 15

With the rapid advances of electronic communication, as Professor Cuming points out, a security agreement covered by the convention should include a security interest created in an electronic format, with any definition of a "writing" to include electronic communications.

The Study Group seemed uniformly in agreement that the convention should not provide a right or remedy which the security agreement does not provide. At the same time, the security agreement should satisfy certain requirements for the convention to apply. To obtain more universal acceptance of the convention, it may also be desirable to require registration of the security interest to effect convention coverage of the security interest. The requirement might also help to solve the problem of establishing internationality.

There may also be some benefit in allowing parties to opt-out of the convention by not registering. An opting-out provision does not seem inimical to the goals of the convention. If lenders believe that the convention provides them significant protection, they will not want to opt out.

While sham filings and statute of frauds objections must be addressed, electronic filings and electronic

confirmations probably provide greater security against sham writings being filed.

9. The Test of Internationality, p. 18

Professor Cuming's second approach was generally discussed at the March 1993 meeting as a way to meet the test of internationality. The difficulty with the approach is that under certain circumstances municipal law may trump the rights and protections provided by the convention. It may be necessary to provide that the convention should attach the moment the security interest is created and registered. In addition, as mentioned above, the internationality test perhaps could be satisfied by the mere fact that convention-covered and registered equipment (which can or will be moved across borders) is involved.

However, Professor Cuming may be correct when he states: "few States [would be] prepared to have an international legal regime govern secured financing transactions that had no international element other than that they involved mobile equipment that is capable of being moved from one state to another." (p. 18).

Meeting the test of internationality while preventing the protections of the convention from being nullified by

municipal law is perhaps the most difficult issue in crafting an effective and widely accepted convention on this subject.

10. Invocation of Convention Priority Rules, p. 20

Some of Professor Cuming's scenarios illustrate possible undesirable results because of the effect given to municipal law. Scenario 1 simply deals with "validity," based upon the proposition that the security interest comes within the terms of the convention. Assuming SP1 registered first, however, SP1 should prevail. Why the "validity" in Scenario 1 is governed by the convention, and validity in Scenario 2 is governed by State A is unclear. The only difference between Scenarios 1 and 2 is that in Scenario 2 both security interests were given in State A before the situs of the equipment changed.

Scenario 3 reflects the fact that to enforce the convention's remedies, the property must be in a convention state. Professor Cuming seems correct in his conclusion that it is not critical that the security interest be created in convention state. However, it does seem necessary that the secured party be able to register its interest (created in a non-convention State) to obtain priority, should the property move to a convention state.

11. The Role of Non-Convention Law in the Priority Structure,  
(pp. 23-28)

Professor Cuming's resolution of Scenario 4 seems correct, because SP1 registered its security interest with the international registry, even though State A may not be a convention state. State C, where the equipment is located when SP1 seeks to enforce its convention rights, was a convention State.

In Scenario 5, contrary to Professor Cuming's resolution, SP1 should prevail, because State A, by adhering to the convention, should recognize the security interest of SP1. To this extent, the convention should displace municipal law. Where SP1 registers a security interest under the convention while the equipment is in State A (non-convention state), and where the property moves to a convention State and SP1's interest is to be enforced in the convention State, SP1 should prevail.

One issue which should nevertheless be clarified is whether a secured party in non-convention State can protect its interest under the convention, in the event the equipment is moved to a convention State. My answer would be: yes. Registration in the international registry should be a notice to the world, with respect to equipment covered by the convention. Registration is basically mechanical. I see no reason why it is



necessary that the State where the security interest is created, must be a contracting state.

Scenario 6. For the same reasons as stated in the discussion of Scenario 5, SP1 should prevail.

Scenario 7. SP1 again should prevail. The interposition of municipal law in this and other scenarios may undermine the very protections the convention was intended to provide.

In Scenario 8, if State A were not a convention state, but SP1 registered, SP1 should prevail. SP2 and SP3, wherever they may be located, should look to the registry to see if a lien is registered on the convention-covered equipment. If enforcement is to take place in State B, a convention state, then SP1 should prevail under the priority rules of the convention. In footnote 10, if SP2 registered before SP1 in State B, SP2 should prevail. Again, the interposition of the municipal law of State B seems contrary to the purposes of the convention.

12. Enforcement of the Security Interest, p. 28

Professor Cuming seems to be correct when he asserts: "the enforcement system of the convention should be applicable even though the security interest being enforced arose when the

equipment was located in another state that is not a party to the convention." (p. 29). Accordingly SP2 should prevail in Scenario 9.

However, SP1 should also prevail in Scenario 10, if SP1 registered its interest with the international registry. While Scenario 10 does not raise competing interests, the Scenario raises the issue whether the enforcement provisions of the convention should govern a basically domestic transaction. Should the convention apply or can it be made to apply where the equipment does not move but stays in the original state. Can the test of internationality be satisfied to provide convention coverage to such a set of circumstances? There should be no difference between the resolution of Scenario 10 and 11. If the security interest was covered by the convention and registered, SP1 should be able to invoke the convention enforcement rules. From the viewpoint of a third party seeking to buy the equipment or giving credit, there seems little difference between the Scenarios 10 and 11, despite the "intention" of the parties in Scenario 11 that the equipment will be used in states other than State A.

### 13. Priority Rules, p. 30

The practical application of the priority rules suggests that registration should perfect a security interest

governed by the convention. Professor Cuming also seems correct that security interests on leaseholds may be impractical.

The special priority rule covering purchase money security interests in property subject to a pre-existing security agreement also seems to be the preferred result, for the reasons stated by Professor Cuming. Registration (constructive notice) should also prevail over actual notice. When a buyer buys equipment with actual notice of an unregistered lien, he nevertheless should have priority over the holder of the unregistered security interest. In this case, certainty is the preferred result.

14. The Registry System, p. 37

The Rules for Registry as set forth by Professor Cuming seem very sound and comprehensive. However, since such rules would most likely benefit from experience, it might be more desirable to include such rules in an Annex, where they could be more readily changed.

It may also be desirable to provide in the convention only what information needs to be filed. We may wish to leave to the Registry the promulgation of rules of administration.

The full exposition of the rules, as Professor Cuming has provided, is extremely helpful. Certainly they should be discussed in the context of the substantive provision of the convention itself, even if ultimately it is decided that they be included in an annex.

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