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RESTRICTED WORKING GROUP RESPONSIBLE FOR DETERMINING THE DESIRABILITY AND FEASIBILITY OF THE PREPARATION BY UNIDROIT OF A MODEL LAW IN THE GENERAL FIELD OF SECURED TRANSACTIONS

Some preliminary considerations with a view to the drawing up
of a check list of the issues to be addressed
in a possible future model law in the general field
of secured transactions

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Introduction

There is growing recognition of the importance of secured financing to modern business development and the expansion of markets for consumer goods. The availability of credit is a central feature of all modern economies, and States which hope to encourage strong domestic markets and maintain or develop strong internationally competitive economies must have legal infrastructures that facilitate secured financing transactions. This has been recognised by international lending Organisations such as the World Bank and the European Bank for Reconstruction and Development which are showing increased interest in the secured financing laws of countries in which they provide loans.

Because of the internationalisation of commercial activity which has occurred in recent years, there is reason to expect that the modernisation of national secured financing laws will involve a significant degree of interjurisdictional harmonisation. This is likely to be induced by several factors. One such factor is recognition of the importance of harmonised law as a vehicle for encouraging transborder credit transactions. Another will be the availability of suitable models either in the form of the extant law of other States which have modernised their secured financing law or model laws prepared and sponsored by international law reform or lending Organisations. The success of efforts such as that undertaken by Unidroit to develop a body of international secured financing law applicable to security interests in large mobile equipment that is generally taken from one State to another can be expected to influence national development in this area of the law.

Anyone acquainted with the recent history of efforts to develop a model designed to provide the basis for modernisation of national secured financing law might be forgiven for harbouring some scepticism as to the chances of developing such a model in an international context. The inability in 1980 of the United Nations Commission on International Trade Law to arrive at a consensus as to the form and usefulness of a model secured financing law provides little basis for optimism. However, it would be a mistake to assume that the failure of the Uncitral project demonstrates that international co-operation in the development of interjurisdictional harmonisation of secured financing law is unrealistic. The world has changed dramatically since 1980. Further, one might conclude that the failure of the Uncitral undertaking can be attributed as much as anything to the approach that was used. It was, perhaps, overly ambitious to attempt to prepare a model secured financing law that would gain acceptance by a body composed of member States, including States with socialist economies, with very differing views of the relevance of secured financing law to national or international economic activity.

The Governing Council of the International Institute for the Unification of Private Law at its June 1993 meeting authorised the Secretariat to proceed to a study of the feasibility and desirability of Unidroit preparing a model law on secured financing transactions. This mandate was discussed at the February 1994 meeting of the Sub-committee of the Study Group for the preparation of uniform rules on certain international aspects of security interests in mobile equipment. The Sub-committee concluded that the first step in the feasibility study, apart from establishing close liaison with other Organisations such as the World Bank and the EBRD which are also involved in developments in this area, should be

the preparation of a "check list" of issues that would have to be addressed when preparing such a model law.

An important feature of recent approaches to the reform of secured financing law is the recognition that pragmatism is more important than faithfulness to legal traditions. This led some jurisdictions, such as the States of the United States and several of the provinces of Canada, to discard traditional structures that no longer had functional significance. For example, modern personal property legislation in these jurisdictions gives no significance to the traditional forms of financing transactions such as chattel mortgages, conditional sales contracts, trust receipts and floating charges. While there are many important benefits associated with this approach, one of its most important, if not intended, by-products is that it permits the development of concepts and structures that can be applied in other States which have different legal traditions.

The considerations set out below reflect this approach. The issues and the suggested approaches to them are not "legal" in any technical sense. They reflect the essential characteristics of modern business financing transactions and the relationships that arise out of them.

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Scope of the model law

Secured credit is used by both business enterprises and consumers. Many, but not all, aspects of a regulatory regime can apply with equal efficacy in both contexts. However, a model law must reflect the difference in bargaining power and commercial sophistication between commercial borrowers and consumers.

Non-possessory charges

Modern secured financing arrangements generally require that the debtor retain possession of the collateral. Consequently, a model secured financing law must recognise the existence and efficacy of non-possessory charges. Indeed, a strong argument can be made for the elimination of the pledge as a form of security device except in cases where the collateral is negotiable property. The traditional view is that possession of the debtor's property by the creditor gives notice to third parties that the property is charged. However, this approach is robbed of its raison d'être by business practices that look not to physical possession of goods but to documentation and public registries as evidence of ownership or freedom from encumbrances.

A unitary concept: a charge on property of the debtor

Many national legal systems which recognise that a creditor can have an in rem interest in or possession of personal (movable) property of its debtor in order to provide an alternative source of payment in the event of default by the debtor have failed to develop a unitary conceptual structure for the various security devices that they regulate. Secured financing occurs in the context of a range of differing legal devices. For example, under the Common law, a chattel mortgage, a floating charge, a hire-purchase contract, a conditional sales contract, an assignment of accounts and an equipment lease conceptually have little in common yet they all serve essentially the same function - the securing of debt obligations.

A model law should eschew conceptual fragmentation by focussing on function rather than form. Any transaction, whatever its form, that has as its principal function the securing of an obligation should be brought within its scope and be subjected to a common set of rules. Not only does this

approach permit the creation of an internally consistent, highly integrated system, but it gives to the parties freedom from the need to force their relationship into one or other of the prescribed legal moulds.

All that is required in this context is to recognise that all forms of financing transaction create a charge on the property which the debtor has offered as security. This is not to suggest that different incidents (e.g. priority consequences) cannot be allocated to financing transactions that arise in particular contexts or that have special functions. However, these incidents should reflect policy choices based on pragmatic considerations.

The property that may be charged

Except where consumer protection is thought necessary, there is little justification for limiting the types of personal property that can be charged. So long as the legitimate commercial expectations of all claimants to property are recognised in the priority structure of the model law, all types of personal property can be charged.

Modern secured financing law designed to facilitate business inventory financing generally accommodates the fact that inventory will be sold in the ordinary course of business of the debtor and, unless replacement collateral is acquired by the debtor, the creditor will lose its security. In order to address this, it recognises that the charge on the inventory can carry over to property received by the debtor in exchange for the sale of the inventory.

The needs of modern secured financing forces reconsideration of the time-honoured conclusion that, when personal property is attached to land, it loses its separate existence and becomes itself land. It is quite possible to recognise that personal property attached to land can be charged with a personal property charge and at the same time meet the legitimate expectations of persons who have interests in the land to which the personal property is affixed.

Conditions for the creation of the charge

Since the model law assumes a consensual relationship between the debtor and the secured party, it should require minimal evidence of the existence of the contract that provides for the charge. This would include not only evidence of the fact of agreement and of an intention to create the charge, but as well a record of the property or kinds of property charged.

A charge can attach only when the debtor acquires an in rem interest in property of the kind described in the agreement. However, full realisation of the wishes of the parties may necessitate recognition that, when the agreement so provides, the charge attaches automatically to property acquired by the debtor at any time during the currency of the agreement. This feature is of crucial importance where the property charged is an ever-changing stock of inventory or accounts generated in the debtor's business.

The obligation secured by the charge

Many business financing transactions involve on-going relationships between the charge holder and the debtor under which the amount of the debt obligation is not static or predetermined but varies depending upon the financing needs of the debtor's business. This being the case, the law must recognise that the charge can secure amounts owing to the charge holder as a result of advances made to the debtor at any time during the life of the agreement between them. A corollary of this is that, in relation to other charges on the property, the priority status of the first charge extends to all amounts owing by

the debtor to the holder of that charge and not just those amounts owing prior to the creation of the competing charges.

A simple priority regime that provides predictable outcomes

The priority structure of a model law should reflect appropriate policy choices based on the need for fairness and balance in the market the regime is designed to serve. Some policy choices are obvious. Good faith buyers of goods sold in the ordinary course of the business of the debtor should take free from a charge on the goods, whether or not they are aware of the charge or could with minimal effort discover that the goods purchased are charged. Good faith transferees of negotiable property who take possession of it through negotiation must be given priority over non-possessory charges on the property. Creditors who provide loans or credit to permit the debtor to acquire personal property should be given priority over prior creditors whose charges attached automatically to the newly-acquired personal property.

Other policy choices may not be so obvious. For example, the relative priority positions of charge holders and unsecured creditors or the debtor's trustee in bankruptcy can be expected to vary from one State to another. Established lending practices will dictate the extent to which personal property remains subject to a charge when it is affixed to land.

The relative priority position of successive charge holders (not including one who has provided a loan or credit to acquire the collateral) raises few significant policy considerations. It is not obvious that the applicable priority rule must be based on the truism that a subsequent charge attaches only to the uncharged interest of the debtor (first-in-time first-in-right). Where the debtor does not own the property at the date two competing charge agreements are executed, a first-to-charge priority rule does not provide an acceptable outcome. Both charges arise at the same time - when the debtor acquires ownership of the property to be charged. However, what is required in order to ensure commercial reasonableness is that any potential creditor who would be allocated a subordinate status should he give credit to the debtor, be given the facility to assess the legal risk he undertakes. Extant charges on the property being offered by the debtor as collateral and the identity of potential creditors allocated an earlier priority must be readily discoverable.

An efficient, accessible registry system

The acceptance of the primacy of non-possessory charges brings with it the need for public disclosure of charges or potential charges. It is inconceivable that computer technology would not be employed in a public registry for charges.

A computerised registry that offers the flexibility necessary for modern business financing transactions would provide for notice registration and not agreement registration. The registered notice would contain only minimal information: the name of the secured party, the name of the debtor and a description of the collateral. It does not contain any of the details of the transaction or transactions to which it relates. A qualifying searching party would be entitled to obtain these details directly from the secured party.

The property subject to the charge would be described generically or by item on the financing statement. In appropriate situations, specific item descriptors (e.g. serial numbers) would be required. Serial number registration is used to deal with the following problem. Assume that Debtor B gives a security interests in his automobile to A. A registers his security interest. B, who is not a commercial seller of automobiles, then fraudulently sells the automobile to C who then resells it to D (or gives a security interest in it to D). Before buying the automobile (or taking a security interest in it), D searches

the registry. If the basis for A's registration is B's name, since it is unlikely that D will be aware of B, he will not be able to discover A's registration. If the basis for A's registration is the serial number of the automobile, D should have no trouble in discovering A's registration by using the serial number. Serial number registration protects both A and D.

Since storage capacity is a matter of little concern when electronic data is involved, subject to safeguards for debtors, the registering party can be given great flexibility in selecting the period during which the registration is effective.

Access to the registry for the purposes of registering, searching and amending registration can be from remote computer terminals located at any points that have telecommunications links to the registry.

Efficient, balanced enforcement measures

The efficacy of a charge on personal property is directly affected by the speed and efficiency with which it can be enforced. A charge is of little value to a creditor if upon default the available enforcement remedies entail expensive, prolonged judicial proceedings during which the value of the collateral is consumed by costs or lost through depreciation.

On the other side of the coin is the need to ensure that the interests of the debtor in the charged property are not squandered through failure on the part of the secured party to act in good faith and in a commercially reasonable manner when enforcing the charge against the property.

Rules of private international law

An aspect of the reform of modern secured financing law is the recognition that it is no longer possible to proceed on the assumption that rules of private international law are of only peripheral significance. Nor is it adequate to accept traditional choice of law rules which, for the most part, do not accommodate the realities of modern financing transactions. Of course, the efficacy of any system of private international law rules is influenced by the degree to which those rules are compatible with the private international law rules of neighbouring States.