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STUDY GROUP FOR THE PREPARATION OF  
UNIFORM RULES ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT

*FIRST SET OF DRAFT ARTICLES OF A FUTURE UNIDROIT CONVENTION  
ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT*

(established by the Drafting Group of the Sub-committee on 19 December 1995  
as revised by the same on 4 March 1996):

*COMMENTS*

(by Ms N. de la Peña, Professor L. Girton and Mr H. Fleisig)

Rome, April 1996



## INTRODUCTION

Subsequently to the comments to the first set of draft articles of a future Unidroit Convention on International Interests in Mobile Equipment, established by the Drafting Group of the Sub-committee on 19 December 1995 as revised by the same on 4 March 1996 (Study LXXII - Doc. 24), grouped together in Study LXXII - Doc. 26 and Study LXXII - Doc. 26 Add. 1, the Unidroit Secretariat received additional comments from Ms N. de la Peña, Mr L. Girton and Mr H. Fleisig, expert consultant to the Study Group on international economic matters. This paper reproduces these comments, set out hereunder. Ms de la Peña is an attorney and consultant to the Center for the Economic Analysis of Law (C.E.A.L.), Mr Girton a Professor of Economics and consultant to C.E.A.L. and Mr Fleisig Director of Research of C.E.A.L. The views and interpretations discussed in these comments are those of the authors and do not necessarily represent the views and policies of C.E.A.L. or of its directors. The authors acknowledge their debt to Mr R.C.C. Cuming, Mr A. Garro, Ms G. Rodriguez-Ferrand and Mr J. Spanogle for their comments and helpful advice.



## Introduction

1. An improved framework for secured transactions represents an essential step in increasing the flow of credit for financing equipment and permitting access to credit by those who cannot offer real estate as a guarantee. Recognizing this, projects are being supported to improve the framework for secured transactions. The authors are presently involved in such projects in Argentina,<sup>1</sup> Bangladesh,<sup>2</sup> Bulgaria,<sup>3</sup> Bolivia,<sup>4</sup> El Salvador,<sup>5</sup> Honduras,<sup>6</sup> Mexico,<sup>7</sup> Peru<sup>8</sup> and Uruguay<sup>9</sup>.

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<sup>1</sup> Work undertaken under the general supervision of Stephen Schonberger, LA3ER, IBRD. Further background set out in Fleisig, Heywood and de la Peña, Nuria, "Argentina: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture" [September 1995: The World Bank, processed]; and Bacchiocchi, Gianluca G.; Dick, Astrid A., and Loeb, Gabriel J., "Maximizing Social Surplus within the Politically Constrained Argentinean Registry System by Increasing Efficiency and Distributional Equity between Registries and Customers", [May 1994: The World Bank, processed].

<sup>2</sup> Work undertaken under the general supervision of Madhur Gautam, SA1AN, IBRD and described in more detail in Fleisig, Heywood, "Bangladesh: Creating a Legal and Regulatory Framework to Promote Access to Credit in Agriculture," [November 1995: The World Bank, forthcoming, processed].

<sup>3</sup> Work undertaken under the general supervision of Zeljko Bogetic (EC1CO), IBRD. Background work done in collaboration with the Europe Bank for Reconstruction and Development and appearing in Fleisig, Heywood; Simpson, John, and Rover, Jan-Hendrik, "The Framework for Secured Transactions in Bulgaria: Economic and Legal Issues" [October 1995: EBRD & IBRD, forthcoming, processed].

<sup>4</sup> Work undertaken under the general supervision of Vicente Fretes-Cibils (LA3C1), Susana Knaudt (LA3NR), Jonathan Parker (LA3NR) and William Shaw (AF2C0). Background material appears in Fleisig, Heywood and de la Peña, Nuria, "Bolivia: Creating a Legal and Regulatory Framework to Promote Access to Credit in Agriculture," [September 1995: The World Bank, processed]; Fleisig, Heywood; de la Peña, Nuria and Aguilar, Juan Carlos "Bolivia: Creating a Legal and Regulatory Framework to Promote Access to Credit for the Poor," [July 1995: The World Bank, processed]; and Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BO].

<sup>5</sup> Work recently initiated under the general supervision of Mark Dutz, Daniel Crisafulli, and Roberto Panzarli (LA2PS), IBRD.

<sup>6</sup> Work originated by Graciela Lituma (LA1NR) and now being carried forward under the general supervision of Silvia V. Castro (LA2NR). Background information appears in de la Peña, Nuria, "Honduras Draft Secured Transactions Law" ("Régimen General de las Garantías Reales Mobiliarias") [March 1994: The Central Bank of Honduras, processed]; de la Peña, Nuria, "Diagnóstico Sobre el Sistema Prendario de Honduras: Su Impacto en el Acceso al Crédito," [December 1993: The Central Bank of Honduras, processed].

<sup>7</sup> Work undertaken under the general supervision of Michael O'Donnell (IADB).

<sup>8</sup> Work now being initiated under the general supervision of Surajit Goswami (LA3NR).

<sup>9</sup> Work initiated by Jonathan Parker (LA3NR) and carried forward under the general supervision of Mariluz Cortes (LA1PS). The details appear in Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed].

2. As the Unidroit background studies indicate, a sound system of security interests in movable property provides a key building block in financing the acquisition of equipment. This paper comments on that reform proposal from the perspective of the countries involved in the projects mentioned above. This paper focuses on the legal aspects of greatest economic importance in the general reform; it does not attempt to comment on other economic aspects of the proposal that remain important to industrial countries. This paper also aims at informing the governments involved in these projects about the relation of Unidroit's valuable effort to their own reform programs.

3. Moreover, many countries may view the international framework proposal as a model for reforming their domestic laws on security interests. The Unidroit Study Group considers more than the problems related to the scope of application and "internationality" of the transaction. It implicitly presents a uniform conceptual framework and a functional mechanism for security interests. Such issues equally apply in a domestic setting.<sup>10</sup>

4. The projects described above have depended on extensive interviews with business operators, bankers, and farmers in each country. These interviews make it clear that problems in the framework for secured transactions in those countries block socially important economic transactions. Our comments, therefore, focus on the key economic issues rather than on problems that may have independent legal interest.

5. Unidroit's focus on improving the international framework for security interests in mobile equipment is welcome. The countries with ongoing projects will carefully consider the options that Unidroit presents.

6. This paper first describes the economic importance of the laws that govern security interests in movable property and the main findings encountered in the projects described above. It then presents some specific comments regarding the scope of the convention, the proposed registration rules, and the enforcement of the security interest.

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<sup>10</sup> We Thank Professor Alejandro Garro for this comment.

## **1. Economic Importance of the Laws that Govern Security Interests in Movable Property and Fixtures**

7. Personal property and fixtures have immense economic importance. In the United States, for example, such property represents about half of the private non-residential capital stock and about three-quarters of corresponding gross investment. In the United States, such property is readily financed.

8. This is not so in many developing countries. For example, in Argentina, Bolivia, Colombia, Honduras, El Salvador, Peru, Venezuela, Uruguay, in several other Latin American countries, in Bangladesh, and in Bulgaria, private banks supply most of the loans to the private sector. These private banks typically accept only real estate as collateral for these loans. These banks may require real estate collateral directly, through a mortgage, or indirectly, by requiring proof that the borrower owns land that the bank could encumber in case of non-payment or by requiring the personal guarantee of another owner of real estate. These banks usually will not accept movable property as collateral -- property like inventory, accounts receivable, or industrial equipment -- unless the borrower also offers additional collateral based on the ownership of real estate.

9. Nor will non-bank non-financial intermediaries -- such as automobile and equipment dealers, and leasing companies -- provide substantial amounts of credit using movable property as collateral. In sharp contrast to countries with an appropriate security interests framework, such credit sellers in Latin America, Bangladesh and Bulgaria extend only small amounts of credit that only the strictest unsecured loan criteria can justify.

10. Lenders and credit sellers in those countries do not accept movable property as collateral for loans. This refusal does not arise from macroeconomic risk, or from high bank intermediation spreads, but from problems in the legal framework.<sup>11</sup> These problems make creating security interests in movable property expensive or impossible.

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<sup>11</sup> For example, see Fleisig, Heywood and de la Peña, Nuria, "Argentina: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture" [September 1995: The World Bank, processed], at para. 63; Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BO], at Chapter I; de la Peña, Nuria and Fleisig, Heywood, Peru: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture; [December 1995: The World Bank Processed]; and Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], at Chapter I.

They make it costly and risky to learn about prior encumbrances, and they provide for slow and costly processes to seize and sell collateral. These problems, and not others, lead to lending policies that discriminate against movable collateral. These lending policies:

- Make it impossible for anyone without unencumbered real estate to finance the purchase of equipment, inventory, or livestock.
- Make it difficult for dealers and manufacturing companies to extend credit for inventory, even when the lender retains physical possession of the inventory.
- Limit access to credit by business enterprises in rented quarters, by farmers who work rented land or have unclear title, and by all businesses who do not own real estate.
- Make it more difficult for rapidly growing firms to get credit than slow-growing firms; make it more difficult for farmers to get credit for expanding output by mechanizing and improving cultivation practices than to get credit for expanding output by purchasing more land and using existing techniques.
- Limit profitable and socially useful lending by banks, and credit sales by manufacturers, importers, and merchants.
- Make non-bank credit expensive, because potential lenders find collateral other than real estate very risky.
- Deprive lenders and borrowers of due process of law, by encouraging illegal enforcement or the use of criminal sanction to substitute for inadequate civil collection of debts.

11. Broadly, this inadequate framework leads to high interest rates and low volumes of lending; it penalizes the progressive and rapidly growing sectors of the economy; it penalizes the poor and the landless.

12. Despite these negative effects, these lending policies reflect a perfectly rational response of private lenders to the policy environment. For a private bank or business in these countries, a borrower who offers movable property as collateral really offers no

collateral at all. The laws and procedures do not provide an appropriate framework for creating, perfecting and enforcing security interests in movable property.

#### **Are there non-legal solutions to this problem?**

13. Many are aware that highly profitable and growth producing investments exist in developing countries that private lenders will not finance for the want of adequate security. The problem has been the focal point of attention for years on the part of the multilateral development banks and the bilateral donors.

14. **Publicly-owned Development Banks?** For years, the typical approach to solving this problem has been to create state lending agencies that would make the loans that the private sector refused to make. Multilateral banks and bilateral donors supported existing state programs and the creation of created new ones. For the most part, however, these programs have failed. State lenders, unlike private lenders, did make these loans. But they were no more able to collect them than were private lenders. The forbidding legal framework for such loans, together with the poor incentive system in most state lenders to collect any loans, combined to produce billions of dollars of loans in default. While borrowing member governments may continue to service these loans to their multilateral and bilateral creditors, these governments have no corresponding domestic portfolio asset of performing loans and, often, no corresponding national asset in capital that produces output.

15. **Guarantees?** In a subsequent strategy, governments, again with the support of the multilateral and bilateral donors, attempted to use guarantees to address private lenders' unwillingness to accept movable property as collateral. Lending in Honduras for commercial inventory or leasing in Bulgaria only exists because a state insurance company is willing to insure the dealers against credit risk.

16. But supplemental public guarantees cannot address these deficiencies in the legal framework. They can only shift risk from the private sector to the public sector, without providing the public sector with a means for dealing with it. Consider a simple example.

17. Private dealers, who can charge any interest rate they like, believe that it is unprofitable to accept the credit risk associated with selling equipment on credit. By what reasoning, then, could a credit-insuring state guarantec agency conclude that accepting the risk associated with the guarantee is profitable? The guarantee agency can



freely set the guarantee fee but the dealer can set the interest rate; typically, the guarantee agency has no better ability to seize and sell the collateral; typically, the guarantee agency will be no more able to assess the risk of an individual borrower than will the dealer.

18. Private banks and dealers typically have owners and staff with strong incentives to seek out profitable business deals. If they correctly believe that they cannot profit from extending this credit, how can the state guarantee fund profit from guaranteeing such loans? If a dealer would go bankrupt making such loans, why will not the state guaranteeing agency go bankrupt? Indeed, that is precisely what we observe -- repeated insolvencies in state lending and guaranteeing agencies in the borrowing member countries of the multilateral lenders.

19. Whoever guarantees the loan will simply absorb the risk and the losses of an inadequate security interest framework that the private sector now refuses to take. That guarantee fund will go bankrupt.

**Public loans to private lenders?** The latest phase of the strategy has been to address the bad loan problem by attempting to direct credit lines toward the economic activities most dependent on fixtures and personal property for their operation but to disburse these loans through private lenders who will be concerned about debt collection. However, for the reasons set out above, private banks will never disburse credit for working capital -- secured by inventory or accounts receivable, or intermediate-term credits -- secured by equipment -- except to borrowers that are already so creditworthy that they would qualify for the same loans without presenting collateral. In the latter case, the directed credit line provides no additional benefit to the country, except for the foreign exchange itself. Where a country is creditworthy and has unrestricted access to foreign loans, that is no advantage at all. These privately disbursed public loans cannot address the problems outline here; either the loan will remain in the hands of the government, undisbursed and unused, or it will disburse to those who have the real estate to provide the guarantees sought by private lenders.

### **Solutions in law and public institutions**

20. Those who favor public intervention to address the high economic costs of credit systems that will not lend for movable property correctly point to a failure in the policy environment that makes such collateral unacceptable. But this problem cannot be remedied by making the loans anyway. Such a solution does not guarantee that loans must be repaid and, therefore, does not guarantee that loans go to their highest return

investments. Rather, solving the problem requires changing the legal and regulatory environment that now makes such loans so risky and unprofitable. Freeing up the flow of credit for these purposes, restoring the chains of credit that link final consumers and exporters to the underlying firms and farms, requires fundamental changes in the laws and legal procedures that govern movable collateral.

21. As noted at the outset, personal property and fixtures have immense economic importance. Credit systems that cannot finance such investment limit economic growth. More detailed analyses of two countries -- Bolivia and Argentina -- reckon these costs at between 5 percent and 10 percent of GNP.<sup>12</sup> These costs are enormous in comparison to the cost of remedying the problem. Accordingly, high priority should be given to improving this framework. Unidroit's effort is an important step in this direction.

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<sup>12</sup> See Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], Chapter I and Appendix I: Economic Costs of Deficiencies in Bolivia's Collateral Law, pp. 55 and 56; and Heywood Fleisig, Assessing the Economic Cost of Deficiencies in the Framework for Secured Transactions: Examinations of Argentina and Bolivia [Processed, The World Bank, 1995].

## II. Comments: Unidroit's proposed Convention and the Circulated Review Comments

22. This chapter first raises some general economic issues that arise in choosing a drafting strategy. It then looks at the economic issues arising from the scope of coverage, priority, the treatment of registration, and enforcement.

### A. Economic Issues in Drafting Strategy

23. The mobility of collateral causes the basic problem in financing equipment, as the title of the Unidroit Convention shows. For example, a jet engine, in which a "security interest" has been created, would be expected to frequently leave the geographical area over which the jurisdiction held sway in which the original security interest was created.

24. In one approach to solving this problem, the international agreement would cover the relevant geographical area with a single set of governing laws: a "homogeneous" approach. In a second "heterogeneous" approach, the international agreement would focus on methods of linking different national systems by enforcing security interests in one country under the second transaction laws of another. The first is a mainframe; the second a LAN. The first is a puree; the second a bouillabaisse.

25. Unidroit's proposed convention approach follows the homogeneous approach. It puts a heavy weight on achieving international agreement over substantive law: at the most extreme the Convention would create a "new international security interest." We consider these approaches in turn.

26. **Homogeneous approach.** In the homogeneous approach, all governments covering the area over which the engine might be moved must agree to the creation of a common set of rules. To the extent that countries cannot agree, unnecessary or additional uncertainty and complexity will arise. That, in turn, will raise the cost of commercial transactions, impede lending, and lower the economic benefits from the convention.

27. This returns us to the basic problem that prompted the Unidroit work in the first place: except for few industrial countries, the domestic laws that would govern security interests in movable property do not provide a viable framework for their financing. There is no enforceable security interest that withstands bankruptcy, registries that works, or enforcement procedures that are fast and certain.

28. Difficulty in getting agreement on the key aspects of security interests -- in their creation, perfection, and enforcement -- has already narrowed the economic scope of the convention to specific types of equipment; this issue is discussed below.

29. **Heterogeneous approach.** A heterogeneous approach would require international agreement that the legal system under which the original contract was signed would govern the transaction. It would assign jurisdiction to the court system of that legal system. Additionally, all would agree that the courts where the collateral is located would enforce the judgment of the courts of that other legal system. This approach would create a legal fiction: that, for legal purposes, the collateral did not move. The jet engine would be physically mobile but the collateral-engine would be "legally" fixed.

30. The heterogeneous approach would allow parties to choose the secured transactions laws of any signatory country. The convention would have to make those laws enforceable.

31. In this approach, for example, Unidroit rules for an international security interest need not gain the support of financiers of equipment in the United States: the convention would allow them to agree that UCC9 would apply in their international transaction. The convention would assure enforcement of that US law when the equipment is located in any signatory country.

32. The heterogeneous approach has the advantage of leveling high, instead of low. The homogeneous approach requires that all countries agree on the rules for an international security interest: countries with a more advanced domestic framework would compromise and accept less advanced rules. Countries with a less advanced framework would move forward. Under the heterogeneous approach, countries with a more advanced secured transactions framework domestically may keep it in the international setting, while those countries with a less advanced framework would allow parties to choose the application of more advanced rules in the international setting.

33. An international transaction that formerly involved competition on quality of merchandise and quality of financing would now also involve competition in systems of secured transactions.

#### **B. Scope of Application and Priority Issues in Unidroit's Proposed Rules**

34. As presently framed, the limited scope of the convention will limit the economic benefits likely to arise from an international framework for security interests. This section discusses this and then turns to issues of priority that arise under the rules for future advances and purchase money security interests.

#### 1. Incomplete Coverage of Property that may Serve as Collateral

35. As now proposed, the Convention applies only to some equipment.<sup>13</sup> Within that limited application, Unidroit considers whether to set out a closed list of equipment, or in some way to allow for additions to this list.<sup>14</sup>

36. What are the economic merits of this restriction? Typically, when private parties conclude a profitable transaction, society gains. The parties to the transaction may keep all the gain, or some gain may spill over to others who are not direct parties to the transaction. Broadly, though, all members of society share a common material interest in promoting profitable transactions. No one can predict all the socially profitable transactions. Therefore, society's broad material interest is best served when the law places as few legal restrictions on these transactions as possible.

37. A law may attempt to list all possible creditors, debtors, types of transactions and types of movable property that may serve collateral. But such lists will, of necessity, have many gaps. These gaps will produce legal uncertainty; both will increase over time. Enumerating equipment is analogous to attempting to list all the numbers between one and two -- a logical impossibility. A general security interest is analogous to defining the interval "all the numbers between one and two" -- logically simple.

38. The convention notes that when possible, countries should prefer a broader coverage of property that can serve as collateral under the convention. The more narrow the application of the convention to a list of specific equipment, the more limited its economic impact. As noted, in the United States, two thirds of the stock of private non-residential capital stock is movable property; as is three quarters of gross investment. Maximizing economic gain would require a long list indeed.

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<sup>13</sup> See "First Set of Draft Articles of a Future Unidroit Convention on International Interests in Mobile Equipment" established by the Drafting Group of the sub-committee on December 19, 1995 and revised by the same on March 4 1996 (Study LXXII - Doc.22), hereafter: "Draft Rules, March 1996," arts. 1 - 4.

<sup>14</sup> Study Group for the Preparation of Uniform Rules on International Interests in Mobile Equipment: Sub-Committee for the Preparation of a First Draft, Third session: Rome, 11-13 October 1995, Summary Report [UNIDROIT 1995, Study LXXII-Doc.21], p. 4 para. 7.

## 2. Problems in Giving Priority to Future Advances

39. The Unidroit draft convention and the comments received by the Airbus Industry and The Boeing Company propose that parties agree to give priority to future advances.<sup>15</sup>

40. However, in many countries mentioned earlier, businesses reported that it was risky to secure lines of credit with movable property because future advances would not get the same rank of priority as the first advance. This loss of position occurred even if the security agreement provided for future advances, the agreement was considered valid, and the security agreement was publicly recorded in the registry.<sup>16</sup> For example, in Argentina, the courts concluded that future advances can have priority only when the first payment is due or the monies are disbursed. The courts reasoned that (i) a security interest may not have priority until it exists, (ii) the security interest cannot exist until there exists a debt that it secures; (iii) that debt that the security interest secures does not exist until monies are disbursed or the first payment is due, and thus, the security interest can only have priority from that time.<sup>17</sup> Other countries in Latin America similarly deny priority to future advances.

41. This problem raises a serious risk to lenders. The priority of a lender strongly affects the lender's risk because parties cannot know the liquidation value of the collateral with certainty. In a simple example, suppose we have a borrower with collateral whose liquidation value is either 90 or 100, with each value being equiprobable. Then a lender in the first position who makes a loan of 80 faces a zero risk of loss; if he makes a loan

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<sup>15</sup> Draft Rules, March 1996, art. 19(1). See also, Future UNIDROIT Convention of International Interests in Mobile Equipment, July 1995 draft, art. 12(2), and "Memorandum prepared jointly by the Airbus Industries and The Boeing Company on behalf of an aviation working group," UNIDROIT 1995, Study LXXII-Doc. 16, at para. 7.3.

<sup>16</sup> For example, See Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], at p. 20; and Fleisig, Heywood and de la Peña, Nuria, "Argentina: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture" [September 1995: The World Bank, processed], at p. 42-43.

<sup>17</sup> See Argentina, Cámara Nacional de Apelaciones en lo Comercial, sala A. July 29-1983, La Ley 1983-D-584, and 82. See also, Fleisig, Heywood and de la Peña, Nuria, "Argentina: How Problems in the Secured Transactions Framework Limit Access to Credit in Agriculture" [The World Bank processed, September 1995], notes 80, 81, and 82.

of 100, he faces a 50 percent chance of a 10 percent loss. However, a lender in the second position who makes a loan of 10 behind a lender in the first position who makes a loan of 90 faces a 50 percent chance of a 100 percent loss. Thus, even with the same underlying transaction, position and size of a loan together present the lender with quite different risk and return combinations. Consequently, it is a matter of great concern to a lender what position he occupies in the sequence of priorities. A system that allows changing that priority without knowledge of the creditor presents great risks.

42. Would Unidroit's rules for giving priority to future advances survive judicial scrutinies, such as that of Argentinean courts? One option is for the proposed rules to link the provisions on future advances with those that deal with the existence of the international interest and the secured debt, such as art. 3.1.c of the July 1995 draft.

### **3. Should the Convention Give Priority to Future Advances?**

43. Some interesting economic reasoning underlies the different thrusts of Article 19(1) in the Draft Rules and Article 9 in the UCC. The economics rests on the "divisibility" of the collateral.

44. The first part of the Article 19(1) (occurring before "except," addresses the following problem: Suppose a \$150,000 engine is used as collateral; suppose it has a collateral value of \$100,000, but the borrower only needs a loan of \$60,000. Assume further that no reasonable way exists to divide the engine - it is a single functional entity. If the borrower uses the engine to collateralize the \$60,000, and if the creditor has priority over subsequent creditors for any additional amounts lent, then the debtor is effectively locked into the original creditor for any additional borrowings. Any other potential creditor could see his interests in the collateral wiped out by any additional lending of the original creditor.

45. If, on the other hand, the collateral is divisible, then the loan contract can tailor the collateral to the amount borrowed, or the size of the credit line. Assume, for example, that a company is using inventory as collateral for a loan. Assume that the inventory consists 100 distinguishable items each of \$1,500 for a total value of \$150,000. Assume the collateral value of each item is \$1,000. Then, if the holder of the inventory wants a \$60,000 loan, the holder can just use the first 60 items in inventory to collateralize the loan. This leaves the additional 40 units unencumbered and available to support any future borrowing needs. Then this financing does not lock the borrower into the original creditor. If the holder of inventory needs to borrow in the future, the holder can negotiate on even ground with other lenders.

46. Of course, if the debtor with the \$150,000 engine as collateral, is foresighted, the debtor would see that the initial creditor will gain a powerful (monopoly) position. If transaction costs (including bargaining costs) are low, a wise debtor would negotiate in the initial loan contract the terms for additional borrowing up to the collateral limit.

47. Will it make a difference whether the law gives the original lender a priority interest in the whole collateral, or alternatively, subsequent lenders can gain a firm interest in the balance of the collateral? It will, to the extent that debtors cannot anticipate future borrowing needs and the transaction's costs of establishing an extended loan commitment are large.

48. It is worth underlining that the different rules may not have any real effects if the costs of transactions are low. Debtors would just negotiate for future advances if subsequent creditors could not get a firm security interest in the indivisible collateral. However, for a variety of reasons, lenders typically charge a fee for unused credit lines. In that case, negotiating a "larger than needed" credit line may be costly.

49. Notice also that the debtor could probably bargain for a lower interest rate on a \$60,000 loan over-collateralized with a \$150,000 engine, when the standard \$150,000 engine has a \$100,000 collateral value, as assumed above. This would only require that the original creditor have a priority security interest in the collateral.

50. Another way of looking at the effects of divisibilities, is to note that if the collateral is not divisible then creating a law that makes loans divisible raises the economic value of that law. That is, if the engine is indivisible, then making the law such that subsequent lenders have a firm security interest against additional lending by the original lender will permit the substitution of loan divisibility for collateral divisibility. This may improve the functioning of the credit market by promoting competition among lenders - borrowers will not be locked into their original lenders for subsequent credits using the same collateral.



#### 4. How to Allow Competition when the Collateral is Indivisible?

51. The drafting group is considering requiring that the security agreement and the filing state a maximum amount of the indebtedness.<sup>18</sup> Essentially, if the collateral is divisible, then the security agreement can slice the available collateral to fit the amount of the borrowing and the over-collateralization/interest cost trade-off. If the collateral is indivisible, e.g., an aircraft engine, then the problem may arise that a senior creditor could lock in the debtor for any subsequent borrowings. One way of preventing this is by making subsequent lendings by the senior creditor junior to any intervening creditors.

52. Another way of protecting debtors and junior creditors would be to require a maximum amount of the indebtedness to be stated. This will force the parties to the agreement to negotiate over an explicit limit on the security interest in the collateral.

53. Art. 19(1) says that subsequent credit extensions by the senior creditor will have priority except where there is no "pre-existing obligation." There might be gray areas.

54. Suppose a debtor negotiated a \$100,000 line of credit secured by an aircraft engine worth \$150,000 and initially drew down \$60,000 what would be the situation? Would it matter whether the line of credit was irrevocable? What if the credit line were contingent? Would a revocable credit line satisfy 19(1) to be an "obligation?"

55. Perhaps the most realistic situation would arise where the debtor negotiated an extra line of credit from a bank as insurance. As in the previous example, suppose the debtor establishes a \$100,000 line of credit but only draws down \$60,000. The debtor might think he could borrow elsewhere to meet future needs at a lower cost than by drawing down the credit line. However, suppose he wants the credit line as insurance. The debtor will have locked himself in because subsequent borrowings from the first creditor would have senior status, thus reducing the ability to borrow elsewhere.

56. Here the rules could support the following contract provision: "that the bank would lend up to \$100,000 if the engine remains unencumbered." Thus, if the debtor borrowed the additional amount, the line of credit would be effectively canceled. The junior creditor has a secured interest. If the debtor cannot borrow elsewhere at favorable terms, then he can borrow from the bank because the bank has the engine as collateral free of competing liens.

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<sup>18</sup> Draft Rules, March 1996, art. 6 (d). See also Study LXXII-Doc. 18 Art. 12(2) and Special Provisions for Aircraft and Aircraft Engines (6) 2nd para. See also Study LXXII-Doc. 16-7.3.

**5. Should the Convention Give Priority to Purchase Money Security Interests without Registration?**

57. The Draft Rules would treat purchase money security interests as automatically perfected when the transaction takes place, without a requirement to file.<sup>19</sup>

58. Determining whether automatic perfection makes sense would require balancing costs and benefits. The costs saved are the filing costs. Assuming a reasonably efficient filing system, these would loom large only for very small transactions. The benefits of explicitly filing in a public registry are to third parties, subsequent creditors or purchasers of the good, who would not be notified of the security interest. The need for the exception, however, is unclear in an international context with presumably sophisticated borrowers and lenders dealing in large sums.

**B. Registration of Security Interests**

59. This section comments on the proposed registry system, as well as competition, public access, notice filing and pre-filing rules.

**1. Should the Convention Use Domestic Registries or an International Registry?**

60. The Unidroit drafters are concerned with the costs of an international registry system. This is a rightful concern. Businesses all over the world view the costs of registration as crucial in undertaking a transaction. Some commentators expressed the opinion that the costs of registration of an international registry would be expensive or more expensive than the domestic registries.<sup>20</sup> They suggest that a domestic registry should be preferred.

61. However, the domestic registries visited under the projects mentioned above provide expensive registration systems. Many have inadequate filing and search criteria, making it difficult to learn about prior encumbrances in collateral. In some countries,

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<sup>19</sup> Draft Rules, March 1996, art. 19

<sup>20</sup> See comments by the Federation of the European Union, 1995.

it may be less expensive to improve the registration systems by buying the services of an offshore international registry, than by modernizing their own registry operation systems. Thus, it may be advisable that Unidroit undertakes further technical and economic analysis of the different options. That analysis may provide better guidance on the most efficient structure and operation of an international registration system.

## **2. Evidence of Registration: Lack of Competition and Lack of Public Access**

62. The proposed convention provides that: "A certificate which records on its face that it was issued by the registrar shall be *prima facie* evidence of the [fact and time] [fact, time and order] of registration without the need to prove the authenticity of the certificate." [Article 16].<sup>21</sup> However, this provision may effectively lessen competition in obtaining registered information: what would be the legal force of certificates issued by private information services, assuming that they could also access, retrieve, and copy information filed in the international registry? Giving some certificates a greater validity than those of others may not foster competitive prices for customers purchasing information.

63. Moreover, the convention must ensure that the registry system would be public. For that, the convention could include provisions on public access. These could specifically state how the registry or registries involved will give public access. And, if local registry offices are used, how can the public access the information through those local offices.<sup>22</sup> If the international registry provides access by electronic mail services, the drafters may consider the applicable communications regulations. Some countries permit direct access to the INTERNET services only to few telecommunication companies (e.g. Argentina).

64. Unidroit could also set standards for public access to domestic registries of security interests. Lack of public access was the most important problem encountered in examining local registries. This may seem paradoxical -- the law establishes registries precisely to give public notice. In many countries, however, registries that are called "public" and that operate under laws that provide for "public access," in practice deny

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<sup>21</sup> Draft Rules, March 1996, art. 16.

<sup>22</sup> A proposal for such provisions is spelled out in Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], at p. 28.

direct access.<sup>23</sup> Typically, only registry officials may give information through the issuance of a certificate for a specific transaction. Often, only the owner of collateral registered there can obtain that certificate. In those countries, the lack of access to local registries deprives private companies of access the information and prevents them from offering registry information services, such as title insurance policies. Thus, when these registries operate badly, not only is their filing slow and expensive, but so is obtaining the information that is registered there.

### 3. Introduce a Notice Filing System

65. As Unidroit's drafting group points out, a notice filing system can address fears arising from making too much information public without respecting the privacy of transactions. Some registries visited in Latin America currently file the entire loan and security agreements. This overloads the filing space, increases the costs of operating registries and requires imposing limits on the access to registered information. Both to address the concerns for privacy and to lower the costs of registration, a notice filing system has been proposed in Argentina,<sup>24</sup> Bolivia,<sup>25</sup> Uruguay,<sup>26</sup> Peru, and Honduras.<sup>27</sup>

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<sup>23</sup> See for example, "Argentina: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture" [September 1995: The World Bank, processed], at para 206; and Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BO], at para. 75.

<sup>24</sup> See Fleisig, Heywood and de la Peña, Nuria, "Argentina: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture" [September 1995: The World Bank, processed]; at para. 210. For a detail discussion of a proposal for Argentine pledge registries see Bacchiocchi, Gianluca G.; Dick, Astrid A., and Loeb, Gabriel J., "Maximizing Social Surplus within the Politically Constrained Argentinean Registry System by Increasing Efficiency and Distributional Equity between Registries and Customers" [May 1994: The World Bank, processed].

<sup>25</sup> Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BO], at p.30.

<sup>26</sup> See Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], at p. 29-30.

<sup>27</sup> De la Peña, Nuria, "Diagnóstico Sobre el Sistema Prendario de Honduras: Su Impacto en el Acceso al Crédito," [December 1993: The Central Bank of Honduras, processed], at para. 126.

#### 4. Convention's Position on Seller Transactions -- Pre-filing

66. The Convention seems to favor promoting seller transactions. Pre-filing -- the best protection for lenders -- is not allowed. There is no time requirement within which a registry must act, and the lender must not only obligate itself in writing, but also enable the debtor to obtain rights in the collateral (by providing funds) before it can even apply for registration.<sup>28</sup> Thus, the lender will undoubtedly have parted with value before it can be certain a security interest is registered prior to any other secured creditor. Few lenders will be willing to take such a risk. Thus, only credit sellers would be willing to enter into these transactions. They would be less at risk, since they can control the time at which the debtor acquires rights in the collateral.<sup>29</sup>

#### C. Problems in Enforcing Security Interests

67. This section comments on the need for introducing creditor-controlled enforcement rules and bankruptcy provisions.

##### 1. Include Creditor-Controlled Enforcement Rights

68. As a practical matter, the greatest diminution in the economic value of collateral arises from problems in enforcing security interests. This diminution has several aspects. First, the costs of collection have a substantial fixed element -- the costs of lawyers, courts, and other officers cannot be reduced below a certain lower bound. Much movable property has a low unit value relative to these fixed costs. Loans against such property are risky when collection costs are high, because an action to repossess and sell will not yield much to cover the underlying loan. Second, movable property often has an economic life shorter than the period required to seize and sell the collateral.

69. Studies of court records conducted in Bolivia and Argentina reported an average time of close to two years to take possession and to sell movable property.<sup>30</sup> A study

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<sup>28</sup> See Draft Rules, March 1996, art. 6 and 14.

<sup>29</sup> We are obliged to Prof. John Spanogle for pointing this out to us.

<sup>30</sup> See de la Peña, Nuria and Mugillo, Roberto, "Case Disposition Time for Seizing and Selling Movable Property in Capital Federal Commercial Courts" [September 1995: The World Bank, processed]; and Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BO], Appendix II: Results of an Analysis of Bolivian Debt Collection Cases.

by the Central Bank of Uruguay indicated a similar length of time.<sup>31</sup> Interviews conducted in Mexico, Peru, Honduras, Bangladesh, and Bulgaria also revealed long and uncertain times to legally repossess and sell collateral.

70. If the period required to seize and sell collateral is two years, equipment with an economic life of two to three years is very risky collateral. Rational lenders will not expect to recoup much. Under such an enforcement system, no rational lender will lend for inventory with a 30-60 day life expectancy.

71. Accordingly, it is extremely important for the convention to include enforcement provisions, such as art. 6 of the July 1995 draft. Studies of the aforementioned countries have proposed including private enforcement procedures such as self-help repossession, receivership, ex-parte court orders, and licensing private parties to repossess collateral in a secured transactions law.

72. Some of these options are already available in many countries, but are limited to certain "qualified" creditors. To avoid such limitation, the convention's enforcement provisions could emphasize that the enforcement mechanisms must apply to all creditors.

73. For speeding up court procedures, the Aviation working group has recommended imposing on courts mandatory deadlines of five days.<sup>32</sup> It is helpful to include such provision to speed up collection. However, mandatory deadlines, by themselves, may not have an important impact. Most of the countries studied above have laws that set out similar mandatory deadlines. Nonetheless, the courts do not dispose of cases in that time framework.<sup>33</sup> Courts take longer than the required time under the law because of the courts' administrative problems, substantial backlogs, legal provisions that permit defenses that are dealt with outside the time limits, and the general absence of any enforcement system to deal with judges and court officers who ignore the legally-

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<sup>31</sup> See Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], at p. 32.

<sup>32</sup> "Memorandum prepared jointly by the Airbus Industries and The Boeing Company on behalf of an aviation working group," UNIDROIT 1995, Study LXXII-Doc. 16, Recommendation at paras. 4.1 to 4.4.

<sup>33</sup> See Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed], at p. 32; and Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BQ], Appendix II: Results of an Analysis of Bolivian Debt Collection Cases.

specified timetable.<sup>34</sup> As mentioned above, private procedures that require less intervention by the courts may be a better alternative to speed up collection.

## **2. Bring Security Interests Outside the Debtor's State in Bankruptcy**

74. Under Art. 19(4) the formulation of the creditor's rights in bankruptcy seems incomplete and may be restated. In many jurisdictions the secured creditor will still be subject to priority claims such as employee wages, obligations owed to the State and certain tax claims. In such jurisdictions, the bankruptcy procedure requires seizing all assets of the debtor, have court officials sell them, and distribute the proceeds according to a statutory formula. The formula often puts the secured creditor fifth or sixth on the distribution list. The current formulation of art. 13 does nothing to change that approach. The only concept which is likely to give the necessary protection to secured creditors is to state explicitly that the collateral described in a registered security interest is outside the debtor's state in bankruptcy proceedings. For the reasons set out earlier, uncertainty about priority will gravely reduce the economic usefulness of the security interest.<sup>35</sup>

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<sup>34</sup> For example, in Argentina, in the cases examined, took 68 days average after the judicial sale, for the court to simply issue the check to the order of the creditor; and 13 days in obtaining the signature of the judge on a court order for seizure that she had already issued. In these cases, the mandatory deadlines set out in the Code of Civil Procedure had been followed -- the court did order the seizure and the sale of the collateral within the time limits. But, in practice, that compliance does not assure a prompt disposition of the collateral. See de la Peña, Nuria and Muguillo, Roberto, "Case Disposition Time for Seizing and Selling Movable Property in Capital Federal Commercial Courts" [September 1995: The World Bank, processed].

<sup>35</sup> We are obliged to Prof. John Spanogle for pointing this out to us.