United Nations A/CN.9/WG.VI/WP.2/Add.9

General Assembly

Distr.: Limited
11 April 2002

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
First session
New York, 20-24 May 2002

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum*

Contents

* This addendum is submitted four weeks less than the required ten weeks prior to the start of the meeting because the secretariat of the Commission was fully occupied with the preparation of other documents, including another eleven addenda of A/CN.9/WG.VI/WP.2, ten of which have already been submitted.

V.02-53319 (E)

IX. Default and enforcement

A. General remarks

1. Introduction

1. This Chapter examines the secured creditor's enforcement of its security right if the debtor fails to perform ("defaults on") a secured obligation without being insolvent (insolvency is dealt with in Chapter X).

2. A reasonable secured creditor expects a debtor to perform its obligations without the need for the creditor to have recourse to encumbered assets. A reasonable debtor will also expect to perform. Both will recognize, however, that there will be times when the debtor will not be able to do so. The failure may result from poor management or business misjudgements, but it may also be for reasons beyond the debtor's control, such as an economic downturn in an industry or more general economic conditions.

3. Reasonable creditors will periodically review their debtors' business activities or the encumbered assets and communicate with those debtors who show signs of having financial difficulties. Reasonable debtors will cooperate with their creditors to work out ways to overcome these financial difficulties. Creditors and debtors working together may enter into "composition" or "work out" agreements, that extend the time for payment, reduce the debtors' obligation or modify security agreements. Negotiations to reach a composition agreement take place in the shadow of two principal legal factors: the secured creditor's right to enforce its security rights if the debtor defaults on its secured obligation and the possibility that insolvency proceedings will be initiated against the debtor.

4. At the heart of secured transactions regime is the right of the secured creditor to look to the value of the encumbered assets to satisfy the secured obligation if the debtor defaults. The availability and the cost of credit will be affected by the amount of the estimated proceeds of the disposition of the encumbered assets. The costs of realizing the value of a security right are also costs that the creditor will include when calculating the amount and cost of credit it is willing to extend to the debtor.

2. Key objectives

[*Note to the Working Group: The Working Group may wish to consider whether this section should be retained and developed within this Chapter or whether any substantive discussion of objectives should be contained in Chapter II. If the latter approach is taken, there are some similarities between (i) and (iv) below, and objectives A and G in Chapter II, though Chapter II may otherwise require some amendment to accommodate the points made here*].

5. Consistent with the key objectives of an efficient regime outlined in Chapter II, a secured transactions regime should have the following specific objectives for a default and enforcement procedure:

(i) Provide clear, simple and transparent legal rules for the enforcement of security rights following a debtor's default, and for the post-default rights, obligations and priorities of interested parties

6. A secured transactions regime should provide procedural and substantive rules for the enforcement of a security right after a debtor has defaulted. These rules should permit the parties to determine what is to be done with the encumbered assets and the allocation of the proceeds of any disposition of the encumbered assets. They should also deal with any deficiency or surplus (i.e. the difference between the monetary value of the secured obligation and the proceeds of any disposition of the encumbered assets), which may be due from or to the debtor. These legal rules should be clear, simple and transparent to ensure certainty about the likely outcome of enforcement proceedings. A secured creditor will, otherwise, incorporate the added risk, created by any uncertainty, into the cost of credit it extends.

(ii) Maximize the realization value of the encumbered assets in a manner consistent with protection of the rights of interested parties and the public

7. All interested parties (i.e. the secured creditor, the debtor, the grantor and other creditors) benefit from maximizing the amount that will be realized by disposing of the encumbered assets after the debtor has defaulted. The secured creditor benefits if any deficiency the debtor may owe as an unsecured debt is reduced. At the same time, the debtor or grantor and the debtor's other creditors benefit, either by a smaller deficiency or by a larger surplus. A secured transactions regime may maximize the value realized by decreasing the transaction costs of the disposition, thus increasing the amount of the proceeds received on disposition of the encumbered assets.

8. Any procedures implemented should be consistent with the need to protect the rights of interested parties and the public. The key issue for a secured transactions regime is what modifications, if any, should be made to the normal rules for debt collection. Some regimes, for example, provide for expedited court proceedings. Other regimes delegate to the secured creditor the authority to take possession of the encumbered assets and dispose of them with no direct government or independent administrative intervention. Expedited procedures and delegation of authority, however, should take into account the right of persons to be heard in protection of legitimate claims to encumbered assets. Moreover, the allocation of resources within the judicial system and any delegation to private persons necessarily raise issues of public interest.

(iii) Provide transactional finality upon compliance with the enforcement procedure

9. After the process for realizing the value of the security right is completed, there should be finality. The secured creditor's security right in the encumbered assets should terminate. If the encumbered assets have been disposed of, the grantor's rights in the assets should also terminate. The law should also determine whether the security rights of other secured creditors in the encumbered assets continue notwithstanding disposition of the assets in the enforcement procedure. In this respect, the law may distinguish between senior and junior security rights (i.e. whether or not other secured creditors have priority over the security right of the creditor initiating enforcement).

(iv) Define clearly the extent to which the secured creditor and the grantor may agree on the procedure for realization of the value of the encumbered assets

10. The principle of freedom of contract rests upon the assumption that self-interested parties are the best judges of the value of a proposed contractual exchange. The aggregate of these contractual exchanges leads to an efficient allocation of resources within an economy. This principle must be balanced with the further principle that a bilateral contract should not affect adversely the rights of third parties or the public interest in such matters such as abuse of rights. In the context of a regime for enforcement of security rights, the law must define the extent to which the secured creditor and debtor may agree on the procedure to be followed. In particular, the law may distinguish between those legal rights that can be modified in the original security agreement and those that can be modified only after default.

(v) Coordinate the enforcement rights and procedures of the security right regime with the rights and procedures for security rights in insolvency proceedings

11. A security right is of particular importance to a secured creditor when the debtor is in financial difficulty. A debtor who is in financial difficulty is more likely to default on its obligations and may end up voluntarily or involuntarily in insolvency proceedings. If the value of a security right in insolvency proceedings is less than the value of that right outside such proceedings, the debtor and other creditors will have an incentive to precipitate the insolvency proceedings. A secured creditor subject to such a regime will, when extending credit, take into account the diminished value of the security right in insolvency proceedings and will reduce the credit extended or increase the costs of the credit to the debtor. Provision for recognition and enforcement of security rights within the insolvency process will create certainty and facilitate the provision of credit (for a discussion of enforcement of security rights in insolvency proceedings, see Chapter X).

3. Default

a. The meaning of "default"

12. If a debtor fails to perform a secured obligation the debtor is in "default". The parties' agreement and the general law of obligations will determine whether there has been a default. A loan agreement, for example, may list events of default

that make the loan immediately repayable. The security agreement will usually define what constitutes default. In the unlikely case where the parties' contracts are silent, general principles of contract law establish whether a debtor has defaulted. A law governing secured transactions, therefore, need not define default. If a definition is included, it is sufficient to state that a default occurs when the debtor fails to perform a secured obligation, or is otherwise in default as defined by the security agreement or other law.

b. Cure of default

13. Whether the law should permit a debtor to cure or correct a default requires weighing protection of the debtor when default does not evidence a long-term inability to perform against protection of the creditor from the costs of delayed performance and a cycle of default-cure. Although this issue of curing or correcting default could be left to the general law of obligations or special debtor protection legislation, the potential removal of the encumbered assets from the control of the debtor may focus attention on the issue in the context of a secured transactions law. A secured transactions law that addresses the issue of cure of default should ensure that it is consistent with existing law and should provide explicit cross-references to legislation that it does not displace to ensure transparency.

c. Notice of default

14. The debtor's default is a precondition to the secured creditor's right to enforce its security right against the encumbered assets. A secured transactions law should address whether notice of the default should be given and to whom. The principal benefit of a notice is that it permits the debtor and other interested parties to protect their interests. A debtor, for example, may challenge whether default has occurred and, if the law so provides, seek to cure the default or to redeem the encumbered assets. Notice to other interested parties allows them to monitor subsequent enforcement by the secured creditor and, if they are secured creditors whose rights have priority, to take control of the enforcement process. The disadvantages of notice include its cost, the opportunity it provides an uncooperative grantor to remove the encumbered assets from the creditor's reach and the possibility that other creditors will race to dismember the debtor's business. Although some secured transactions laws do not require notice of default, many do so.

15. As with other situations where notice may be necessary, a secured transactions law should spell out the minimum contents of a notice, the manner in which it is to be given and its timing. When doing so, the law might distinguish between notice to the debtor, notice to the grantor when the grantor is not the debtor, notice to other creditors and notice to public authorities or the public in general. The secured creditor might, for example, be required to give prior written notice to the debtor and grantor followed by filing a notice in a public register. The creditor might also be required to give written notice to those other secured creditors who have filed notice of their interests or who have otherwise notified the creditor. Alternatively, the registrar might be required to give such notice. As for the information to be included in the notice, the law might require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default and detail the steps the debtor or grantor may take to cure the default or to redeem the encumbered assets. The secured creditor may also be required to elect, at least provisionally, the steps it intends to take to enforce its security right.

d. Judicial or administrative review

16. To ensure the integrity of the enforcement procedure, the debtor and other interested parties should have an opportunity to have judicial or administrative review of acts of the secured creditor. The debtor should have an opportunity to challenge the secured creditor's position that there has been a default, or the calculation of the amount owing as a result of the default. To avoid unduly delaying rightful enforcement, the review should be expedited. Safeguards should be built into the process to discourage debtors from making unfounded claims to delay the enforcement.

4. Options following default

17. Most legal systems recognize that a secured creditor may enforce the secured obligation by judicial action following the same procedure used to enforce any claim. If judgement is rendered on the secured obligation, the judgement may then be executed in the same way on any of the debtor's assets available to creditors, including the encumbered assets. The discussion in the following paragraphs focuses, however, on enforcement of the secured creditor's security right in the encumbered assets, whether by judicial action or otherwise.

18. When the debtor defaults, the secured creditor may or may not be in possession of the encumbered assets. A secured creditor in possession is protected against potential abuse (e.g. hiding or misusing the assets) by the debtor or grantor. A secured transactions regime should protect the non-possessing secured creditor from such abuse as well. Leaving aside the issue of protection against potential abuse, however, there is no reason to distinguish between a creditor with a possessory security right and other secured creditors, and the same procedures for realizing the value of the security right may be applied to all secured creditors.

a. Judicial action to enforce the security right

19. A key issue for a secured transactions regime is the extent to which the secured creditor must resort to the courts or other authorities (e.g. bailiffs, notaries or the police) to enforce its security right.

20. In order to protect the debtor and other parties with rights in the encumbered assets, many legal systems require the secured creditor to resort to the courts or other authorities to enforce its security right. However, this approach may inadvertently result in delays and costs that the debtor may have to ultimately bear, because they are factored into the cost of the financing transaction and, in any case, reduce the realization value of the encumbered assets. In addition, this approach involves formal procedures that are not geared to yield a reasonable market price for the encumbered assets.

21. In order to avoid these problems, some legal systems limit the role of courts or other authorities in the enforcement process. In these legal systems the secured creditor is often authorized to enforce its security right without any prior intervention of official State institutions, such as courts, bailiffs or the police. In other legal systems, there is only limited prior intervention of official State

institutions in the enforcement process.[1] The justification for such an approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. It may also maximize the realization value of the encumbered assets.

22. However, even in these legal systems the courts are available to ensure recognition of legitimate claims and defences of the grantor and other parties with rights in the encumbered assets. In order to inform these parties and give them an opportunity to react, the secured creditor is required to give them a notice of default and enforcement (see paras. 14-15). In addition, if the debtor does not consent, the secured creditor may not enforce its rights if such enforcement would result in a disturbance of the public order (see para. 30). Moreover, in disposing of the encumbered assets, the secured creditor has to act in a "commercially reasonable" manner (see para. 33).

23. Even if permitted to act without official intervention, a secured creditor is normally not precluded from seeking to enforce its security right by judicial action. The secured creditor may choose to bring a judicial action, for example, to avoid the risk of having its private actions challenged after the fact or may conclude that it will have to bring a judicial action anyway to recover an anticipated deficiency.

24. Whether or not they require a secured creditor to resort to the courts, many legal systems modify the normal rules of civil procedure when a secured creditor seeks to enforce security rights. These modifications may limit the time within which the court must act or limit the claims or defences that the parties may raise. If the court concludes that there has been default, the objective of any decision should be to satisfy the creditor's secured claim. The court should be authorized to order the debtor to pay the obligation, to dispose of the encumbered assets itself, or to turn over the assets to the secured creditor or to the court for disposition.

b. Freedom of parties to agree to the enforcement procedure

25. Another key issue for a secured transactions regime is the extent to which the secured creditor and grantor may agree to modify the statutory framework for the enforcement of the security right. Permitting the parties to agree freely on the consequences of their exchange encourages an efficient allocation of resources. When, however, a secured transactions law imposes mandatory obligations on a secured creditor, especially in those regimes that authorize enforcement with limited State intervention, the law may also prohibit or limit the parties' ability to contract out of these obligations. The law may also distinguish between terms agreed to at the time the security agreement is concluded and terms agreed to after the debtor has defaulted.

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[1] For example, under the Model Inter-American Law on Secured Transactions, the secured creditor has to file a notice of default and enforcement in the public register, and to deliver a copy to the debtor and any creditor with a publicized security right (see article 54). The secured creditor has to also apply to a court for an order of repossession which the court issues without a hearing (the debtor has to initiate an independent proceeding to challenge this order; see article 57). Once in possession of the asset, the secured creditor may sell it directly following certain prescribed procedures (see article 59).

c. Acceptance of the encumbered assets in satisfaction of the secured obligation

26. Following default the secured creditor may propose that it accept the encumbered assets in full or partial satisfaction of the secured obligation. Most jurisdictions make unenforceable an agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default, if the agreement is set out in the security agreement, although some laws make a subsequent agreement enforceable. The advantage of permitting subsequent agreements is that enforcement costs are minimized and the security right is terminated more quickly. The disadvantage is that the secured party may put undue pressure on the debtor or grantor in cases where the encumbered assets are more valuable than the obligation secured.

27. The law may guard against abusive behaviour by requiring the consent of the debtor and grantor, third parties or the court under certain circumstances, such as where the debtor has made substantial payments on the secured debt. Publicity may be required and a fixed delay before final settlement may be prescribed to allow an appeal to a court. The law might also require an official appraisal.

d. Redemption of the encumbered assets

28. Most laws permit a defaulting debtor or grantor to redeem the encumbered assets by paying the outstanding secured obligation, including interest and the costs of enforcement up to the time of redemption. Redemption brings the transaction to an end. The hope of redemption may encourage the debtor or grantor to search for potential buyers to purchase the encumbered assets and to monitor the secured creditor's acts closely. Redemption of the encumbered assets should be distinguished from reinstatement of the secured obligation. Reinstating the secured obligation (e.g. by paying a missed instalment) cures a default and the restored obligation continues to be secured by the encumbered assets. Redeeming the encumbered assets discharges the secured obligation.

e. Authorized disposition by the grantor

29. Following default, the secured party will be concerned about realizing the maximum value of the encumbered assets. Frequently, the debtor will be more knowledgeable about the market for the assets than the secured creditor. For this reason, the debtor is often given a limited period of time following default during which it is entitled to dispose of the encumbered assets.

f. Removing the encumbered assets from the grantor's control

30. Upon the debtor's default, the secured creditor who is not already in possession of the encumbered assets will be concerned about potential dissipation or misuse of the assets. This may be alleviated by placing the assets in the hands of a court, a State official, a trusted third party or the secured creditor itself. Permitting the secured creditor to take possession without any or only limited recourse to a court or other authority reduces the costs of enforcement (see para. 21). However, even those laws that permit such repossession by the secured creditor recognize the potential for abuse, especially the possibility of public disorder or intimidation. Most of these laws, therefore, condition repossession on avoiding a disturbance of the public order ("breach of the peace"). Some require prior notice of default as a precondition to taking possession.

31. In the special case where the encumbered assets threaten to decline rapidly in value, most laws provide for preliminary relief ordered by a court or other relevant authority to preserve the value of the assets.

g. Sale or other disposition of the encumbered assets

32. A security right entitles the secured creditor to have the encumbered assets sold or otherwise disposed of. The objective of the disposition should be to maximize the value of the encumbered assets, while not jeopardizing the legitimate claims and defenses of the grantor or other persons.

33. Requirements in existing legal systems range from the less to the more formal. Some legal systems require disposition subject to the same public procedures used to enforce court judgements. Other legal systems permit the secured creditor to control the disposition but prescribe uniform procedures for the disposition by public auction of encumbered assets, with rules on such matters as timing, publicity and minimum price. Yet other legal systems permit the secured creditor to control the disposition subject to flexible rules on how to proceed. These systems may condition the right of the creditor on the consent of the grantor, whether in the security agreement or after default. A general standard is usually prescribed which the secured creditor must observe (e.g. “commercially reasonable” or “with the care of a prudent business person”). There may also be special rules for how the proceeds of a disposition are to be collected and kept pending distribution.

34. Most secured transactions laws share the requirement that notice must be given to certain parties with respect to a proposed disposition. Due to the finality of any disposition, detailed rules are necessary to alert interested parties to protect their interest. The issues regarding whom to notify, the manner of notification, and the timing of notification are similar to those discussed in connection with default (see paras. 14-15). Special procedures are often prescribed for the sale of a business as a going concern .

h. Allocation of proceeds of disposition

35. To minimize disputes, a secured transactions law should set out rules on the distribution of the proceeds of the disposition. The most common allocation is to pay reasonable enforcement costs first and then the secured obligation. The law should include rules on if and when a secured creditor is responsible for distributing proceeds to some or all other secured creditors with security rights in the same encumbered assets. These rules should require that notice of these other interests be given to the secured creditor. The law should also provide that any surplus proceeds are to be returned to the grantor.

36. The proceeds distributed to the secured creditor are applied towards satisfaction of the secured obligation. If there is a deficiency after the distribution, the obligation should be discharged only to the extent of the proceeds received. The law should provide expressly that the secured creditor is entitled to recover the amount of the deficiency from the debtor. Unless the debtor creates a security right in other assets for the benefit of the creditor, the creditor’s claim for the deficiency is unsecured.

i. Finality

37. A secured transactions law should provide finality following disposition of the encumbered assets. The secured creditor's security right in the encumbered assets should terminate, as should the grantor's rights. The law should also determine whether the rights of other persons in the encumbered assets (including other secured creditors) continue notwithstanding disposition of the assets in the enforcement procedure.

j. Variations on general framework

38. A secured transactions law that includes within its scope many different types of encumbered assets may need to provide, where necessary, special rules for the disposition of some types of asset. This is especially true of intangibles, securities and negotiable instruments. For example, a secured creditor with a security right in a receivable should be entitled to inform the obligor of the receivable following the debtor's default.

39. A secured transactions law should also address the issue of how a secured creditor is to proceed when a single transaction includes security rights in both movable and immovable assets. Enforcement of a security right in fixtures may also require special rules to deal with the problem of severing a fixture from immovable property owned by someone other than the grantor.

5. Judicial proceedings brought by other creditors

40. The secured transactions law should be coordinated with general civil procedural law to provide a right for secured creditors to intervene in court proceedings to protect security rights and to ensure consistent ranking of claims. The other creditors of the debtor or grantor may resort to the courts to enforce their claims against the debtor and procedural law may give these creditors the right to force the disposition of encumbered assets. The secured creditor will look to procedural law for rules on intervening in these judicial actions in order to protect its priority. In some cases, procedural law may provide exceptions to general rules of priority. In some legal systems, for example, a court may order a person who owes money to a judgement debtor to pay the judgement creditor. If a secured creditor has a security right in this receivable, the court order may effectively give priority to the judgement creditor. If this reversal of the general rules of priority is unintended, the relevant law should be corrected.

B. Summary and recommendations

41. The key objectives of provisions on default and enforcement in a secured transactions regime are to:

(i) Provide clear, simple and transparent rules for the enforcement of security rights following a debtor's default, and for the post-default rights, obligations, and priorities of interested parties;

(ii) Maximize the realization value of the encumbered assets in a manner consistent with protection of the rights of interested parties and the public;

(iii) Provide transactional finality upon compliance with the enforcement procedure;
(iv) Clearly define the extent to which the secured creditor and the debtor may agree on the procedure for realization of the value of the encumbered assets; and
(v) Coordinate the enforcement rights and procedures of the security right regime with the rights and procedures for security rights in insolvency proceedings.

42. The law need not define "default". If a definition is included, it is sufficient to state that a default occurs when the debtor fails to perform a secured obligation or is otherwise in default, as defined by the security agreement or other law. The law should address the question whether notice of default should be given and to whom. The debtor should have recourse to the courts or other relevant authorities to challenge a creditor's claim of a default, or the calculation of the amount owing as a result of the default. To avoid unduly delaying rightful enforcement, the review should be expedited. Safeguards should be built into the process to discourage debtors from making unfounded claims to delay the enforcement.

43. [*Note to the Working Group: The Working Group may wish to consider the extent of judicial control of the enforcement process. The Working Group may wish to consider in particular (see paras.19-25 and 30-34):*

(i) whether, in the case of a non-posessory security interest, some type of official intervention should be required for the repossession of the encumbered asset by the secured creditor or whether the secured creditor should be authorized to remove the encumbered asset from the debtor's control, subject to provisions relating to public order; and
(ii) whether, subject to reasonable commercial standards and provisions guarding against abusive behaviour, the secured creditor should be authorized to dispose of the asset directly or through a court supervised procedure.]

44. Following default, the debtor or grantor should be permitted to redeem the encumbered assets by paying the outstanding secured obligation, including interest and the costs of enforcement up to the time of redemption.

45. The law should set out rules on the distribution of the proceeds of the disposition. Proceeds should be allocated in the following order: reasonable costs of disposition; the secured obligation; other secured obligations; and the surplus, if any, to the grantor. If application of the proceeds to the secured obligation leaves a deficiency, the secured creditor should be entitled to an unsecured claim for the deficiency against the debtor. Following disposition of the encumbered assets, there should be finality.

46. Special rules for the disposition of intangibles, negotiable instruments and fixtures should be considered. The law should also provide guidance on applicable procedures when a single transaction includes security rights in both movables and immovables.

47. There is a need for coordination with general civil procedural law to provide for intervention in court proceedings to protect security rights and to ensure consistent ranking of claims.