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Report on UNCITRAL-CFA international colloquium on secured transactions (Vienna, 20-22 March 2002)

Report of the Secretary-General*

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* This report is submitted late because it reports on a colloquium held only late in March and it is based on contributions by speakers, some of which were submitted much later.

Introduction

1. At its thirty-fourth session, the Commission decided to establish a working group with the mandate to develop an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, including the form of the instrument and the exact scope of assets that can serve as security.[1]

2. At that session, the Commission emphasized the importance of the subject of security interests and the need to consult with representatives of the relevant practice and industry, and recommended that a colloquium be held before the first session of Working Group VI (Security Interests).[2]

3. The colloquium, organized jointly with the Commercial Finance Association (CFA), was held in Vienna from 20 to 22 March 2002. The colloquium was designed to provide a forum for dialogue among practitioners, international organizations and Government representatives on the work of the Commission on security interests.

4. It was attended by approximately fifty experts from around twenty countries, including officials of Governments and international organizations, such as the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund (IMF) and the International Federation of Insolvency Professionals (INSOL). Speakers included experts who had significant experience in secured credit and insolvency law.

5. The present note provides a summary of the discussions that took place amongst the participants of the colloquium.

I. Economic background and scope

6. General support was expressed for a comprehensive scope of work that would encompass a broad range of assets as encumbered assets, a broad range of obligations to be secured and a broad array of debtors, creditors and credit transactions. It was noted that such an approach would be consistent with one of the key objectives of any efficient secured credit law, namely the need to permit parties to utilize the full value of their assets to obtain credit. However, a note of caution was struck that, to facilitate the completion of work within a reasonable timeframe and the wide adoption of the new regime, the scope of work should not be overly ambitious. It was also stated that, while immovables should not be covered, there were cases where a distinction might be difficult to draw (as was the case, for example, with fixtures and crops or enterprise mortgages that could include both movable and immovable assets).

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[1] *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 358.

[2] Ibid., para. 359.

7. It was emphasized that the new regime would be part of national law and as such would apply not only to international but also to purely domestic credit transactions.

Terminology

8. It was agreed that, while the focus should be on consensual security rights, priority conflicts with non-consensual security rights should also be addressed. It was, therefore, suggested that in any definition of "security right" reference should be made to both consensual (created by agreement) and to non-consensual (created by law or court judgement) security rights. It was also suggested that "security right" should be defined as a property right (i.e. a right *in rem*). As to the use of a uniform term "security right", it was stated that it did not prejudge the issue whether one uniform, functional security right should be introduced to replace all security rights or quasi-security rights existing under national law or a specific security right that would coexist with the various security devices used in the various legal systems (see para. 14).

9. It was stated that a distinction should be drawn between the terms "debtor" (the person that owes the secured obligation) and "grantor" (the person that gives an asset as security) to cover cases where a third party gives an asset as security in favour of the debtor. It was also observed that use of these terms should be consistent and the reasons for using one or the other term should be clear.

Key objectives

10. General support was expressed for the view that that the economic impact of secured transactions legislation should be emphasized. It was agreed that the overall objective of any efficient secured transaction legislation should be to promote increased availability of low-cost credit.

11. As to the particular objectives of such legislation, a number of suggestions were made. One suggestion was that the importance of balancing the interests of debtors, creditors and affected third parties should be emphasized. Another suggestion was that key objectives should be clear, simple and concise. Yet another suggestion was that the need to avoid that secured creditors become exposed to liabilities, such as environmental liabilities, should be highlighted. Yet another suggestion was that the importance of coordination between the secured transactions and insolvency law regimes should be emphasized. Yet another suggestion was that, while recognizing party autonomy was an important objective, it was often limited by statutory limitations. In that connection, it was stated that reference should be made to the United Nations Assignment Convention, which contained principles with respect to certain statutory limitations. Yet another suggestion was that it should be made clear that transparency could be achieved in various ways and not only through registration.

II. General approaches to security

12. It was noted that possessory security rights that were traditionally regarded as providing strong security were sufficiently regulated. However, the law in many countries needed to be further developed with regard to non-possessory security rights, for which there was a clear economic need. A number of questions were identified. One question was whether both possessory and non-possessory security

rights should be covered and, if so, whether the same rules could apply to both. Another question was whether quasi-security devices (e.g. retention and transfer of title arrangements) should be covered. Yet another question was whether a new uniform, functional security right should be established or a new special type of right to coexist with other types of current security or quasi-security rights.

13. It was stated that both possessory and non-possessory security rights should be covered and treated in the same way, unless a different treatment was justified by practical realities as was the case, for example, with the issue of repossession of the encumbered asset by the secured creditor. In addition, it was observed that quasi-security rights should also be covered. Moreover, it was said that a new uniform, functional, comprehensive security right in all types of asset should be introduced. On the other hand, it was pointed out that replacing existing security devices with a new uniform, functional security right might not be feasible or even desirable. In addition, it was said that covering retention and transfer of title arrangements in a secured transactions project might be particularly problematic and needed to be considered very carefully with a view to identifying advantages and disadvantages. It was agreed that the costs and benefits of a comprehensive, functional approach as compared with a specific approach should be explained in detail.

III. Creation of security rights

14. It was stated that it should be possible to give any type of asset as security and to secure any type of obligation. Particular reference was made to the need to allow security to be created in assets acquired after the conclusion of the security agreement and in changing pools of assets in order to secure even obligations arising after the conclusion of the security agreement and obligations in revolving credits. It was recognized that, in order to achieve that objective, it was necessary to adapt requirements as to the description of the encumbered asset or the secured obligation. It was also observed that policy choices to protect certain debtors (e.g. consumers) or unsecured creditors could be accommodated by way of limited exceptions. For example, household goods should not be made subject to security other than that necessary to secure their purchase price. Furthermore, it was said that a modern secured transactions regime should allow security to be created over an asset, whether the grantor had ownership or a limited right (e.g. a usufruct or a pledge). In that respect, it was pointed out that the object of security was not the asset itself but the grantor's right in the asset.

IV. Publicity

15. The discussion focused on whether an effective secured transactions regime dealing with non-possessory security rights required the establishment of a system in the context of which notices could be filed to alert potential financiers of the possible existence of security rights and to provide a basis for resolving conflicts between competing claims in the same assets. One view was that such a public registry was unnecessary. It was stated that fraudulent antedating of security instruments could be dealt with through less costly and complex requirements. It was also observed that the appearance of false wealth created by the debtor's continued possession of the encumbered assets was not a valid concern. It was pointed out that, in a credit-dominated economy, parties ought to know that an

enterprise's or even a consumer's assets were likely to be encumbered or be subject to a quasi-security device (e.g. lease or title retention).

16. In addition, it was said that parties should be presumed to be acting honestly and in good faith. The law should encourage that behaviour by providing for civil and even criminal penalties for dishonest or bad faith behaviour. Potential financiers could be adequately protected by the debtor's representations as to the existence of security rights combined with the debtor's promise not to give the same asset as security to another creditor without the consent of the secured creditor. It was also stated that the establishment and operation of a filing system would add cost and complexity to secured transactions. Moreover, it was observed that the filing system might inappropriately disclose confidential information even to competitors and thus harm debtors. Furthermore, it was said that priority rules based on filing of a notice about a transaction could inappropriately favour bank over supplier credit. Such supplier credit was said to be in many countries much more substantial in value and importance for the economy than bank credit.

17. In response, it was observed that anti-fraud and date-certain features were incidental partial benefits, but not the primary function of the filing system, which was to alert potential financiers of any existing security rights and to serve as a tool for resolving priority conflicts. It was also said that potential financiers could not rely only on the debtor's representations as to any existing security rights. In a global market, debtors may not be known to creditors or may not yet have established a relationship of trust with creditors. In that connection, it was pointed out that misrepresentations were not necessarily the result of dishonesty or bad faith. For example, in the absence of expert advice, a debtor might not easily understand that the fact that it has granted security over a general category of assets to one creditor precluded the debtor from offering specific assets from that category as security to other creditors. Miscalculation of the value of assets was also said to be a normal occurrence in practice that was not the result of dishonesty or bad faith.

18. As to the costs of establishing and operating a filing system, it was stated that such a system had been established and was working at a minimal cost even in some of the least developed countries of the world. It was also observed that one of the key characteristics of the filing system was low, flat filing fees. A system with high, *ad valorem* filing fees was generally found to be completely undesirable. In addition, with regard to the concern that a filing system might inadvertently disclose confidential information, it was observed that an efficient notice-filing system disclosed very little information. In any case, that information was not confidential, but was available on balance sheets or through various credit-reporting agencies. On the other hand, it was pointed out that, if such information was available, a filing system was not necessary and would unnecessarily increase transaction costs. Disagreement was expressed with that view since credit reporting systems could not play the function of alerting potential financiers to the possibility of the existence of any security rights or the function of resolving priority conflicts. It was also pointed out that there was a cost associated, in particular in the context of an insolvency proceeding, with determining priority in a legal system that did not provide sufficient information about competing claims. Moreover, as to the concern expressed as to the relevant priority of supplier credit, it was observed that even in countries with a notice-filing system priority was given to suppliers as long as they filed a notice about their claim. In that context again, the concern about publicizing a business relationship was raised in particular with respect to retention of title arrangements (see paras. 20-22).

V. Priority

19. It was stated that a system providing priority to different creditors permitted the use of the same asset as security for credit granted by multiple creditors. That result would facilitate the full utilization of the value of assets for the purpose of obtaining credit, which was said to be one of the key objectives of any efficient secured transactions regime. It was also observed that that objective could most effectively be achieved by a first-to-file priority rule. However, several objections were raised.

20. One objection was that requiring suppliers with a retention of title to secure payment of the price to file a notice each time they supplied goods would unnecessarily add cost and complexity to the transaction, while encouraging irresponsible or even dishonest behaviour on the part of the debtor or other grantor. It was stated that supplier credit was important for the economy and should not be disrupted. It was, therefore, suggested that a first-to-conclude-a-contract rule would be more appropriate. A creditor providing general credit should be expected to rely on the debtor to accurately describe to the general secured creditor the rights that the debtor may have granted to a supplier. Failure of the debtor to accurately report such information to the general secured creditor should make the debtor subject to civil or even criminal penalties.

21. In response, it was stated that suppliers should not need to file a notice each time they supplied goods but that one notice should be sufficient for goods provided during the duration of the contract. It was also observed that the filing fee should be nominal reflecting only the operating cost of the filing office. In addition, it was said that the absence of any notice had also cost implications since it was bound to create uncertainty. Moreover, it was stated that super-priority could be given to suppliers in order to protect supplier credit. Such an approach would be based on the fact that, once notice was filed about the supplier's rights, other lenders, whether previous or subsequent, would be on notice about the supplier's super-priority. As to the extent of the priority of supplier credit, it was stated that whether it would extend to proceeds (e.g. receivables) of the encumbered assets (e.g. inventory) would depend on whether the legislator wanted to promote more receivables as opposed to inventory financing.

22. As to the suggestion that a general creditor should rely on the representations of the debtor, several countervailing considerations were mentioned. One consideration was that it was questionable whether the secured creditor could rely on the debtor to know accurately and specifically the scope and nature of the rights that it might have given to the supplier. It was stated that relying on the debtor assumed a certain quality of record-keeping which especially with a company in financial distress might not be available or readily accessible. Another consideration was that relying on the debtor's description of the rights given to the supplier might not be safe as there was the possibility that the supplier might have a different view of the scope and nature of its rights against the debtor and its assets from that given by the debtor. Yet another consideration was that while criminal penalties might be severe, their implementation might not be sufficiently certain since the standards required to find liability under criminal law were normally greater than under civil law. Lowering those standards was said to be inappropriate. In addition, criminal

penalties from the secured creditor's perspective were not a substitute for repayment of its debt pursuant to recourse to the property of the debtor.

23. On the other hand, it was stated that a secured transactions regime that would include retention of title rights (purchase-money security rights) would be complex. In response, it was stated that the nature of that financing was relatively simple and straightforward and that suppliers and secured creditors were easily identified for purposes of the debtor providing the applicable information to the general secured creditor. That fact was confirmed also by the absence in many countries of a requirement that suppliers comply with the notice filing to establish priority. It was also observed that the absence of a filing might involve additional evidentiary burdens. The, supplier, for example would have to prove that it had a valid reservation of title and the date such rights were established. The possibility was also raised that rights in property to secure debt, such as pursuant to a retention of title by a seller of goods, might continue to exist as a separate category of rights, but could still be made subject to a filing system as a method of establishing priority relative to other types of security rights.

24. The need to grant super-priority to certain non-consensual rights (e.g. of the State for taxes or of employees for wages) was also emphasized. Divergent views were expressed as to whether notice should be filed about such rights.

VI. Pre-default rights and obligations of the parties

25. There was general support for the view that that any default rules should be limited to those that were absolutely essential and those that the parties would have most likely have agreed to. Some doubt was expressed as to the need for a rule providing that the encumbered assets should be insured. It was noted that in some jurisdictions insurance was not made available for many types of assets.

26. The need to distinguish between rights and obligations for possessory and non-possessory security was questioned in view of the fact that some of the default rules applied to both possessory and non-possessory security (e.g. the secured creditor's right to assign the secured obligation). It was also noted that the right to repledge conferred on the secured creditor referred to the right to repledge the security right in the encumbered asset rather than the encumbered asset itself.

VII. Default and enforcement

27. The importance of providing for effective enforcement of security rights was emphasized. It was stated that the best law for the creation of security rights would be of no practical use if secured creditors were unable to realize the economic value of their rights. In that connection, attention was called to the need to review the institutional context in which enforcement took place and to assess frankly the efficiency of procedures used by institutions such as the civil courts. It was also observed that reference should be made also to arbitral tribunals and other non-judicial bodies.

28. The diversity of possible mechanisms for realizing the economic value of security rights was also emphasized. With respect to procedures for initiating enforcement, it was stated that there were several alternatives. Alternatives

mentioned included enforcement by the secured creditor without prior court intervention, enforcement by the creditor with executory title, registered with a court or notarized, and enforcement based on presumptions or a limitation of defences in cases where judicial action was required. Some preference was expressed in favour of enforcement by the creditor without prior court intervention, with executory title issued by a notary as the second-best solution. It was also stated that, if judicial action were required, debtor defences should be limited to avoid dilatory practices. For example, in the case of a non-possessory right the only defence against reposession should be that there was no default (and not the anount owed or other details). In addition, it was observed that the secured creditor should be able to sell the encumbered assets at the market price in the place where the assets were located. Moreover, it was stated that it was essential to ensure that assets would be converted into cash in a timely manner in order to avoid loss of value.

29. Attention was also called to the need to provide prompt and effective ways for a secured creditor to take possession of the encumbered assets following default in the case of a non-possessory security right. In other respects, however, it was not thought necessary to distinguish between possessory and non-possessory security rights. The view was expressed that the potential for abuse by secured creditors should also be considered. The example was given of agreements between debtors and secured creditors that in some jurisdictions were treated differently in the sense that pre-default agreements were void, while post-default agreements were valid and enforceable.

VIII. Insolvency

30. It was agreed that both secured transactions and insolvency regimes were concerned with debtor-creditor relationships and that both regimes exercised an important influence on corporate governance in the sense that they both had an interest in credit discipline and responsibility for debt. It was also agreed that there were also areas of tension between the two regimes, such as, for example, the different approaches to debt, to the extent that each regime upheld different rights and had different stakeholder constituencies.

31. It was stated that the insolvency viewpoint was not adverse to and should support a secured transactions regime that enabled the consensual “creation” of appropriately defined third-party security rights interests in property. The need was identified to clarify and to provide certainty in the classification of “quasi-security devices”, such as retention of title and financial leases. It was pointed out that the greater the range of property over which security might be taken, the greater the possibility of assessing the ability of a borrower to service a borrowing (that reduced over-indebtedness and consequent insolvency).

32. In addition, it was observed that an insolvency viewpoint also supported a notice-filing system that would be all embracing and provide a certain, efficient and cost-effective search base. It was said that a filing system provided an insolvency representative with certainty by facilitation the identification of encumbered assets, the secured obligation and the secured creditor. It would also assist an insolvency representative in determining validity and enforceability and in determining priority between competing security rights over the same property. Within the context of

registration, however, two issues were mentioned as requiring particular consideration. The first concerned whether a secured transaction or an insolvency regime should emphasize the need for filing by, for example, avoiding or otherwise rendering ineffective unregistered secured property rights for failure to file or otherwise perfect. It was mentioned that that approach was taken in some insolvency and secured transactions regimes. The second issue concerned the applicability to secured transactions, otherwise validly concluded, of provisions dealing with the avoidance of antecedent preferential and fraudulent transactions as found in most insolvency law regimes.

33. With regard to the actual impact of the commencement of an insolvency process upon secured creditors, it was suggested that it might be necessary to distinguish between liquidation and rescue processes. Under the former, an insolvency viewpoint would generally support the view that in a liquidation process there should be no lengthy or, indeed, any stay or suspension on enforcement of a security right. However, in relation to a rescue process, there should be a stay or suspension on enforcement of a security right, because of the possibility of enhanced value through rescue and of avoiding dismemberment of the estate. That should not, however, affect or threaten the substantive rights of secured creditors, but rather postpone the exercise of immediate enforcement rights. More difficult issues mentioned included: binding a secured creditor to a rescue plan; abuse of a rescue process by debtors; post-insolvency commencement funding; and the possible creation of a "super priority" that might affect holders of existing security rights. The need to coordinate enforcement and insolvency responses with the work of the Working Group on Insolvency Law was also emphasized.

IX. Conflict of laws

34. The discussion focused on the law that should govern the creation, publicity and priority of security rights over receivables and inventory. With respect to receivables, the appropriateness of the conflict rule contained in the United Nations Assignment Convention (leading to the application of the law of the grantor's location) was confirmed. It was observed, however, that for certain categories of intangibles, such as bank deposits and securities accounts, a different approach might need to be taken.

35. With respect to the law applicable to security rights over tangible property, it was noted that there were two alternatives. The first alternative was the traditional rule, which subjected creation, publicity and priority issues to the law of the State in which tangible assets were located (*lex situs*). The second alternative was a two-fold rule according to which creation and publicity would be governed by the law of the location of the grantor but priority would be governed by the *lex situs*.

36. A number of concerns were raised with respect to the second alternative. One concern was that such a rule would run counter to the expectations of third parties that would expect the *lex situs* to apply to all property aspects of a security right in tangible property. Another concern was that a two-fold rule might be difficult to apply if the legal system governing priority was based on publicity concepts that did not exist under the law of the location of the grantor. However, in support of such a bifurcated rule it was stated that departing from the traditional rule would have the benefit of applying the same law to the creation and publicity of a security right in both tangible and intangible property.

37. As to the law applicable to enforcement, it was suggested that most of enforcement-related issues should be governed by the *lex situs*, since enforcement was necessary when the debtor did not voluntarily perform its obligations and the assistance of local authorities was required. It was also stated that enforcement might not be treated as a single issue but a series of issues. It was also observed that some of those issues might be subject to party autonomy (e.g. disposition of encumbered asset by agreement of the parties), while with respect to other issues that raised public policy issues an objective connecting factor might need to be used.

38. With respect to the law applicable to insolvency proceedings, it was stated that, in the case of assets located in the State where the main insolvency proceeding was opened, the widely accepted rule, providing for the application of the law of that State, should be adopted. As to the situation in which assets were located in another jurisdiction, it was stated that there was no generally accepted solution and the matter needed to be discussed with a view to providing guidance to States.

X. Transition

39. It was stated that the contents of any transition rules would depend on the circumstances prevailing in each State and that, therefore, no guidance could be provided to States. It was recognized, however, that the matter should be discussed since, in the absence of adequate transition rules, either parties mightd not be able to obtain the full benefits of new legislation or existing relationships might be disrupted.