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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

Contents

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III. Basic approaches to security

A. General remarks

1. Introduction

1. Over time, a broad variety of practices have been developed in different countries to secure a creditor's claims (usually for monetary payment), against its debtor. This Guide focuses on the core practices which, in many countries, have proved to be particularly efficient (i.e. the contractual creation of a property right).

2. In a general sense, it is possible to distinguish three major types of instruments that are used for the purposes of security. These are, first, instruments designed for and openly denominated as security (see section A.2); second, the recourse to title (ownership) for purposes of security combined with various types of contractual arrangements (see section A.3); and, third, a uniform comprehensive security (see section A.4).

2. Instruments traditionally designed for security

a. Security rights in tangible movable property

3. Traditionally, most countries distinguish between proprietary security rights in tangible movable property ("tangibles"; see section A.2.a) and those in intangible movable property ("intangibles"; see section A.2.b). In fact, the tangible nature of an asset gives rise to forms of security that are not available for intangibles.

4. Within the group of security rights in tangibles, most countries draw a distinction based upon whether the debtor (or a third party) granting the security can retain possession or not. The first alternative is traditionally designated as possessory security and the second alternative as non-possessory security.

i. Possessory security

(a) Pledge

5. By far the most common (and also ancient) form of possessory security in tangibles is the pledge. A pledge requires for its validity that the debtor (or a third-party grantor) effectively give up possession of the encumbered tangibles and that these be transferred either to the secured creditor or to a third party agreed upon by the parties (e.g. a warehouse). The required dispossession of the debtor (or other grantor) must not only occur at the creation of the security right but it must be maintained during the life of the pledge; return of the encumbered assets to the debtor usually extinguishes the pledge.

6. Dispossession need not always require physical removal of the encumbered assets from the debtor's premises, provided that the debtor's access to them is excluded in other ways. This can be achieved, for example, by handing over the keys

to the rooms in which the encumbered assets are stored to the secured creditor, provided that this excludes any unauthorized access by the debtor.

7. The debtor's dispossession can also be effected by delivering the encumbered assets to, or by using assets that are already held by, a third party. Examples are merchandise or raw materials stored in a warehouse or a tank of a third party. An institutional (and more expensive) arrangement may be involving an independent "warehousing" company, which exercises control over the pledged assets as agent for the secured creditor. For this arrangement to be valid, there cannot be any unauthorized access by the debtor to the rooms in which the pledged assets are stored. In addition, the warehousing company's employees must not work for the debtor (if they are drawn from the debtor's workforce, because of their expertise, they may no longer work for the debtor).

8. In the case of assets of a special nature, such as documents and instruments (whether or not negotiable), that embody rights in tangible assets (e.g. bills of lading or warehouse receipts) or intangible rights (e.g. negotiable instruments, bonds or share certificates), dispossession is effected by transferring the documents or instruments to the secured creditor. However, in this context, the line between possessory and non-possessory security may not always be easy to draw.

9. In view of the debtor's dispossession, the possessory pledge presents three important advantages for the secured creditor. First, the debtor is unable to dispose of the pledged assets without the secured creditor's consent. Second, the creditor does not run the risk that the actual value of the encumbered assets will be reduced through the debtor neglecting upkeep and maintenance. Third, if enforcement becomes necessary, the secured creditor is saved the trouble, time, expense and risk of having to claim delivery of the encumbered assets from the debtor.

10. On the other hand, the possessory pledge has certain disadvantages. The greatest disadvantage for the debtor is the required dispossession, which precludes the debtor from using the encumbered assets. Dispossession is particularly troublesome in situations where possession of the encumbered assets is necessary for the debtor to generate the income from which to repay the loan (as is the case, for example, with raw materials, semi-finished goods, equipment and inventory).

11. For the secured creditor, the possessory pledge has the disadvantage that the secured creditor has to store, preserve and maintain the encumbered assets, unless a third party assumes this task. Where secured creditors themselves are neither able nor willing to assume these charges, entrusting third parties will involve additional costs that will be directly or indirectly borne by the debtor. Another disadvantage is the potential liability of the secured creditor in possession of encumbered assets (e.g. pledgee, holder of a warehouse warrant or a bill of lading) that might have caused a damage. This is a particularly serious problem in the case of liability for contamination of the environment, since often the monetary consequences (cleanup, damages) substantially exceed the value of the encumbered asset, let alone the prejudice to the reputation and image of the lender. Very few laws address environmental liability of secured creditors in possession. Some of them set it aside (see, for example, the Swedish Environmental Code of 11 June 1998, whose basic exemption principle was subsequently adopted by the European Union Commission

White Book on environmental liability of 9 February 2000). Other laws limit the liability under certain conditions (e.g. the Comprehensive Environmental Response, Compensation, and Liability Act of the United States of America; "CERCLA", as amended).

12. However, where the parties are able to avoid the aforementioned disadvantages, the possessory pledge can be utilized successfully. There are two major fields of application. First, where the encumbered assets are already held by or can easily be brought into the possession of a third party, especially a commercial keeper of other persons' assets. The second field of application is where instruments and documents, embodying tangible assets or intangible rights, can be easily kept by the secured creditor itself (such situations are addressed by special laws).

(b) Right of retention

13. A right of retention is a contractual (not a property) right. It allows a party whose contractual partner is in breach of contract to withhold its own performance and, in particular, an asset which under the terms of the contract the withholding party is obliged to deliver to the party in breach. For example, a repair shop need not return a repaired item to the customer if the latter, contrary to their agreement, does not pay the price agreed upon.

14. If, however, a contractual right of retention is reinforced by the power to sell the retained item, the party entitled to retention obtains a property right in the retained asset. In some legal systems, this property right is regarded as a pledge, although the method of its creation deviates from that of the pledge proper (see paras. 5-8). Alternatively, a reinforced right of retention may be regarded as having some of the effects of a pledge.

ii. Non-possessory security

15. As noted above (see para. 10), a possessory pledge of tangibles required for production or sale (such as equipment, raw materials, semi-finished goods and inventory) is economically impractical. These goods are necessary for the entrepreneurial activity of commercial debtors. Without access to, and the right and power of disposition over those assets, the debtor would not be able to earn the necessary income to repay the loan. This problem is particularly acute for the growing number of commercial debtors who do not own immovables that can be used as security.

16. To address this problem, laws, especially in the last fifty years, began providing for security in movable assets outside the narrow confines of the possessory pledge. While some countries introduced a new, functional security right, most countries, historically, insisted on the "pledge principle" as the only legitimate method of creating security in movable assets. The English common law "charge" was for some time the only genuine non-possessory security. In the twentieth century, legislators and courts have come to acknowledge the economic need to provide security without recourse to the possessory pledge.

17. Individual countries attempted to find appropriate solutions according to particular local needs and taste. The result is a diverse range of solutions. An external indication of the existing diversity is the variety of names for the relevant institutions, some times differing even within a single country, such as: "fictive" dispossession of the debtor; non-possessory pledge; registered pledge; *nantissement*; warrant; *hypothec*; bill of sale; chattel mortgage; trust; etc. More relevant is the limited scope of application of the approaches taken. Only few countries enacted a general statute on non-possessory security (for a more comprehensive approach, see section A.4). Some countries have two sets of legislation, one dealing with security for financing of industrial and artisanal enterprises, the other with security for financing of farming and fishing enterprises. In most countries, however, there is a variety of statutes covering only small economic sectors, such as the acquisition of cars or of machinery, or the production of films.

18. In some countries, there is even some reluctance to allow security rights in inventory. This is sometimes based upon an alleged inconsistency between the creditor's security right and the debtor's right and power to sell. Another objection is that the disposition of inventory will often give rise to difficult conflicts between multiple transferees or multiple secured creditors. Yet another possible objection may come from a policy choice to make inventory available for the satisfaction of the claims of the debtor's unsecured creditors.

19. Varied as the legislation providing for non-possessory security might be, it shares one common feature, namely that some form of publicity of the security right is usually provided for. The purpose of publicity is to dispel the false impression of wealth which may be given by the fact that the security right in assets held by the debtor is not apparent ("secrecy"; for details, see chapter V, Publicity).

20. There appears to be a need to bridge the gap between the general economic demand for security in commercial assets that are and must be held by the debtor, with the often limited access to such security. A major purpose of legal reform in the area of non-possessory security in general and of this Guide in particular is to develop suggestions for improvement in this special field and in the related field of security in intangibles (see section A.2.b).

21. While modern regimes have shown that difficulties can be overcome, legislation on non-possessory security is more complicated than the regulation of the traditional possessory pledge. This is due mainly to the following four main characteristics of non-possessory security rights. First, since the debtor retains possession, it has the power to dispose of or create a competing right in the encumbered assets, even against the secured creditor's will. This situation makes necessary the introduction of rules concerning the effects and priority of such dispositions (see Chapter VII, Priority). Second, the secured creditor must ensure that the debtor in possession takes proper care of, duly insures and protects the encumbered assets to preserve their commercial value. This makes it necessary for the secured creditor to address these matters in the security agreement with the debtor (see Chapter VIII, Rights and obligations of parties before default). Third, if enforcement of the security becomes necessary, the secured creditor will often prefer to obtain the encumbered assets. However, if the debtor is not willing to part with those assets, court proceedings may have to be instituted. Proper remedies and

possibly an accelerated proceeding may have to be provided for (see chapters IX, Default and enforcement, and X, Insolvency). Fourth, the appearance of false wealth in the debtor which is created by secret security rights in assets held by the debtor may have to be counteracted, where it is felt necessary, by various forms of publicity (see chapters V, Publicity, and VI, Publicity via filing).

22. In view of earlier legislative models (see paras. 16-19), legislators may be faced with three alternatives. One alternative may be to adopt uniform legislation for both possessory and non-possessory security rights (see section A.4). Another alternative may be to adopt uniform legislation for non-possessory security rights, leaving the regime on possessory rights to other domestic law (see Model Law of Organization of American States; see also para. 40). Yet another alternative may be to adopt special legislation allowing non-possessory security for credit to debtors in specific branches of business. The prevailing trend of modern legislation, both at the national and the international level is towards a uniform approach at least as far as non-possessory security is concerned. A selective approach is likely to result in gaps and inconsistencies, as well as in discontent in those sectors of the industry that might be excluded.

b. Security rights in intangible movable property

23. Intangibles comprise a broad variety of rights (e.g. right to the payment of money or the performance of other contractual obligation, such as the delivery of oil under a production contract). They include some relatively new types of asset (e.g. securities, certificated or uncertificated, held directly by the owner or through an intermediary). Intellectual property rights (i.e. patents, trade marks and copyright) form another group of intangibles. In view of the dramatic increase in the economic importance of intangibles in recent years, there is a growing demand to use these rights as assets for security. Even in inventory or equipment financing transactions, security is taken in inventory- or equipment-related intellectual property rights and often the main value of the security is in those rights.

24. By definition, intangibles are incapable of (physical) possession. Nevertheless, most codes of the so-called “civil law” countries have dealt with the creation of possessory pledges (see paras. 5-12) at least in monetary claims. Some codes have attempted to create the semblance of dispossession by requiring the debtor to transfer any writing or document relating to the pledged claim (such as the contract from which the claim was derived) to the creditor. However, such transfer does not suffice to constitute the pledge. Rather, the debtor’s “dispossession” is usually (quite artificially) replaced by requiring that a notice of the pledge be given to the debtor of the pledged claim.

25. In some countries, techniques have been developed that achieve ends that are comparable to those attained by the possession of tangibles. The most radical method is the full transfer of the encumbered right (or the encumbered share of it) to the secured creditor. However, this goes beyond creation of a security right and amounts to transfer of title (see section A.3.a). Under a more restrained approach, title to the encumbered rights is not affected but dispositions by the debtor that are not authorized by the secured creditor are blocked. This technique can be used where a person other than the person owing the performance in which the secured creditor’s

right is created (the third-party debtor) has the power to dispose of the encumbered right. In the case of a bank account, if the debtor as holder of the account agrees that its account can be blocked in favour of the secured creditor, the latter has the equivalent of possession of a tangible movable. That is even more true if the bank itself is the secured creditor.

26. In modern terminology, such techniques of obtaining "possession" of intangible property are appropriately called "control". The degree of control though may vary. In some cases, the control is absolute and any disposition by the debtor is prevented. In other cases, the debtor is allowed to make certain dispositions or dispositions up to a fixed maximum, as long as the secured creditor has access to the account. Control may be a condition for the validity of a security right (see A/CN.9/WG.VI/WP.2/Add.4, para. …) or priority (see A/CN.9/WG.VI/WP.2/Add.7, para. …).

3. The use of title for security purposes

27. In addition to instruments for security proper (see section A.2), practice and sometimes also legislation has in many countries developed an alternative approach for non-possessory security rights in both tangible and intangible assets, namely title (or ownership) as security (*propriété sûreté*). Title as security can be created either by transfer of title to the creditor (see section A.3.a) or, by retention of title by the creditor (see section A.3.b). Both transfer and retention of title enable the creditor to obtain non-possessory security (for the economic need for, and justification of, non-possessory security, see para. 15).

a. Transfer of title to the creditor

28. There are two features that make the security transfer of title attractive for creditors in certain jurisdictions. First, the requirements for transferring title to another person are often less demanding than the requirements for creating a security right. Second, in the case of enforcement and in the case of the debtor's insolvency, a creditor often has a better position as an owner than as a holder of a mere security right. In other jurisdictions, there is no difference between title for security purposes and security rights with respect to the requirements for creation or enforcement.

29. The security transfer of title has been allowed by law in some countries and by court practice in other countries. In many other countries, especially from the civil law world, such transfers of title are regarded as a circumvention of their ordinary regime of security instruments proper and are therefore held to be void. Some jurisdictions compromise by reducing the effect of a security transfer of title to that of an ordinary secured creditor, especially where it competes with other creditors of the debtor.

30. Legislators are faced with two policy options. One option is to admit security transfers of title with the (usually) reduced requirements and the greater effects of a full transfer, thus avoiding the general regime for security rights. The other option is to admit security transfers of title, but to limit either the requirements or the effects or both to those of a mere security right. The first option may result in enhancing the

secured creditor's position, while weakening the position of the debtor and the debtor's other creditors. This solution may make sense if the ordinary security regime for non-possessory security is underdeveloped. Under the second option, a graduated reduction of the secured creditor's advantages and of the other parties' corresponding disadvantages is possible, especially if the requirements of a transfer or its effects or both are limited to those relating to a security right. Any variant of this solution also may make sense to counter specific weaknesses of the ordinary regime for non-possessory security.

b. Retention of title by the creditor

31. The second way of using title as security is by contractual retention of title (reservation of ownership). The seller or other lender of the money necessary to purchase tangible or even intangible assets may retain title until the full payment of the purchase price. This type of transaction is often called "purchase money financing", (see description and example in A/CN.9/WG.VI/WP.2/Add.2, paras. 3-5).

32. A variation of a retention of title arrangement (or purchase money financing) is achieved by combining a lease contract with an option to purchase for the lessee (for a nominal value), which may only be exercised after the lessee has paid most of the "purchase price" through rent instalments (see example in A/CN.9/WG.VI/WP.2/Add.2, para. 7). In some cases, where the lease covers the useful life of, e.g., equipment, it is a retention of title arrangement even without an option to buy.

33. Economically, a retention of title arrangement provides a security right which is particularly well adapted to the needs of, and therefore is widely used by, sellers for securing purchase money credit. In many countries, this kind of credit is widely used as an alternative to bank financing that is not purchase money financing. A bank may provide purchase money financing, for example, where the seller sells to a bank and the bank sells to buyer with a retention of title or where the buyer pays the seller in cash from a loan and gives to the bank title as security for the loan. For the promotion of competition, this source of credit and its attendant specific security deserve special attention.

34. Due to its origin as a term of a contract of sale or lease, many countries regard the retention of title arrangement as a mere quasi-security, and, therefore, not subject to the general rules on security, such as requirements of form, publicity or effects (principally priority). Contrary to the transfer of title, its retention by the creditor has, in many countries, a privileged status. This may be justified by the desire to promote purchase money financing by suppliers as an alternative to bank credit that is not purchase money financing. Another argument often used, but less convincing, is that the seller, by parting with the sold goods without having received payment, requires protection.

35. In contrast, a number of jurisdictions do not recognize or even prohibit retention of title clauses. Other countries restrict the scope of application of such clauses by denying them effect with respect to certain assets, especially inventory, on the theory that the seller's retention of title is incompatible with the seller granting to the buyer the right and power of disposition over the inventory.

36. Several policy options may be considered. One option is to preserve the special character of the retention of title arrangement as title device. Another option might be to limit the effect of the retention of title arrangement to: only the purchase price of the respective asset to the exclusion of any other credit; and/or to the purchased asset to the exclusion of proceeds or products. Yet another option might be to integrate the retention of title arrangement into the ordinary system of security rights. In such a case, certain advantages should be granted to the seller-creditor. Yet another option might be to place the retention of title fully on a par with any other non-possessory security.

37. The first two options would preserve or even create a special regime outside a comprehensive system of non-possessory security rights. In particular, the first option provides the seller-creditor with extensive privileges, a result that has consequential disadvantages for competing creditors of the buyer, especially in the case of execution and insolvency. A technical disadvantage of the title approach is that it prevents the buyer from using the purchased assets for granting a second-ranking security to another creditor. Another disadvantage of the title approach is that executions by the buyer's other creditors are impossible or difficult without the seller's consent.

38. The last two options mentioned above (see para. 36) are more in line with a comprehensive system of security rights. These options accept that the seller extending credit deserves a certain privileged position since it parts with the sold goods on credit and purchase money credit should be promoted for economic reasons. On the other hand, in the interest of competing creditors, the privilege is limited to the purchase price for the specific asset and to the sold goods as such. By contrast, rights in proceeds or products of the purchased goods do not enjoy such a privilege and are subject to the rules applicable to ordinary security rights.

39. Conversion of retention of title to a security right would enhance the position of the buyer-debtor since it would be enabled to create a second-ranking (non-possessory) security right to secure a loan from another creditor. It would also improve the position of other creditors of the buyer-debtor in the case of execution with respect to the encumbered asset and in the case of the debtor's insolvency.

4. Uniform comprehensive security

40. The idea of a single, uniform, comprehensive security right was first developed in the United States of America in the middle of the twentieth century in the context of the Uniform Commercial Code ("UCC"). The Uniform Commercial Code, a model law adopted by all fifty states, created a single, comprehensive security right. Article 9 UCC unified numerous and diverse possessory and non-possessory rights in tangibles and intangibles, including transfer and retention of title arrangements, that existed under state statutes and common law. The idea spread to Canada and New Zealand and has been adopted by a few countries in Europe. It is recommended in the Model Law of the European Bank for Reconstruction and Development. The Model Law of the Organization of American States, which follows in many respects a similar approach, is restricted to non-possessory security,

leaving possessory security to state law in view of the division of legislative powers in federal States.[1]

41. The main feature of a broad, all-comprehensive approach is that it merges the rules for the traditional possessory pledge with rules on non-possessory pledge and on the transfer or retention of title for security purposes. This approach results in the creation of a single, comprehensive and consistent system of security rights that avoids gaps and inconsistencies. The policies underlying the basic approach and the contents of the individual provisions implementing it can freely be determined by each legislature. For example, within this unitary system, special interests may be addressed by means of priority rules (e.g. for purchase money security).

B. Summary and recommendations

42. In certain, albeit limited, practical situations, the possessory pledge functions usefully as a strong security right.

43. A contractual right of retention, if accompanied by the creditor's power of sale, functions as a possessory pledge (see para. 14).

[*Note to the Working Group: The Working Group may wish to consider subjecting such a contractual right of retention to the same rules that govern possessory pledges, perhaps, with the exception, at least in some cases, of the rules governing the creation of such rights of retention*].

44. Non-possessory security rights are of utmost importance for a modern and efficient regime governing secured transactions. Debtors need to retain possession of encumbered assets and secured creditors need to be protected against competing claims in the case of debtor default and in particular insolvency (see para. 15).

[*Note to the Working Group: The Working Group may wish to consider whether such a regime should govern both possessory and non-possessory security rights or only non-possessory security rights (see para. 22)*.]

45. In light of the growing importance of intangibles as security for credit, and the often insufficient rules applicable to this type of security, it would be desirable to develop a modern legal regime for intangibles (see para. 23).

[*Note to the Working Group: To ensure consistency, the Working Group may wish to consider that a regime for security rights in intangibles should be as close as possible to that for non-possessory security in tangibles.*

The Working Group may also wish to discuss the recommendations to be made in the Guide with respect to intangibles and particular types of intangibles, such as securities and intellectual property rights and receivables arising therefrom. In its discussion of this matter, the Working Group may wish to take into account: the work of other organizations; the fact that intangibles may be taken as security in the

[1] In States such as Argentina, Brazil and Mexico only the provinces have the legislative power to enact law on possessory pledges.

context of transactions relating to security in tangibles (e.g. inventory or equipment financing); and the complexity and feasibility of a regime on security interests in intangibles.

In addition, the Working Group may wish to consider whether the transfer of title for security purposes is useful and should be retained in an efficient and effective system of non-possessory security in tangible and intangible assets (see para. 30). The Working Group may also wish to consider whether retention of title should be treated as a title or a security device (see paras. 36-37).

If the Working Group decides to treat retention of title as a security device, it may wish to confer upon the seller-creditor or other purchase money credit provider a special priority equivalent to that of a holder of title. Such a special priority could be limited to the sold asset and to its outstanding purchase price (to the exclusion of proceeds and other credits (see para. 38). The Working Group may also wish to consider that treating the retention of title as equivalent to an "ordinary" security right should not prejudice its qualification for other purposes (e.g. taxation, accounting, etc.).

Moreover, the Working Group may wish to consider the advantages and disadvantages of the approach taken in several modern security laws that introduce a uniform comprehensive security right (see paras. 40-41).]