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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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Draft legislative guide on secured transactions

[Prefatory remarks to be prepared at a later stage]

I. Introduction**A. Purpose and scope**

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws, with the goal of promoting the availability of low-cost secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.
2. The Guide is based on the premise that sound secured transactions laws can have many benefits for States that adopt them, including attracting credit from domestic as well as from foreign creditors, promoting the development and growth of domestic businesses, and generally promoting trade. Such laws also can result in benefits for consumers by lowering the cost of goods and services and promoting the availability of low-cost consumer credit. To be effective in promoting the availability of low-cost credit, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws.
3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable and limited costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.
4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development, the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.
5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing credit risk for the creditor. Risk is reduced because credit secured by the assets of a business gives creditors access to the assets as another source of payment in the event of non-payment by the debtor. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls. On the other hand, in States where creditors perceive the risks associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. In some States, the absence of an efficient and effective secured transactions regime or of an insolvency law regime, under which security rights are recognized, has resulted in the virtual elimination of credit for consumers, as well as for small and medium commercial enterprises.

7. Creating a legal regime that promotes secured credit not only aids in the cultivation and growth of individual businesses, but also can have a positive effect upon the economic prosperity of States. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves a valuable potential economic benefit.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. The primary focus of the Guide is consensual security rights in movables, and the Guide suggests that a broad range of movables be permitted to serve as encumbered assets, including inventory, equipment and receivables. In addition to movables, the Guide covers immovables that are fixtures, and also recommends the recognition of a security device (sometimes referred to as an “enterprise mortgage”) under which an enterprise may create a security right in all or substantially all of its assets (including immovables) so long as this security device does not inappropriately conflict with other laws dealing with real property. Although the Guide focuses on consensual security rights, it also contains references to non-consensual security rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.2/Add.7, paras. 33-38).

9. The Guide does not cover security rights in securities as original encumbered assets (as to rights in proceeds, see ...). The nature of securities and their importance for the functioning of financial markets gives rise to a broad range of issues that merit special legislative treatment. These issues are the subject of a text being prepared by the International Institute for the Unification of Private Law (UNIDROIT). The law applicable to security and other rights in securities is addressed in a convention being prepared by the Hague Conference on Private International Law. The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts being prepared by UNIDROIT and the Hague Conference. [*Note to the Working Group: In due course, the Working Group may wish to expand on this matter*].

10. Because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the mutual recognition of security rights validly created in other jurisdictions. This would represent a marked improvement over the laws currently in effect in many States, under which security rights often are lost once an encumbered asset is transported across national borders,

and would go far toward encouraging creditors to extend credit in cross-border transactions.

11. Various concerns with respect to secured credit have been voiced. For example, providing a creditor with a priority claim to all or substantially all of a grantor's assets (who may be the debtor or a third party, see Terminology, Section B) may appear to limit the ability of the grantor to obtain financing from other sources. Additionally, a secured creditor can wield significant influence over a grantor's business, as the creditor may seize, or threaten seizure of, the encumbered assets upon default. There is also the further concern that secured creditors will effectively take most or all of an insolvent grantor's assets and leave little for unsecured creditors, some of whom are not in a position to bargain for a security right in the grantor's assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, the Guide suggests solutions.

12. Throughout, the Guide seeks to establish a balance between the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, purchasers and other transferees and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that creditors will accept such a balanced approach, and will thereby be encouraged to extend low-cost credit, so long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will realize the economic value of the encumbered assets. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization of an insolvent debtor. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since this matter does not lend itself to unification.

13. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the United Nations Convention on the Assignment of Receivables in International Trade, adopted in December 2001; the Convention on International Interests in Mobile Equipment, approved in November 2001; the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the OAS Model Inter-American Law on Secured Transactions, prepared in 2002; [...].

B. Terminology

14. This Guide has adopted terminology to express the concepts that underlie a secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given the term may differ. This approach is taken to provide readers a common vocabulary and conceptual framework and to encourage transnational harmonization of the law governing security rights. The following paragraphs therefore identify the principal terms used and the core

meaning given to them in this Guide. The meaning of these terms is further refined when the terms are used in subsequent chapters. Those chapters also define and use additional terms.

Security right	A “security right” is a consensual <i>in rem</i> right in movable property [and fixtures] that secures payment or other performance of one or more obligations.
Secured obligation	A “secured obligation” is the obligation secured by a security right.
Secured creditor	A “secured creditor” is a creditor that has a security right.
Debtor	A “debtor” is a person that owes performance of the secured obligation. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor).
Grantor	A “grantor” is a person that creates a security right in one or more of its assets in favour of a secured creditor. The grantor may or may not be the debtor that owes performance of the secured obligation (see debtor).
Security agreement	A “security agreement” is an agreement between a grantor and a creditor which creates a security right that secures one or more of the debtor’s obligations.
Encumbered assets	An “encumbered asset” is property subject to a security right. In general, encumbered assets are divided into tangible and intangible property. Each of these two general classes comprises several sub-types.
Tangibles	The term “tangibles” includes all forms of tangible movable property. Among the sub-types of tangibles are inventory, equipment, and fixtures.
Inventory	“Inventory” includes not only a stock of tangibles held for sale or lease in the usual course of business but also raw and semi-processed materials.
Equipment	“Equipment” means tangibles, other than inventory, used by a person in the operation of its business.
Fixtures	The term “fixtures” means tangibles that have become immovable property under the law of the State where the immovable property is situated.
Intangibles	The term “intangibles” covers all movable property other than tangibles. Among the sub-types of intangibles are claims and receivables.
Claims	The term “claims” includes both a receivable and a right to the performance of a non-monetary obligation.
Receivable	A “receivable” is a right to the payment of a monetary sum.

Proceeds	The term “proceeds” includes [the fruits of encumbered assets and] whatever is received on the disposition of encumbered assets.
Priority	The “priority” of a secured creditor refers to the extent to which the secured creditor may derive the economic benefit of its security right in preference to other parties with a right in the same encumbered asset. Rules of priority rank security rights and other property rights in encumbered assets in the order in which they are to be satisfied out of the encumbered assets.
Possessory security right	A “possessory security right” is a security right in encumbered assets in the possession of a secured creditor or of its agent other than the grantor.
Non-possessory security right	A “non-possessory security right” is a security right in intangible encumbered assets and in tangible encumbered assets in the possession of the grantor or of its agent.
Insolvent debtor	An “insolvent debtor” is a person that is subject to insolvency proceedings. If a security right has been granted by a third party grantor, the Guide refers to an “insolvent grantor”.
Insolvency proceedings	“Insolvency proceedings” are collective proceedings that involve the partial or total divestment of the insolvent debtor and the appointment of an insolvency representative for the purpose of either liquidation or reorganization of the insolvent debtor’s assets or affairs.
Insolvency representative	An “insolvency representative” is a person, designated by law or appointed by a court, that is in charge of administering the insolvent debtor’s assets or affairs for the purpose of either the liquidation or reorganization of those assets or affairs. Insolvency representatives include insolvent debtors left in possession to administer their assets or affairs in reorganization proceedings in those legal regimes where this is permitted.

C. Examples of financing practices to be covered in the Guide

15. Set forth below are three short examples of the types of secured credit transactions that the Guide is designed to encourage, and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use, and an effective secured transactions regime must be sufficiently flexible to accommodate many existing modes of financing, as well as modes that may evolve in the future.

[Note to the Working Group: In order to avoid distracting the reader with an overly complex discussion, only a few limited examples of the most basic and common transactions are given. Other examples of some of the more complex

transactions, such as project finance and securitization, may be added by the Working Group, if necessary to illustrate points made in the Guide.]

1. Inventory and equipment purchase-money financing

16. Businesses often desire to finance specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the goods. In other cases, the financing is provided by a lender instead of the seller. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller.

17. This type of financing is often referred to as “purchase money financing” and occurs in a number of different legal forms (e.g. retention of title). In many States, the seller retains by agreement title to the goods sold until the credit is paid in full. These types of transactions are generally referred to as retention of title arrangements or conditional sales agreements (see also A/CN.9/WP.6/Add.2, paras. ...). In other States, the seller or lender is granted by agreement a security right in the goods sold to secure the repayment of the credit or loan.

18. Here is an example of “purchase money financing”: Agrico is a manufacturer and distributor of agricultural equipment with facilities located in State X and customers located in multiple States. Agrico desires to purchase 10,000 units of paint from Vendor A and 5,000 wheels from Vendor B, and to lease certain manufacturing equipment from Lessor A, all of which will be used by Agrico in manufacturing certain types of agricultural equipment.

19. Under the purchase agreement with Vendor A, Agrico is required to pay the purchase price for the paint within thirty days of delivery to Agrico, and Vendor A retains title to the units until Agrico pays the purchase price in full. Under the purchase agreement with Vendor B, Agrico is required to pay the purchase price for the wheels before they are delivered to Agrico. Agrico obtains a loan from Lender A to finance the purchase of the wheels from Vendor B. The loan is secured by the wheels being purchased.

20. Under the lease agreement with Lessor A, Agrico leases the manufacturing equipment from Lessor A for a period of two years. Agrico is required to make monthly lease payments during the lease term. Agrico has the option to purchase the manufacturing equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the manufacturing equipment during the lease term. Title will transfer to Agrico at the end of the lease term if Agrico exercises the purchase option.

2. Receivable and inventory revolving loan financing

21. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

22. One highly effective method of providing such working capital is a revolving loan facility. Under this type of facility, loans secured by the borrower's existing and future receivables and inventory are made from time to time at the request of the borrower to fund the borrower's working capital needs (see also A/CN.9/WG.VI/WP.6/Add.3, para. ...). The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower.

23. Here is an example of this type of financing: Agrico is a manufacturer and distributor of agricultural equipment with facilities located in State X and customers located in multiple States. It typically takes four months for Agrico to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving line of credit to Agrico to finance this process. Under the line of credit, Agrico may obtain loans from time to time in an aggregate amount of up to 80% of the value of its receivables and of up to 50% of the value of its inventory. Agrico is expected to repay these loans from time to time as it receives payments from its customers. The line of credit is secured by all of Agrico's existing and future receivables and inventory.

3. Term loan financing

24. Businesses often need to obtain financing for large, non-ordinary course expenditures, such as the construction of a new manufacturing plant. In these situations, businesses often seek financing that is not repayable until long after construction is completed. This type of facility is typically referred to as a term loan. In many cases, a term loan is amortized in accordance with an agreed-upon payment schedule, while in other cases the principal balance may be repayable in full at the end of the term.

25. For businesses that do not have strong, well-established credit ratings, term loan financing will typically only be available to the extent that the business is able to grant security rights in assets to secure the financing. The amount of the financing will be based in part on the creditor's estimated net realizable value of the assets securing the financing. In many States, real property is the only type of asset that generally secures term loan financing. However, many businesses, particularly newly-established businesses, do not own any real property and, therefore, may not have access to term loan financing. In other States, term loans secured by other assets, such as equipment and even intellectual property, are common.

26. Here is an example of this type of financing: Agrico is a manufacturer and distributor of agricultural equipment with facilities located in State X and customers located in multiple States. Agrico desires to expand its operations and construct a new manufacturing plant in State Y. Agrico obtains a loan from Lender C to finance such construction. The loan is repayable in equal monthly instalments over a period of ten years. The loan is secured by the new manufacturing plant, including all equipment located in the plant at the time of the conclusion of the financing contract and thereafter.

II. Key objectives of an effective and efficient secured transactions regime

27. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime:

A. Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions

28. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (including inventory, equipment, and receivables); (ii) permitting a broad range of obligations (including future obligations) to be secured; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

B. Obtain security rights in a simple and efficient manner

29. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in after-acquired property without additional actions on the part of the parties.

C. Recognize party autonomy

30. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the importance of party autonomy, while at the same time protecting the legitimate interests of all persons (especially consumers) affected by the transaction.

D. Provide for equal treatment of domestic and non-domestic creditors

31. Because healthy competition among all potential creditors (both domestic and non-domestic) is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to domestic and non-domestic creditors.

E. Validate non-possessory security rights

32. Because the granting of a security right should not make it difficult or impossible for the grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in encumbered assets coupled with mechanisms for publicizing the existence of such security rights.

F. Encourage responsible behaviour by enhancing predictability and transparency

33. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting, and addressing, confidentiality concerns.

G. Establish clear and predictable priority rules

34. A security right will have little or no value to a creditor unless the creditor is able to ascertain its priority in the property relative to other creditors (including an insolvency representative for the grantor). Thus, the Guide proposes clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

H. Facilitate enforcement of creditor's rights in a predictable and efficient manner

35. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner, including realizing the full economic value of the security right in the event of the insolvency of the grantor. The Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review, when appropriate, and recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws.

I. Balance the interests of the affected persons

36. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors (including secured, privileged and unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.
