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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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[to be added to the Guide as section C of Chapter I)

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

1. 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. The Working Group may wish to consider whether this discussion should be expanded to some of the more complex transactions such as project finance and securitization.*]

1. Inventory and equipment purchase-money financing

2. 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.

3. This type of financing is often referred to as “purchase money financing” and occurs in a number of different legal forms. In many States, the seller retains 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.2/Add.3, paras. 35-44). In other States, the seller or lender is granted a security right in the goods sold to secure the repayment of the credit or loan.

4. 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.

5. 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.

6. 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.

7. 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

8. 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.

9. 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.2/Add.4, para. 13). 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.

10. 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

11. 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.

12. 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.

13. 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 installments 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.