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Security Interests

Draft legislative guide on secured transactions

Note by the Secretariat*

1. At its thirty-fourth session, the Commission decided to entrust 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, such as the form of the instrument, the exact scope of the assets that can serve as collateral …".[1] Emphasizing the importance of the matter and the need to consult with representatives of the relevant industry and practice, the Commission recommended that a two- to three-day colloquium be held.[2]

2. In order to facilitate the work of the Working Group, the Secretariat has prepared a first, preliminary draft Legislative Guide on Secured Transactions (A/CN.9/WG.VI/WP.2 and Addenda 1 to 12). An international colloquium on secured transactions was also held in Vienna from 20 to 22 March 2002 (the report of the colloquium is contained in document A/CN.9/WG.VI/WP.3). Following the colloquium, the Secretariat received from the European Bank for Reconstruction and Development (EBRD) comments on the first preliminary draft of the Legislative Guide. These comments are reproduced in the annex to this note.

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* This note is issued later than the required ten weeks prior to the start of the meeting because it contains comments submitted to the secretariat of the Commission a few days prior to its issuance.

[1] Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 (A/56/17), para. 358.
[2] Ibid., para. 359.

Annex

Comments by the European Bank for Reconstruction and Development (EBRD)

1. As part of its legal reform work undertaken in the last ten years, secured transactions constitutes an area of particular importance to the European Bank for Reconstruction and Development (EBRD). When the EBRD was founded in 1991 to participate in the reconstruction efforts in the former communist countries of Central and Eastern Europe, it was immediately clear that investments by the Bank and others in the region would be seriously impeded if the legal framework necessary to secure these investments was not in place. Such a framework could not be achieved by the simple enactment of a new law but required an entire re-thinking of the legal provisions applicable to security rights over property and the effective implementation of such policy reform. This process started slowly and has intensified over the years. Every country in the region has since undertaken reform of the subject in one way or another.

2. The EBRD has itself contributed to this process in many ways. For example, it has developed a template for reform. The EBRD Model Law for Secured Transactions, was published in 1994 and the EBRD Ten Core Principles for Secured Transactions Law, were published in 1998. In addition, the EBRD has conducted an assessment of progress in the region. The EBRD Regional Survey of Secured Transactions Laws, was published for the first time in 1999 and has been regularly up-dated ever since. Moreover, the EBRD has contributed to progress directly by providing technical assistance to a number of countries for the reform of secured transactions law and its implementation. It is thus of great interest to the EBRD to follow and participate to the new initiative of UNCITRAL in this field. This initiative constitutes an opportunity to expand and develop the work that has been carried out in this field by the EBRD, the Asian Development Bank (ADB), the International Bank for Reconstruction and Development (the World Bank), and other institutions working on international legal reform. UNCITRAL's work can have an immense impact on nations globally. Moreover, despite the non-binding nature of a Legislative Guide, as opposed to a Convention, we believe that it can have more impact on law-reformers throughout the world, as it would certainly be the most advanced and comprehensive document on secured transactions legal regimes to date.

3. The EBRD sees its role as that of an active observer, providing examples of the issues faced in the legal reform process, and the way they have been resolved in different jurisdictions of Central and Eastern Europe. The EBRD would also stress the economic benefits to be derived from an efficient secured credit market, which should not be sacrificed to traditions and theoretical concepts. Practical problems in the area of secured transactions, and the difficulties and economic inefficiencies of solving them under existing legislation (if it is possible at all) should be the trigger of any legislature to undertake reform in this field, and thereby to refer to the future UNCITRAL Legislative Guide. It is practitioners who are often best placed to put forward the persuasive arguments needed to convince lawmakers that traditional rules and practices have to be changed if they are to serve modern economic needs.

4. Having read the first preliminary draft of the Legislative Guide, which is now before the Working Group, and participated in the Colloquium, we would like to emphasise certain issues that have featured in our work in transition countries.

a. The Guide should stimulate change

5. The objective of developing a legislative guide is that the resulting product should stimulate change. It would be disappointing if the Guide were read and endorsed by those countries that already have an effective legal regime for secured transactions, but studiously ignored by those countries where there is a strong case for change. It is interesting to note that the Guide is likely to be as relevant and useful for many developed countries, as it will be for developing countries and countries with economies in transition. It would equally be disappointing if the need for compromise within the Working Group lead to the reform policies being diluted to the extent that the message of the Guide would no longer be clear or compelling.

6. Whereas it is inevitable that the Guide takes the form of a relatively long document with a mine of detail, it is crucial that it should emphasise a set of recommendations that concentrate on the essential results that have to be obtained, with an indication (where appropriate) of alternative (yet effective) means by which those results may be achieved. We find, for example, that the basic requirements for the creation of the security interest and the elements that should be present in any given regime need to be spelled out very clearly. The Guide cannot be limited to a presentation of the various options present in existing regimes as part of a "pick and choose" exercise. It is necessary to draw a distinction between those concepts or features of the system that are essential to the whole reform process (for example, the ability to encumber, without additional formalities, assets which are identified generally or are acquired in the future), and those that are of less importance and may be introduced or refined at a later stage, depending on the need and inclination within the country concerned. Conversely, the Guide should not seek to impose solutions, even in matters of practical detail, where other approaches might be adopted (e.g. extending the security to the proceeds of sale of the encumbered asset; purchase money security; method of giving certainty to the date of the security agreement; renewal of filing).

b. The Guide should not polarise Common Law systems and Civil Law systems

7. It is desirable that the Guide, while acknowledging the division between Civil Law legal tradition and Common Law legal tradition, does not in practice "ostracise" some countries, leaving them feeling excluded from reform efforts and needs because of their seemingly "different" legal tradition. One principle which has guided the work of the EBRD in this field has been to draw on many useful solutions that have developed in Common Law systems to accommodate modern financing techniques in a manner which is compatible with the Civil Law traditions underlying many Central and Eastern European legal systems. Our experience has confirmed our belief that legal tradition is no obstacle to reform in the field of secured transactions towards an economically efficient regime, provided that the determination to reform exists, and that variations and accommodations can be made to acknowledge difference in institutions, style and accepted practice.

8. The Guide's message must remain simple (but not simplistic) so that its substance may be readily understood by those contemplating reform. If the Guide is too complex or obscure in style, or seems to be too heavily inspired by an existing system, which may not appeal as a model to all countries, then it will not be used. It must also be remembered that it is likely to be translated and used in many different legal reform contexts, hence the need for clarity and plain, unbiased language.

c. The Guide should emphasise the distinction between a formal and a functional approach

9. The need for a functional analysis of secured transactions is evident as noted throughout the Guide with various justifications, but without any clear explanation. We consider that this is one of the most difficult issues, as well as one of the most controversial, and that it must be addressed openly. There are strongly held views for and against adopting a functional approach to security interests (which encompasses any transaction whose function is to provide security to one party for re-payment of an underlying obligation, regardless of the form and the legal technique adopted by the parties). Reform that entails adopting a functional approach also implies a major review of the law on obligations and property, and some fundamental changes in the approach to legal and practical issues. Such reform cannot be a question of a relatively self-contained introduction of non-possessory security interests that would provide the market with a new type of security adapted to its needs. The objective becomes far more comprehensive, and both the reform and its implementation will require more extensive preparation and resources. Reform-makers need to understand this very clearly, and balance carefully the advantages and disadvantages of adopting a fully functional approach. Based on our experience, we would suggest that a formal approach (encompassing only those transactions that are in the form required for the creation of security) could serve the economic objectives of secured transactions reform, while leaving considerable scope to encourage convergence, for example, by introducing similar rules for quasi-security transactions on the questions of publicity, priority and enforcement.

10. The Guide needs to be very clear on this point, in its terminology, in the definition of the key objectives and in the basic approach to security issues, rather than making an implicit assumption that a functional approach should be adopted, without proper explanation.

d. The Guide should remain open to the concept of a secured transactions regime encompassing movable and immovable property

11. Another implicit assumption, which is made in the Guide, is the strict separation between movable and immovable assets. This separation, although it may make perfect sense in some legal regimes, may not always be appropriate. On the contrary, in some cases, there can be a very good case for a country to attempt to reform both areas at the same time and to submit security over movable and immovable assets to similar rules. The Guide should leave this option open and should give general guidance as to how reform encompassing both movable and immovable assets may be successfully developed.

e. The need for publicity of the security interest must be made absolutely clear

12. The Guide should leave no doubt that a modern regime for secured transactions requires a system of publicity, which puts third parties on notice that a security interest over defined assets has been created by the debtor in favour of a creditor, and which can also resolve priority issues. This should be reflected, in particular, in the key principles of the Guide. Although the absence of publicity has not prevented some economies from developing a secured credit market, it is contradictory, in an open-market economy, to encourage greater use of assets as security and, at the same time, to allow the existence of that security to be concealed from other persons in the market. The principle of publicity is being slowly but steadily adopted throughout the region where the EBRD operates. Difficult policy choices for the implementation of publicity have to be made, such as the legal effects of registration and the non-authentic nature of registered information, and these must be clearly presented in the Guide, as the current draft accepts.

f. The Guide needs to take a clear stance on enforcement

13. Enforcement of a security interest tests the ultimate *raison d'être* of the security. If enforcement does not enable quick and effective realisation of the encumbered assets and payment of the secured creditor, the reliance on the security as a means to reduce credit risk is severely undermined. However, this may be the most difficult part of the reform because the enforcement regime will necessarily be closely interlocked with the existing rules on civil procedure on matters, such as debt collection (enforcement of contracts) by judicial action, possessory actions, provisional measures over assets and enforcement over movable and immovable assets. Moreover, here, more than in any other area, the existence of institutions and their functioning (or not) will be key to the success of the reform. For example, the court system, its capacity, way of functioning and the risk of corruption, the existence and effectiveness of other professions that can play a key role in enforcement procedures, (especially when they are conducted privately, such as through judicial enforcement officers, notaries, other lawyers, auctioneers and other experts) will be key to the success of the reform.

14. Because of the importance of enforcement and the limitations on adopting a general prescriptive approach when so many external factors must be taken into account, it is essential to refer to the system's objectives in terms of timing and efficiency. In this connection, it is important to have regard to the realistic expectations of what can be achieved in a country, as opposed to imposing solutions that may work in some jurisdictions but not in others due to the differences in procedural law and institutional framework.

15. Views are often polarised when discussions on enforcement focus on the involvement of the courts. The approach of allowing parties broad rights to resolve issues themselves and reserving the role of the courts as a fall-back position has much to commend it but often runs directly against entrenched traditions and perceptions of the court's role. In many countries, there is a strong expectation of court involvement. Where there are deficiencies in the way the court system operates, an inefficient court-dominated realisation process may be seen as a lesser

evil than a self-help regime where the courts are not capable of assuring adequate protection against abusive or wrongful actions by the creditor. The way towards workable solutions is most often found by a reasoned exploration of the different methods by which enforcement can be achieved, the potential economic impact of each method (and the resultant effect on the perception of security) and the different available means of ensuring a fair balance between the justifiable interests of debtor and creditor.