United Nations A/CN.9/WG.VI/WP.14/Add.2

General Assembly

Distr.: Limited
7 July 2004

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
Sixth session
Vienna, 27 September-1 October 2004

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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V.04-56208 (E) 270704 280704

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A. General remarks

1. Introduction

1. A reasonable secured creditor expects a debtor to perform its obligations without the need for the creditor to have recourse to encumbered assets. A reasonable debtor will also expect to perform. Both will recognize, however, that there will be times when the debtor will not be able to do so. The failure may result from poor management or business misjudgements, but it may also be for reasons beyond the debtor's control, such as an economic downturn in an industry or more general economic conditions.

2. Creditors generally will periodically review their debtors' business activities and the encumbered assets and communicate with those debtors who show signs of having financial difficulties. Debtors generally will cooperate with their creditors to work out ways to overcome these financial difficulties. A debtor and its creditors working together may enter into a "composition" or "work out" agreement that extends the time for payment, reduces the debtor's obligation or modifies the security agreements. Negotiations to reach a composition agreement take place in the shadow of two principal legal factors: the secured creditor's right to enforce its security rights if the debtor defaults on its secured obligation and the possibility that insolvency proceedings will be initiated by or against the debtor.

3. At the heart of a secured transactions regime is the right of the secured creditor to look to the value of the encumbered assets to satisfy the secured obligation if the debtor defaults. The availability of efficient enforcement and economical mechanisms that allow creditors accurately to predict the time and cost involved in the enforcement of the secured obligation, as well as the amount they might recover from the disposition of the encumbered assets will have an impact on the availability and the cost of credit. A secured transactions regime should, therefore, provide efficient predictable and economical procedural and substantive rules for the enforcement of a security right after a debtor has defaulted. These rules should be clear, simple and transparent to ensure certainty about the likely outcome of enforcement proceedings. At the same time, the rules should provide reasonable safeguards for the interests of the debtor, the grantor, and other persons with an interest in the encumbered assets.

4. This chapter examines the secured creditor's enforcement of its security right if the debtor fails to perform ("defaults on"; see para. 5) the secured obligation prior to the institution of insolvency proceedings or with the permission of the appropriate body in insolvency (insolvency is dealt with in chapter IX).

2. Default

5. If a debtor fails to perform the secured obligation, the debtor is "in default". The debtor's default is a precondition to the secured creditor's right to enforce its security right against the encumbered assets. The parties' agreement and the general law of obligations will determine whether there has been an event of default, whether notice of default should be given and whether the debtor should be entitled to cure the default. Normally, the debtor must take the initiative to seek to challenge

before a court the secured creditor's position that there has been an event of default, or the calculation of the amount owing as a result of the default. To avoid unduly delaying rightful enforcement, the review should be expedited. Safeguards should be built into the process to discourage debtors from making unfounded claims to delay enforcement.

3. Enforcement

(a) General considerations

6. The key issue for a secured transactions regime is what modifications, if any, should be made to the normal rules for debt collection to facilitate the enforcement of security rights. Some regimes, for example, provide for expedited court proceedings. Other regimes delegate to the secured creditor the right to determine if a breach has occurred, to take possession of the encumbered assets and to dispose of them with no direct government or independent administrative intervention. Expedited procedures and delegation of authority, however, should take into account the right of other persons to be heard in protection of their legitimate claims to the encumbered assets. Moreover, the allocation of resources within the judicial system and any delegation to private persons necessarily raise issues of public interest. When determining the role of the judiciary or other administrative authorities in the enforcement of security rights, it is essential to do so in a clear and straightforward manner.

7. All interested parties (i.e. the secured creditor, the debtor or grantor and other creditors) benefit from maximizing the amount that will be realized by disposing of the encumbered assets after the debtor has defaulted. The secured creditor benefits by the potential reduction of any deficiency the debtor may owe as an unsecured debt after application of the proceeds of the encumbered assets. At the same time, the debtor or grantor and the debtor's other creditors benefit, either by a smaller deficiency or by a larger surplus. A secured transactions regime that decreases the hurdles and transaction costs of the disposition, while assuring that the secured creditor makes commercially reasonable efforts to dispose of the encumbered assets, will increase the amount of the proceeds received on disposition of the encumbered assets.

8. A security right is of particular importance to a secured creditor when the debtor is in financial difficulty. A debtor who is in financial difficulty is more likely to default on its obligations and may end up voluntarily or involuntarily in insolvency proceedings. If insolvency proceedings place undue barriers in the way of the secured creditor seeking to enforce its security right so that the value of that right in insolvency proceedings is less than its value outside such proceedings, the debtor and its other creditors will have an incentive to precipitate the insolvency proceedings. When initially deciding whether to extend credit, a secured creditor subject to such a regime will take into account the diminished value of the security right in insolvency proceedings and will reduce the credit extended or increase the costs of the credit to the debtor to compensate for the increased risk to its security rights. Thus, provision for recognition and enforcement of security rights within the insolvency process will create certainty and facilitate the provision of credit (for a discussion of enforcement of security rights in insolvency proceedings, see chapter IX).

9. It is important that the system take into account the rights of the debtor, the grantor and other persons with an interest in the encumbered assets. Many systems impose, as a general and overriding matter, a requirement that the secured creditor in enforcing its rights must act in good faith, follow commercially reasonable standards and respect public policy.

(b) Notice of enforcement

10. Secured transactions law normally addresses whether notice of the intention to enforce should be given and to whom. The principal benefit of a specific notice to the debtor or grantor is that it alerts them to the need to protect their interests in the encumbered assets (the debtor will not be unaware of its default but the third-party grantor may be), such as by curing the debtor's default, if otherwise allowed. Notice to other interested parties allows them to monitor subsequent enforcement by the secured creditor and, if they are secured creditors whose rights have priority (and the debtor is in default towards them as well), to participate in or take control of the enforcement process. The disadvantages of notice include its cost, the opportunity it provides an uncooperative debtor or grantor to remove the encumbered assets from the creditor's reach and the possibility that other creditors will race to assert claims against the debtor's business. Because of the requirement for notice of any disposition of the encumbered assets, many regimes do not also require a notice of default (see para. 5).

11. As with other situations where notice may be required, in those legal systems where a notice of default is required, secured transactions law normally spells out the minimum contents of a notice, the manner in which it is to be given and its timing. When doing so, the law might distinguish between notice to the debtor, notice to the grantor when the grantor is not the debtor, notice to other creditors and notice to public authorities or the public in general. The secured creditor might, for example, be required to give prior written notice to the debtor and grantor followed by filing a notice in a public register (see article 54 of Inter-American Model Law). The creditor might also be required to give written notice to those other secured creditors who have filed notice of their interests or who have otherwise notified the creditor. Alternatively, the registrar might be required to give such notice. As for the information to be included in the notice to the debtor and grantor, the law might require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default and detail the steps the debtor or grantor may take to pay the secured obligation or to cure the default. The secured creditor may also be required to indicate, at least provisionally, the steps it intends to take to enforce its security right. Notice to other interested parties may not need to be so specific.

(c) The extent of court supervision of enforcement

12. A key issue for a secured transactions regime is the extent to which the secured creditor must resort to the courts or other authorities (e.g. bailiffs, notaries or the police) to enforce its security right rather than to make use of out-of-court procedures. In order to protect the debtor and other parties with rights in the encumbered assets, some legal systems require the secured creditor to resort exclusively to the courts or other governmental authorities to enforce its security right. However, because court proceedings often cannot produce a result in a timely and cost-efficient manner or the maximum possible value of the encumbered assets,

the requirement of court proceedings will negatively impact on the availability and the cost of credit. The time and cost involved reduce the realization value of the encumbered assets and will be factored into the cost of the financing transaction.

13. In order to avoid these problems, some legal systems do not require the secured creditor to use the courts or other governmental authorities in the enforcement process. In these legal systems the secured creditor is often authorized to enforce its security right without any prior intervention of official State institutions, such as courts, bailiffs or the police. In other legal systems, there is only limited prior intervention of official State institutions in the enforcement process. For example, the secured creditor may apply to a court for an order of repossession, which the court issues without a hearing (although the debtor may initiate an independent proceeding to challenge this order; see article 57 of the Inter-American Model Law). In such a case, once the secured creditor is in possession of the asset, it may sell it directly without court intervention following certain prescribed procedures (see article 59 of the Inter-American Model Law). The justification for such an approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. It may also maximize the realization value of the encumbered assets.

14. However, even in these legal systems the courts are available to ensure recognition of legitimate claims and defences of the debtor and other parties with rights in the encumbered assets. In order to inform these parties and give them an opportunity to react, the secured creditor may be required to give them a notice of default and enforcement (see paras. 5 and 10). In addition, the secured creditor may not enforce its rights to take possession of the encumbered assets if such enforcement would result in a disturbance of the public order. Moreover, in disposing of the encumbered assets, the secured creditor has to act in a "commercially reasonable" manner (see para. 9).

15. Even if permitted to act without official intervention, a secured creditor is normally also entitled to seek to enforce its security right by judicial action. The secured creditor may choose to bring a judicial action, rather than rely on its own actions, for a number of reasons. For example, the secured creditor may wish to avoid the risk of having its private actions challenged after the fact, or may conclude that it will have to bring a judicial action anyway to recover an anticipated deficiency.

16. Whether or not they require a secured creditor to resort to the courts, many legal systems modify the normal rules of civil procedure when a secured creditor seeks to enforce security rights. These modifications may limit the time within which the court must act or limit the claims or defences that the parties may raise. If the court concludes that there has been default, the objective of any decision is to satisfy the creditor's secured claim. The court is typically authorized to order the debtor to pay the obligation, to dispose of the encumbered assets itself, or to turn over the assets to the secured creditor or to the court for disposition.

(d) Freedom of parties to agree to the enforcement procedure

17. Another key issue is the extent to which the secured creditor and the debtor or other grantor may agree to modify the statutory framework for the enforcement of

the security right. In some legal systems, the enforcement procedure is part of mandatory law that the parties cannot modify by agreement. In other legal systems, the parties are allowed to modify the statutory framework for enforcement as long as public policy, priority, and third-party rights (in particular in the case of insolvency) are not affected. In yet other legal systems, emphasis is placed on efficient enforcement mechanisms in which judicial enforcement is not the exclusive or the primary procedure. Even if a system has limits on the extent to which the secured creditor and the debtor or other grantor may agree to modify the statutory framework, permitting the parties to agree freely on the consequences of their exchange after a default encourages an efficient allocation of resources. However, such freedom may be the subject of abuse at the time of conclusion of the security agreement. Thus, the law may only recognize agreements modifying the statutory framework reached after the debtor has defaulted.

(e) Acceptance of the encumbered assets in satisfaction of the secured obligation

18. Following default, the secured creditor may propose to the grantor that the secured creditor accept the encumbered assets in full or partial satisfaction of the secured obligation. Most jurisdictions make unenforceable an agreement entered into prior to default that automatically vests ownership of the encumbered assets in the secured creditor upon default, although some laws make an agreement entered into after default enforceable. The advantage of permitting agreements entered into after default is that, as a result of such an agreement, enforcement costs are minimized and the security right is enforced more quickly. The disadvantage is that the secured creditor may put undue pressure on the debtor or grantor in cases where the encumbered assets are more valuable than the secured obligation.

19. The law may guard against abusive behaviour in connection with such agreements by requiring the consent of the debtor or other grantor, third parties or the court under certain circumstances, such as where the debtor has made substantial payments on the secured obligation. Notice to other interested persons may be required and a fixed delay before final settlement may be prescribed to allow an appeal to a court (by an interested person who has not consented). The law might also require an official appraisal of the value of the encumbered assets.

(f) Redemption of the encumbered assets

20. Most laws permit a defaulting debtor or grantor to redeem the encumbered assets before their disposition by the secured creditor by paying the outstanding amount of the secured obligation, including interest and the costs of enforcement up to the time of redemption. Redemption brings the transaction to an end. The hope of redemption may encourage the debtor or other grantor to search for potential buyers to purchase the encumbered assets and to monitor the secured creditor's acts closely. Redemption of the encumbered assets should be distinguished from reinstatement of the secured obligation. Reinstating the secured obligation (e.g. by paying a missed instalment before disposition), if permitted under the general law of obligations, cures a default and the restored obligation continues to be secured by the encumbered assets. Redeeming the encumbered assets discharges the secured obligation.

(g) Authorized disposition by the grantor

21. Following default, the secured creditor will be concerned about realizing the maximum value of the encumbered assets. Frequently, the grantor will be more knowledgeable about the market for the assets than the secured creditor. For this reason, the grantor is sometimes given a limited period of time following default during which it is entitled to dispose of the encumbered assets.

(h) Removing the encumbered assets from the grantor's control

22. Upon the debtor's default, the secured creditor who is not already in possession of the encumbered assets will be concerned about potential dissipation or misuse of the assets. This may be alleviated by placing the assets in the hands of a court, a State official, a trusted third party or the secured creditor itself. Permitting the secured creditor to take possession without any or only limited recourse to a court or other authority reduces the costs of enforcement (see paras. 13-14). However, even those laws that permit such repossession by the secured creditor recognize the potential for abuse, especially the possibility of public disorder or intimidation. Most of these laws, therefore, condition repossession on avoiding a disturbance of the public order ("breach of the peace"). Some laws require prior notice of default as a precondition to taking possession.

23. In the special case where the encumbered assets threaten to decline rapidly in value, most laws provide for preliminary relief ordered by a court or other relevant authority to preserve the value of the assets.

(i) Sale or other disposition of the encumbered assets

24. A security right entitles the secured creditor to have the encumbered assets sold or otherwise disposed of. Law should provide additional general procedures for the disposition of the encumbered assets. These should include the method of advertising a proposed disposition, whether to have a public auction and permission to sell, lease, license or collect upon the encumbered assets. The objective of the disposition should be to maximize the value of the encumbered assets, while not jeopardizing the legitimate claims and defences of the debtor or grantor and other persons.

25. Requirements in existing legal systems range from the less to the more formal. Some legal systems require disposition subject to the same public procedures used to enforce court judgements. Other legal systems permit the secured creditor to control the disposition but prescribe uniform procedures for the disposition by public auction of encumbered assets, with rules on such matters as timing, publicity and minimum price. Yet other legal systems permit the secured creditor to control the disposition subject to flexible rules on how to proceed (always subject to an independent standard, such as commercial reasonableness). These systems may condition the right of the creditor on the consent of the debtor or other grantor, whether in the security agreement or after default. A general standard is usually prescribed which the secured creditor must observe (e.g. "commercially reasonable" or "with the care of a prudent business person"). There may also be special rules dealing with the manner by which the proceeds of a disposition are to be collected and kept pending distribution.

26. Most secured transactions laws share the requirements that notice must be given to certain parties with respect to a proposed disposition and the sale must be advertised or offers sought from appropriate parties. Due to the finality of any disposition, detailed rules are necessary to alert interested parties to protect their interest. Special procedures may be prescribed for the sale of a business as a going concern.

27. The collection of intangibles and negotiable instruments may not fit easily into the procedures for disposition of the encumbered assets. Thus many systems have special rules for this type of encumbered asset, including the right to require the person obligated to make any payments owed directly to the secured creditor.

(j) Allocation of proceeds of disposition

28. To minimize disputes, secured transactions laws set out rules on the distribution of the proceeds of the disposition. The most common allocation is to pay reasonable enforcement costs first and then the secured obligation. Laws typically include rules prescribing if and when a secured creditor is responsible for distributing proceeds to some or all other secured creditors (such as secured creditors with junior security rights in the encumbered assets) with security rights in the same encumbered assets. These rules often require that notice of these other interests be given to the secured creditor and that any surplus proceeds are to be returned to the debtor or other grantor.

29. The proceeds distributed to the secured creditor are applied towards the costs of the distribution and the satisfaction of the secured obligation. If there is a deficiency after the distribution, the obligation is discharged only to the extent of the proceeds received. The secured creditor is normally entitled to recover the amount of the deficiency from the debtor. Unless the debtor has created a security right in other assets for the benefit of the creditor, the creditor's claim for the deficiency is unsecured vis-à-vis the debtor (although the secured creditor may have received security rights from a third party).

(k) Finality

30. Secured transactions laws normally provide finality following disposition of the encumbered assets. The secured creditor's security right in the encumbered assets terminates, as does the debtor's or other grantor's rights, and the rights of any junior secured creditor or other person with a lower ranking right in the encumbered assets. The law normally provides that the rights of other persons in the encumbered assets (including other secured creditors) continue notwithstanding disposition of the assets in the enforcement procedure.

(l) Variations on general framework

31. Secured transactions law that includes within its scope many different types of encumbered assets provides, where necessary, special rules for the disposition of some types of asset. This is especially true of receivables and negotiable instruments. For example, a secured creditor with a security right in a receivable should be entitled to inform the account debtor to make payments directly to the secured creditor following the debtor's default.

32. Secured transactions laws also address the issue of how a secured creditor is to proceed when a single transaction includes security rights in both movable and immovable assets. Enforcement of a security right in fixtures also requires special rules to deal with the problem of severing a fixture from immovable property owned by someone other than the debtor or other grantor.

(m) Judicial proceedings brought by other creditors

33. Other creditors of the debtor or grantor may resort to the courts to enforce their claims against the debtor and procedural law may give these creditors the right to force the disposition of encumbered assets, subject to the interests of the secured creditor. The secured creditor will look to procedural law for rules on intervening in these judicial actions in order to protect its priority. In rare cases, procedural law may provide exceptions to general rules of priority. In some legal systems, for example, a court may order a person who owes money to a judgement debtor to pay the judgement creditor. If the court order may effectively give priority to the judgement creditor and if a secured creditor has a security right in this receivable, the result is bound to affect the availability and cost of credit extended on the basis of receivables.

B. Recommendations

[*Note to the Working Group: As documents A/CN.9/WG.VI/WP.13 and Add.1 include a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations on default and enforcement are not reproduced here. Once the recommendations are finalized, the Working Group may wish to consider whether they should be reproduced at the end of each chapter or in an appendix at the end of the guide or in both places.*]