

IV. THE POLICY QUESTIONS IN DESIGNING LEGAL FRAMEWORKS FOR SECURED TRANSACTIONS

72. This chapter gives an overview of the policy questions countries confront when they design an economically effective legal framework, or regime, for securing transactions with personal property, and identifies ways they can resolve the questions. It offers a baseline regime that would foster secured credit. The baseline policy model allows comparison of the legal frameworks in the five RETA countries. The following four chapters then discuss ways in which the countries' frameworks differ from the baseline policy model. These divergences from an economically effective framework suggest that problems will arise for debtors. The field interviews reported in Chapter IX further investigate these questions.

A. The Questions for Policy Makers

73. Any regime must address questions concerning the creation, priority, publicity, and enforcement of security interests. In addition, any regime must confront questions that cut across all four topics. This part presents four topics. The purpose of this part is not to present the deep broad literature on this topic, but to prepare the reader for the analysis of the regimes in the five RETA countries that appears in later chapters.

(i) Questions relating to the Creation of a Security Interest

74. Creation is the process in the law by which the creditor establishes a security interest in the property that serves as collateral for the credit. Creation raises questions for the design of a secured transactions regime.

75. A major question is what can serve as collateral (here we discuss only movable property). Not every thing can be collateral. No country today would admit to allowing slaves, for example, to secure a loan. Within these limits, however, policy makers must decide whether to permit any movable property or to narrow the set to, for example, only identifiable assets. Should one, for example, be able to use intellectual property rights as collateral?

76. The specificity with which the collateral must be identified is a related question. A secured transactions law designed for real property may apply concepts of title when applied to personal property, in which case the law will require that the property be specifically identified. This approach would not be relevant to the many forms of movable property for which title need not be clearly established. Alternatively, a regime that permits a creditor and a debtor to create a security interest in all assets does not rely on title-based concepts. It permits as collateral property that the debtor does not yet own but acquires in the future, even property that does not exist at the time the interest is created, to serve as collateral.

77. The time and methods by which the security interest is created raise questions that are resolved in different ways among the RETA countries. The regimes often, but not always, distinguish between the time when the interest binds the creditor and debtor (sometimes called attachment) and when it can be enforced against third parties (sometimes called perfection). Attachment commonly occurs with the contract between debtor and creditor, but sometimes takes place at another time, such as filing.

78. Several techniques perfect the security interest against third parties. These include possession, filing, control, and automatic creation. The key question concerns the circumstances in

which each technique is available or mandatory. Some types of property are more susceptible to one technique than others. The creditor may take possession of the collateral to publicize the security interest. The security interest may have to be publicized, which is usually done by filing in a registry but in some countries may be accomplished in other ways, such as by announcing the interest in a trade journal. A secured creditor may establish control, rather than file or take possession. For example, a custodian may hold stocks or bonds that serve as collateral for the benefit of the secured creditor. Finally, a security interest may automatically bind third parties when it is created, without more. In some regimes, the purchase money security interest in consumer goods is an example of a security interest being automatically created. A store sells a refrigerator to a retail customer on credit, for example, and its security interest in the refrigerator automatically perfects without filing. This eliminates the need for large numbers of filings when the value of the goods depreciates quickly after sale and other creditors are unlikely to lend against consumer goods, even durables.⁷

79. The parties to, or nature of, the underlying debt may raise questions for the design of the regime. Certain types of creditors or debtors may be limited in their ability to give credit that is secured or offer debt with security. Some countries require the debt to exist when the security interest is given, while others allow the debt to be incurred later.

80. Chapter V compares the rules governing creation in each of the five RETA countries.

(ii) Questions relating to Setting Priority

81. Priority is the process by which the law permits creditors to establish the rank of their security interests against other possible claimants to the collateral. This order of priority becomes important when the debtor is bankrupt.

82. The basic question is whether priority will be first in time, meaning that when one security interest is established earlier in time than another, the first interest is satisfied before the later interest. Countries following the first-in-time rule regularly make exceptions to it. The rules vary according to whether the other claimant to the property is a second secured creditor, an unsecured creditor, a buyer, or another type of claimant in bankruptcy. The following paragraphs discuss each.

83. When contending claimants to collateral are both secured creditors, the first-in-time rule most readily applies, but even then exceptions are made. One example is the super priority for the purchase money security interest mentioned in Chapter II. Some regimes automatically give such a purchase money security interest priority over earlier secured interests. The theory is that the debtor should not be subject to the monopoly power of prior secured creditors with all-asset security interests and that the supplier's credit benefits all other creditors by keeping the borrower operating as a business.

84. Given the purpose of security interests, the secured creditor would be expected to have priority over the unsecured creditor regardless of when the latter provided the credit. Regimes that derogate from this seriously risk undermining the institution of secured credit.

85. A secured creditor may generally have priority over a later buyer, but exceptions are commonly made. The issue is when to protect the buyer. The United States, for example, gives priority to most buyers in the ordinary course of business, acting in good faith and ignorant that the purchase violates the security agreement. The United States also carves out exceptions to this protection.

⁷ See J. White and R. Summers, *Uniform Commercial Code* (2000), at 760.

86. Finally, in bankruptcy other types of claimants compete with the secured creditor for priority. The law governing secured transactions will not normally establish priority rules against these other types of claimants. A major question is the relationship between secured transactions and bankruptcy proceedings (see Chapter VI).

87. Many permutations in priority rules are discussed in Chapter VI.

(iii) Questions relating to Publicizing of Security Interests

88. Publicity is the practical means by which creditors inform others of their claim to collateral, thus publicly establishing their rank in the collateral. Often a system of registration gives publicity.

89. The nature of giving publicity raises many procedural questions. One concerns the relative importance of registration compared to possession, control, or automaticity, as discussed above. Registration often simply notifies other claimants of the security interest, but in some regimes it publicizes the entire agreement, raising issues of confidentiality for the parties. Countries need to decide between these approaches. Where registries in different districts are not integrated, the law must specify how one decides where to register the security interest. Options include the debtor's residence, place of incorporation, or place of business, and the location of the collateral, with special rules for collateral that is mobile. Ease of access to the registry is important. Is access available only to the debtor and creditor or also to third parties? Can access be remote or must it be in person? How fast and inexpensive is it?

90. Countries, including the five in this study, vary widely on all of these dimensions. This is discussed in Chapter VII.

(iv) Questions relating to Enforcement of Security Interests

91. Enforcement is the process by which, when the debtor defaults, the creditor can have the collateral seized (or repossessed) and sold to satisfy the secured claim.

92. The question of whether default has occurred is usually defined by contract law rather than the law governing secured transactions.

93. The basic question for the law of secured transactions is, assuming that a default has occurred, the extent to which courts must play a central role in enforcement. Regimes vary in the extent to which they permit or restrict self-help by the creditor either to repossess the collateral or to decide what to do with it, perhaps by using the collateral itself, or selling it. In some countries, basic principles protecting citizens—perhaps constitutional in nature—require that persons be able to use the courts to resolve disputes. The regime must decide whether to place the burden of using the courts on the creditor or the debtor.

94. The pressure to avoid the courts is intense, particularly when they are inefficient or overburdened, so regimes must decide on alternatives. Some countries provide special enforcement procedures for certain types of institutions, such as banks. Some allow substitutes for civil court enforcement. Arbitration is one option, but it poses difficult problems for the rights of third parties. Criminal procedures, jailing debtors for example, socialize the costs of enforcement and may impose too high a cost on the debtors and society.

95. When functionally similar security interests take different legal forms, the regime must decide whether to enforce them in similar or different ways. For example, should self-help be easier when the creditor retains title to the collateral than when it does not?

96. Chapter VIII examines each of the five RETA countries' approach to enforcement.

(v) General Questions relating to the Legal Framework for Security Interests

97. A broad question that cuts across all aspects of the regime is whether it is conceptually unified. Can a creditor and debtor escape the rules governing security interests by casting the transaction in different legal terms, such as a transfer of ownership? Elements of many regimes for secured transactions evolved under different legal concepts, some based on title and others on more circumscribed interests, such as trust law in common law countries. Some countries, including several of the five in this report, have left these growths unpruned, allowing a thicket of rules to flourish. Other countries have tried to integrate the rules so that form is not significant.

98. A second important question is whether the rules are readily accessible and understandable to all debtors and creditors. This is not the same as conceptual unity. When the rules governing the range of secured transactions are scattered across many laws and cases, they raise the cost of using lawyers' services, at the very least.

B. Solutions to These Policy Questions

(i) General Structure of Secured Transactions Regime

99. In general structure—allowing security interests to be created, setting priorities, providing methods of publicity, and techniques of enforcement—the regimes in each of the five RETA countries provide for secured transactions. For all, an interest in collateral in the creditor's possession is easy to create and enforce, while interests in collateral that the debtor continues to possess conjure many more problems. Some obvious differences reflect the different traditions of civil and common law. For example, common law countries allow general or all-asset floating security interests and the civil law countries do not, as described in Chapter II. Civil law countries may provide for a general security interest by special legislation.

100. To examine the effect of the existing laws in the five RETA countries, this report presents here the contours of a regime dedicated to promoting the use of secured credit. It sketches, as a comparative baseline, the major components of this economically useful regime. The following section identifies the goals for solutions to the legal issues outlined above.

(ii) A Baseline Policy Model: An Economically Useful Framework Favoring Secured Credit

101. The law must set out a system for security interests that meets certain minimum economic requirements.⁸ The economic requirements for a regime whose single goal is to promote secured credit are:

⁸ Based upon criteria set by John A. Spanogle, *Proposed Polish Charges Act* (1992).

- **Creation that is cheap, simple, comprehensive**
An economically effective law permits inexpensive creation of a security interest against all property by any person for any transaction.
- **Publicity that is public, inexpensive to file, easy to search**
The law enforces publicity of the priority by public filing system where the public can, both inexpensively and quickly, search for prior security interests and file anew.
- **Priority based on a simple and unambiguous rule**
An economically effective law fixes priority by clear first-to-file rules that include the claims of third parties such as junior secured and unsecured creditors, bankruptcy trustees, or some purchasers of the collateral.
- **Enforcement that is fast and cheap**
The law provides inexpensive and fast enforcement, permitting recovery and sale even at low costs relative to the value of the collateral; that means, typically, a system substantially administered by the creditor.

102. The key legal features of such a regime are that it is unified functionally, provides for publication by registration, gives security interests high priority with no exceptions, and provides for speedy enforcement outside the courts. This is the extreme form of the broad functional approach that Chapter X describes in a more comprehensive fashion. In practice, countries do not enact a law in such an extreme form because they have other values than simply maximizing secured lending. This model is useful, however, as a baseline against which exceptions need to be justified.

(iii) Qualifications or Alternatives to the Baseline Policy Model

103. An emerging school of thought suggests that the regime should reflect local legal and other conditions to such an extent that no single model can apply to all countries. Each country must find its own appropriate balance between the needs of secured creditors and those of others. The need to protect weak debtors means that a system substantially administered by the creditor will need to take account of the written rules protecting such debtors. The need to protect workers, or restructure a company rather than close it, requires a balancing of rights of debtors and creditors and could result in a temporary restriction on the rights of secured creditors. The nature of various types of security interests makes a first-to-file rule with no exceptions unworkable. For example, a prior all asset security interest should not necessarily have priority over a later purchase money security interest. The legal traditions of a country may imbue ownership with rights that are not appropriate to the holder of a security interest, so the broad functional regime oversimplifies when it unifies all interests by credit function. Overall, countries should be encouraged to evolve the system that achieves the right balance.

104. These qualifications, then, differ with the baseline policy model over the timing or sequence of reform, regardless of the goal of reform, as well as the ultimate goal itself. They are presented in more detail in Chapter X as, perhaps, an alternative to the baseline policy model that could be called evolutionary non-convergence. Unfortunately for this report, they are not yet fully articulated in the literature.

C. Problems Encountered and Generated by the Solutions

105. For purposes of this report, we compare the regimes in the five RETA countries against the baseline. While several countries have made important reforms, the solutions to the issues outlined above leave differences so basic that they go substantially beyond those that would be countenanced by the dictates of an evolutionary non-convergence approach. The systems for secured transactions in the countries studied largely do not meet the tests of either approach. The failure to meet them rarely has an obvious justification in public policy. Even where a public policy justification does exist, the means of achieving that objective carries with it a high cost in reducing access to credit. Less costly methods can typically achieve such public policy objectives better.

106. In the five RETA countries, problems in the law mean the credit chain does not work remotely as well as it could. The following chapters discuss in turn the problems in each of the four features—creation, priority, publicity, and enforcement.

D. Methodology

107. The data for these chapters come from research done by legal teams in each of the five RETA countries. Each team answered a set of detailed questions about the regime for secured transactions in its country. The questions raised the issues identified in this chapter. The answers were reviewed by one or more members of the International Legal Advisory Group (ILAG), which consisted of scholars with great experience in the law of secured transactions in many countries around the world. A list of the members of each country team and ILAG appears as an Appendix to this report.

108. The footnotes in the following chapters refer either to the Local Lawyer, who is the team leader of the identified country, or to an ILAG reviewer, who is identified by number (e.g., Reviewer #1, the first, or Reviewer #2, the second). The key to their identities is in the Appendix. Note that citations to laws⁹ or cases are those given by the Local Lawyer or the ILAG Reviewer. The authors of this report have not checked all of these citations. The source of each answer is given in the footnote by a reference to the question that it answered in the questionnaire and is identified with the following sign: §. For example, §28.3.1 refers to the question with that number. ADB has the completed responses available for review upon request. In some cases, a country may not have answered the question. Where appropriate, in tables for example, these are reported as “n.a.” which stands for “not available.”

V. PROBLEMS RELATING TO CREATION OF SECURITY INTERESTS

109. For decentralized markets to work well, debtors and creditors need the flexibility to agree about what property can serve as the best collateral for their loan. A company’s balance sheet will include various types of assets held in very different proportions. Accountants classify assets differently around the world, but the range includes the following types of personal property:

- Current assets, which are cash and assets, such as receivables and inventory, that would be used within a year.

⁹ Laws enacted up to the end of 31 December 1999 were considered for purposes of research.