

professional agent usually charges a percentage of the value of the property sold. The percentages vary from 1% upwards, depending on the value of the property.

437. Self-help can speed the process, though it is not available in Indonesia or Thailand, where enforcing a security interest requires use of the courts. In India, in contrast, upon default the bank notifies debtor of the default and the bank's intent of enforcing the security interest. The procedure for taking possession of collateral depends on the type of collateral. If taking possession can occur without requiring a right to entry (with a car, for example), possession agents take it and bring it to the custody of the bank, which completes and dates previously signed forms assigning the vehicle to the financial institution. If the possession of collateral, like a household computer, requires a right to entry then the bank seeks permission to enter and take possession of the collateral. If the debtor refuses permission when provided with a contractual right to entry, then the possession agents get police assistance in entering and taking possession of the goods. In practice, however, even banks are reported to use strong-arm tactics to repossess collateral.

438. These problems augment the others just described. A weak judiciary encourages banks to choose forms of collateral that can circumvent the courts. In Indonesia, most banks try to avoid court proceedings that enforce security interests in many types of movable property by taking only liquid and enforceable property. The fiduciary transfer of ownership carries substantial risk when the banks try enforcing it and remains quite unpopular among them. Banks facilitate enforcement of legally weak security instruments by using supplementary legal devices. In India, banks supplement the pledge or hypothecation of personal property with a signed power of attorney or transfer instrument that they can use should default occur.

439. Political influence over enforcement influences the choice of collateral because it affects the collateral's usefulness. One finance company raised an interesting concern about collateral. Explaining why the company would finance urban industrial equipment but not agricultural equipment, the manager remarked that "it is difficult to lay hands on the security (equipment) because the wealthy rural people are very influential and powerful." This leads financial creditors to prefer real estate or cash collateral, and only take as collateral movable property that they may easily repossess.

(iv) Some Taxes Impede the Use of Some Types of Collateral

440. Transaction taxes can make a secured transaction too costly. India's high stamp duty taxes their creation. Financial institutions report stamp duty prevents them from accepting as collateral heavy machinery attached to real estate. Mortgages may treat heavy machinery as immovable property and often take it as collateral. English Mortgages must be registered and is subject to a high stamp duty. The common effort to reduce, eliminate, or by-pass stamp duty leads to creation of the security interest by depositing a title deed (ownership papers). As a result, creditors do not legally perfect the mortgage and set a ranking of their priority to collect against the equipment that is collateral. Upon default, other creditors could set them aside.

X. OPTIONS FOR REFORM

441. This report examines the effect that problems in the legal systems of five RETA countries have on credit and debt secured by movable property. The particulars vary by country, but the conclusion is remarkably consistent.

442. The legal problems are serious, arising from multiple or fragmented laws, with limited scope (security interests in only certain types of property were protected, for example) and unclear application (among several persons with an interest in the same collateral which would have priority, for example). Transparency is lacking, so a potential creditor could not know about other claimants. Enforcement often takes much too long, with too uncertain an outcome. Debtors were even open to criminal sanctions, including prison.

443. Creditors and debtors suffered as a result of the inefficient regime for secured transactions. Even in the countries in which a creditor may theoretically take a security interest in all the debtor's assets, they could not use most forms of movable property to reduce the risk of a loan or supplier's credit, a job done with great success in some other countries. The loss to each country's economy could be substantial, although this report does not quantify that impact.

444. Reform is needed to resolve these problems and permit the broader and more efficient use of credit to finance the countries' growth. The benefits to the economy could be large. The question concerns the range of real options.

445. Several possible lines of action will not bear fruit, for reasons which are provided in detail below. A country will not solve the problems only by making changes outside the regime for secured transactions. Law is a major problem. General reform of the entire legal system or a major part of it, such as the courts, is important but the institution building will take many years. Promoting substitutes for strict security interests will not resolve the problems either.

446. The country must come to grips with the question of what kind of regime for secured transactions is best for it. This study did not systematically address this question. The answers that follow come from the literature and the experience of other countries, tailored to circumstances in Asia.

447. A baseline policy model for reform is drawn to maximize secured credit, or at least allow it to reach an optimal level. This is based on a functional approach, broadly applied, and is described below. No country has adopted it in pure form. All vary from it because in no country is secured credit the only goal of financial and legal policy. The variations are numerous. Even so, it is worthwhile stating this approach in simple form.

448. A growing literature questions basic assumptions made by this baseline policy model. The critics raise some issues that one finds in any general discussion of law development. For example, how fast should a country introduce change? How relevant are local conditions? The literature also asks if this baseline policy model is correct in some of its prescriptions about creation, priority, publication, and enforcement. The themes underlying this critical analysis are diverse.

449. One important subset of critical themes could be called evolutionary non-convergence, in that it posits a role for local culture and priorities that might allow a system for secured transactions to evolve successfully while remaining different from the functional baseline. The debate is abstract. Little if any economic analysis has examined these theoretical questions. No empirical research has evaluated the effect of an evolutionary non-convergence approach to secured transactions. The academic prescriptions are cautiously made and untested. The experience in countries that have adopted a broad functional approach supports its usefulness if the goal is to promote secured credit. Much work remains to be done to test proposals made by its critics, as they themselves would confirm.

450. This chapter explains why some options do not address the problems identified earlier in this report, and presents the broad functional approach, as well as criticisms from evolutionary non-convergence first in the context of general issues confronting legal policy reform. It then gives the prescriptions of the functional approach for the key elements of a secured transactions regime, along with evaluations by the critics, as a basis for approaches to promoting secured credit.

A. Options That Have Not Succeeded

(i) Ignore or Work Around the Regime for Secured Transactions

451. For many years, reform of the legal framework for credit has worked around the regime for secured transactions rather than addressing the problems the regime creates.

(a) Reform Bank Supervision and Regulation Without Fixing the Secured Transactions Regime

452. Banks are major creditors, so some people call for reform of the prudential rules governing banks as an alternative to resolving problems in the regime for secured transactions. Effective reform of supervision and regulation of banks, however, requires a legal framework that permits using collateral for credit and effective debt collection. Reforming supervision and regulation of banks without fixing the regime for secured transactions will not address the problems for creditors and producers that arise from the absence of a framework for secured credit.

453. Banks live by making loans. Banks that cannot collect loans eventually become recapitalized and insolvent. In such a world, authorities have nothing to supervise. In such a world, supervisors merely determine is the speed with which banks go out of business and how to distribute losses shall fall among the shareholders, the depositors, the local taxpayers, and the citizens of creditor countries.

(b) Substitute Equity Finance for Defective Credit Systems

454. Some people suggest promoting equity finance as an alternative for credit systems that are defective but not easily repaired. This approach is misplaced.

455. Businesses need both equity and debt to operate and grow, so an effort to develop markets for equity finance as a substitute for effective credit systems would not be a viable solution. In 1994, for example, new US stock issues amounted to \$85 billion, new private bond issues were \$500 billion, and total net lending exceeded \$1 trillion. US gross private domestic investment in the same year also amounted to over \$1 trillion. US equity markets could handle less than 10% of the investment needs of US investors and that figure emerges from a country with one of the most sophisticated infrastructures for issuing equities that exists in the world. Even in the United States, an environment extraordinarily conducive to equity finance, new issues represent a tiny fraction of total investment.

456. Even if all new funding could appropriately consist of equity, those markets require standards of disclosure and protection of minority shareholders far more difficult to satisfy even the weak credit standards already in place in most countries.

(c) Use State Credit, State Guarantees, and State Insurance in Place of a Legal System that Permits Private Creditors to Collect the Debt

457. Using state-owned or guaranteed loans to make socially necessary loans is an old and politically popular solution in many countries. However, for precisely the same reasons private creditors cannot collect their debt, public creditors and public guarantee agencies cannot either.

458. State creditors and guarantors implementing social or political missions may, even though they face the same legal regime as private creditors, find themselves losing money. They then shift these losses either back into the financial sector where, when sufficiently large, they can disrupt the financial sector, or to the public sector where, when sufficiently large, the losses disturb the macro-economy, leading to recession or economic stagnation. When sufficiently large, the losses prevent servicing the external debt of the country and the losses return to the taxpayers of the industrial countries.

(d) Promote Collateral Substitutes Without Reforming the Secured Transactions Regime

459. In addition to the formal regime for secured transactions, debtors and creditors in every country use substitutes for collateral outside that system. One definition of collateral substitutes is that they cannot be enforced through the formal judicial system and that they cannot be sold in a market.⁵⁷⁹ Examples include peer pressure, (e.g., members of a group who share liability for a debtor's obligation exert social pressure on the debtor to perform), the threat that the debtor will lose access to credit in the future, and the threat that default by the debtor will affect other obligations to the debtor.

460. While collateral substitutes can be very important in many countries, and are particularly valuable for micro-credit, they are largely impractical outside the ambit of credit based on relationships. Peer pressure requires a peer group. Loss of future credit is not a threat if the defaulting party can tap other credit markets where its history is not known. As economic activity becomes distant and impersonal, these substitutes lose their power. A formal regime for secured transactions becomes necessary. Much financial sector reform consists of bringing into the formal financial system many creditors and debtors who have relied on the informal markets in the past.

(ii) Partial Reform of the Secured Transactions Regime

461. A second futile line of reform is piecemeal change in the regime for secured transactions. The notion is that a country can transcend the problems described in earlier chapters simply by promoting hybrids like financial leasing, reforming registries or dispute resolution, or giving banks a special set of rules. The following partial reforms are often useful but cannot alone completely solve the problems described in prior chapters.

(a) Financial Leasing

462. Although tax rules promote much financial leasing, when it is used as a secured transaction, it faces many of the same limitations as the pledge. The leasehold collateral must presently exist, specifically identified, and its use may occur only for securing a present obligation. A lease cannot apply to inventories of goods, accounts receivable, or chattel paper, nor can a lease secure a credit line.

⁵⁷⁹ International Labour Organization. *Collateral, Collateral Law, and Collateral Substitutes* (1995) at 3.

463. The main advantage of financial leasing, in this setting, arises from the way it is supposed to reduce collection costs and the time required to sell the collateral. By using a financial lease, the lessor (creditor) is supposed to skip the judicial sale part of the enforcement process. Since the lessor (creditor) owns the leasehold collateral, the lessor can sell the collateral without the mandated judicially administered sale.

464. However, financial leasing does not necessarily avoid the repossession part of the enforcement process. As seen in Chapter VIII, the lessor (creditor) still needs a court order to take possession of the leasehold collateral in these countries. Getting such an order can take a long time and, therefore, lower the chance and value of repossession.

465. Financial leasing represents another element of a fragmented secured transactions system. It does not address the most severe faults of the existing system and cannot substitute for a reform aimed at creating a general framework for security interests. Rather, the converse applies: leasing improves with reform of the regime for secured transactions. The reforms permit the bundling of the leases into portfolios—intangible movable property—that can serve as security for credits from others. This greatly expands the access of lessors to funds with which they can expand their operations.

(b) Judicial Reform and Arbitration

466. Many of the most severe legal problems encountered in earlier chapters arose from deficiencies in the judicial systems of the countries, but reliance entirely on judicial reform to speed repossession and sale of collateral is not sufficient to solve the problems.⁵⁸⁰ Even in industrial countries with refined security interest regimes, a court's disposition time can be too long. Rather, the comparative experience shows non-judicial processes can bring the total collection time and costs within a range that would let movable property serve as collateral for credits. Not only will a judicial reform project be a broad, long, and difficult a task, but it may never achieve a sufficiently fast and inexpensive way to enforce security interests in movable property. Even the most modern courts cannot accommodate such requirements.

467. Arbitration also requires more time than is available for many types of movable property. It often needs extra court steps to execute the arbitrators' award. A long and costly judicial repossession and judicially administered sale save little time, as Chapter VIII shows. Arbitration, if faster, could become effective for the parties to the transaction, but would not resolve the claims of third parties so effectively.

(c) Invest in Registry Reforms Without Changing the Law

468. Among unsuccessful reforms, a standout is to invest in modern registration systems without revising the laws that constrain creation, priority, publicity and enforcement. First, the key features of all stages must be met for a creditor to take collateral. For example, very modern filing techniques for fixtures will not offset the damage if law gives subsequent mortgagees a claim superior to that of the person who financed the fixtures. A modern register for future crops will not increase secured credit if the pledge laws let only existing property serve as collateral. Finally, archaic substantive law will require the new registry to invest in technologies and systems to meet those requirements. For

⁵⁸⁰H. Fleisig, J.C. Aguilar, and N. de la Pena "Legal Restrictions on Security Interests Limit Access to Credit in Bolivia", 31 *The Int'l Law 65* (Spring 1997).

example, in Bolivia, a registry reform project invested in expensive image scanners to scan a computer printout into the system because the law required a judge's signature on a registry filing.⁵⁸¹

(d) Security interests laws for banks only

469. Legal reform strategies that pass laws applying only to bank creditors lead to a system where only financial institutions can "legally" provide credit. Such laws actually limit access to credit: they hamper non-bank creditors, such as credit sellers, who extend credit to clients in which banks have no interest. This legal limitation added to the general ineffective secured transactions framework in many countries can have important effects in contracting the overall availability of credit. For example, while US banks provide no more than 40 percent of the total private credit, banks in unreformed financial systems provide considerably more. Such laws actually increase the risk to the financial sector because a larger fraction of lending must rely on state-insured or guaranteed deposit-taking institutions. Such a supply of credit increases the risk that a failure of the banking system will be sufficiently large for producing macroeconomic instability.

470. Banks would do better with a smaller share of a larger, reformed system. Banks in reformed security interest systems can expand new lines of credit. The new framework lets businesses develop a strong portfolio of sales on credit, and provides banks with the means to create security interests in credit portfolios, such as security interests in accounts receivable and chattel paper without using the traditional legal transfer or assignment of credits. Banks see profit in lending to businesses by creating a security interest in portfolios of sales on credit as collateral for loans. While banks account for 40 percent of US credit, US credit is 220 percent of GDP. In countries with weak legal frameworks for security interests, banks may have 95 percent of credit but credit is only 30 to 35 percent of GDP. Relative to GDP, US banks have a market more than twice as large as a result of the general reform.⁵⁸²

B. Options to Reform the Secured Transactions Regime

471. All law and policy reform activities face several very basic issues that are related. The options to reform the law of secured transactions are no exception.

- Should reform take place all at once, as a Big Bang, or in stages, so that as essential institutions grow and behavior changes the law becomes increasingly complex and similar to law in industrial countries?⁵⁸³ Over decades, the latter approach has seemed more common in Asia, but recent initiatives in the financial sectors of countries like Japan, with its Big Bang, or Korea may belie this generalization.
- How much should the reform accommodate the law and culture of the country, even if the practice in many industrial states is different? Sometimes the argument is that local values should guide legal reform even if it means the country foregoes effective legal tools. This would vitiate most structural reforms. A more persuasive rationale is that a

⁵⁸¹ Those projects that have invested in registries reform programs without making sure first that "first-to-register" priority laws exist, have not reduced the risk on the secured transactions system. See, for example, Fleisig and de la Pena, Peru: "How Problems in the Framework for Secured Transactions Limit Access to Credit", Vol. 111 No. 2 *NAFTA Law And Business Review Of The Americas* 33 (Spring 1997). See also de la Pena, "Reforming the Legal Framework for Security Interests in Mobile Property" *Vol. IV Unif. I. Rev.* 347 (1999-2).

⁵⁸² N. de la Pena, "Reforming the Legal Framework for Security Interests in Mobile Property" *Vol. IV Unif. I. Rev.* 347 (1999-2).

⁵⁸³ See, e.g., P. Wellons, "Sequencing Legal Development To Support Financial Sector Reforms," in A. Harwood and B. Smith, eds., *Sequencing? Financial Strategies for Developing Countries* (1997).

legal reformer who ignores local law and culture is doomed to see the reforms ignored in practice.

- A third question reflects the long-term trend among countries toward convergence in substantive law and a continuing divergence in legal process, particularly enforcement. These trends were demonstrated for Asian countries in an earlier study by the ADB.⁵⁸⁴ Chapters V - VIII of this report on secured transactions show a similar trend. The question is how a country with weak implementation and enforcement of law can rely solely on enforcement techniques used in industrial countries that have much stronger institutions.
- Finally, all three questions assume a single or dominant legal model for reform that is used by industrial countries. The reality is quite different in most circumstances. Searches for common “Western” law, for example, founder on the great diversity among the countries in “the West.”

472. These big issues must be resolved by any reform strategy for a secured transactions regime. The broad functional approach of the baseline policy model takes a stand on each. Its critics raise counter-arguments on each. The evolutionary non-convergence approach, at this point in its formulation, is a composite of these counter-arguments. The following sections explain this.

(i) The Baseline Policy Model: The Broad Functional Approach

473. The broad functional approach of the baseline policy model states that one comprehensive law on security interests with a broad scope of application that emphasizes function, not simply legal form, is the best way to solve the problems arising from a fragmented system. A comprehensive statute should govern all stages of a security interest—creation, priority, publicity, and enforcement—in all property, or at least all movable property and fixtures, and all transactions. For each stage, a broad functional approach for which the sole policy goal was to promote secured credit would have the characteristics described in Chapter IV and reproduced in Box X-1. This approach offers the best legal regime to accomplish this goal because it solves the many problems described in earlier chapters efficiently.

474. In this view, a functional approach is the only way for a broad secured transactions law to avoid all possible inconsistencies among the rights of secured parties. In it, the law on security interests extends to any transaction for purposes of security. The law would apply to all possible claims against collateral, including strict and hybrid security interests. The law, as a result, extends to any transactions where the creditor or a third party has rights to property for purposes of security, such as the financial lease, conditional sales (with retention or reversion of title, such as hire purchases), as well as the trust, by which a security interest in collateral is created, such as the fiduciary transfer.

475. The broad functional approach embodied in the baseline policy model answers the four basic questions posed above as follows:

- local culture is relevant in that one must follow the legal forms, but does not justify derogating from broad functionalism;

⁵⁸⁴K. Pistor and P. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development, 1960-1995* (1999) (Pistor and Wellons 1999).

- a Big Bang is essential to ensure that the initial framework is broad and functional, and to avoid the repeated pressures to derogate from the model that will occur if reform moves in stages;
- because of problems with judicial enforcement, self-help must be developed as a key tool for the creditor; and
- a single model—broad functionalism—should govern because it offers a more efficient legal framework for secured transactions than any other regime, and has proved itself. No other model offers an adequate substitute for broad functionalism.

(ii) Toward an Alternative Approach: Evolutionary Non-convergence

476. While it is not clear that critics of the baseline policy model's approach offer an alternative that has really congealed into a full counter-approach, they have raised a set of counter-proposals that are related. The basic arguments are several. First, while broad functionalism has worked well where applied, one cannot therefore assume that it offers the only way to design a workable system of secured transactions. Regimes in other industrial countries use their own tools to protect secured creditors. Second, the goal of protecting secured creditors is not at the top of the policy list in many industrial countries. For them, other interests need protection. Their secured transactions regimes appropriately reflect this. Developing countries may have still other needs. Third, it is difficult to transplant some concepts and tools from one type of legal system to another.⁵⁸⁵

477. This approach answers the four basic questions as follows:

- culture, legal and otherwise, is important;
- basic change in the regime for secured transactions should perhaps be in stages;
- given weak enforcement institutions, reliance on self-help may be harmful;
- no single model of a best or optimal secured transactions regime exists, so what is best for one country may not be appropriate for another with different concerns and institutions.

478. These arguments that counter the baseline policy model approach reflect a long-standing debate about trends in law and the world economy. Asia offers a recurrent battleground for them. However, the counter-arguments do not now offer a substitute for the baseline policy model. It is either too early, because of the need for much more thought and field work, or impossible, because of the complexity of the topic, to characterize these counter-arguments as a coherent alternative, either conceptually or from empirical analysis, to the baseline policy model's approach that would guide policy makers. Instead, in the paragraphs that follows, the arguments are aired as they apply.

⁵⁸⁵These points are drawn from C. Walsh, *Secured Credit: A Topical Review and Analysis of the (English-Language) Foreign and Comparative Law Literature* (Dec. 1998, revised Aug. 1998, partially up-dated Nov. 1999) (Walsh 1999) and other articles cited below. A more precise articulation of the concerns appears later in this report in the discussion of specific policies.

Box X-1. The Broad Functional Approach: A Baseline Policy Model for an Economically Useful Framework Favoring Secured Credit

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

- *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, a trustee in 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.

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 IV also describes. In practice, countries do not enact a law in such an extreme form because they have other values than simply maximizing secured credit. This model is useful, however, as a baseline against which exceptions need to be justified.

Source: see Chapter IV.

C. Substantive Issues for Secured Transactions Regimes

479. The substantive issues involve rules governing creation, priority, publicity, and enforcement.

(i) Creation

480. The serious legal problems that reform must address, which are explored in Chapter V, are lack of clarity, overlapping types of security interests, limited types of movable property that can serve as collateral, and the very limited range of possible interests in that collateral.

481. The baseline approach is that the security interest regime must include all property essential for important classes of economic transactions:

- Tangible goods, corporeal and incorporeal, such as crops and electricity.

- Rights, such as patent and trademark rights.
- Fixtures, which are movable goods attached to real estate, such as a furnace, an elevator, or an industrial oven.
- Intangible property, especially portfolios of credits, which can serve as collateral for other credits, for example:
 - Accounts receivable, which are unsecured credits not represented by negotiable instruments, such as portfolios of invoices pending payment for goods sold or services rendered, small unsecured credits of NGO creditors, credit card slips, or contracts for the sale of a crop;⁵⁸⁶ and
 - Chattel paper, which bundle secured credits, such as the portfolios of real estate mortgages of a bank, or the portfolio of pledge credits of a pawnbroker.

482. This baseline policy model's approach states that the reforms must permit the secured party and the debtor to use any type of movable property as collateral. Limits on types of movable property sometimes arise because the law requires the parties to describe the collateral in ways that preclude the use of certain types of property. A requirement that the property be described with great specificity may prevent future or intangible property from serving as collateral. Instead, the goal should be to allow the parties to describe the collateral in the agreement the way they deem appropriate in the circumstances. Sometimes they may want great specificity. For example, they may choose to describe a quantity, such as "300 head of Hereford cattle," or a value, as in "\$600,000 in Hereford cattle," or even use specific identification, as in "Roger Prime Blue Ribbon, Hereford bull, tattoo #123, breeding registry number #456" for a prime breeding animal worth alone several hundred thousand dollars. But at other times, the creditor and debtor may want a security interests that floats on a broadly defined set of goods serving as inventory or accounts receivable or chattel paper in a portfolio. The choice should be up to them.

483. To achieve its maximum economic impact, the baseline policy model applies the security interest law equally to all persons and does not discriminate among qualified creditors or debtors, such as banks or companies.

484. Critics ask if security interests should be so inclusive. Several issues arise. Should certain types of assets be excluded "to keep imprudent individuals from becoming social charges?" Perhaps "the legal systems in transition and developing economies, where subsistence level income is the norm, and where it may be harder to draw the line between consumer and production-oriented assets, may and should be more hesitant to endorse a comprehensive view of the scope of collateral capable of being pledged."⁵⁸⁷ It is only a partial answer to this that the income disparities giving rise to these concerns will diminish over the long run with growth and development, which higher levels and better allocation of credit will promote more effectively. At the very least, the reforms must take into account the country's safety net. All systems exempt some property to prevent the debtor from being stripped of everything and becoming a burden on society. But each exemption has consequences for credit. One might exclude, for example, a workman's tools so that the workman can continue to earn income despite bankruptcy. If the workman wants to borrow to buy tools, however, they will not serve as effective collateral.

⁵⁸⁶ For an excellent discussion on how recent improvements on security interests laws in accounts receivable and chattel paper facilitate securitization, See Schwarcz, Steven L. "The Impact on Securitization of Revised UCC Article 9", *Chicago-Kent Law Review* Vol. 74 No.3 (1999) at 947.

⁵⁸⁷ Walsh 1999, at 58.

485. A second issue is whether an all-assets security interest is good policy. The security interest may prejudice unsecured creditors or other claimants who cannot protect themselves by raising the cost of their credits to offset the risk. It may be a disincentive to monitoring and enforcement by secured creditors who are too well protected. It will complicate priority rankings when tax and wage claimants have super-priority. These matters go to the debate about priorities in bankruptcy among competing claimants that are discussed in companion reports.⁵⁸⁸ Regimes that provide a floating all-asset security interest, however, do carve out exceptions such as that for the supplier's credit secured by the goods sold (the purchase money security interest), for reasons discussed in previous chapters (see Chapter IV).

486. Third, should hybrid security interests be treated the same as strict security interests? By removing the line between strict security interests and ownership interests, it is argued, the baseline policy model extends the law for collateral to true ownership interests, perhaps even including bailment. Equating hybrid interests and strict security interests also means that it is impossible to give ownership a higher level of protection, by priority, than a strict security interest even if it would be appropriate to do so.⁵⁸⁹ However, these concerns may be more fitting for the nuances of a sophisticated financial system than one moving from directed to market economy. Clarity and simplicity have important roles in the legal reform. Even the baseline policy model's approach distinguishes, for purposes of enforcement, between certain kinds of strict security interests and certain hybrids.

487. These are important concerns. The severity of the problems described in Chapters V - VIII, however, call for major change to a simple inclusive rule modified, as even the most functionalist countries do, in specific cases, each carefully considered.⁵⁹⁰ One example is the purchase money security interest exception to first-in-time priority (see the next section).

(ii) Priority

488. The serious problems that need reform, identified in Chapter VI, include priority rules that are so unclear it is impossible for a potential creditor to know where it would stand if it could identify all other creditors claiming against the same collateral. The creditor cannot identify all other claimants, however, because many hidden security interests can hold priority rights made pursuant to various laws.

489. The baseline policy model's solution to these problems is for a security interest law to give a strict clear first-to-file priority for security interests in all property and transactions. This general rule must apply to all transactions, including those of the State. Assuring a uniform ranking of priority, and eliminating the risk of hidden creditors, requires applying the priority rules to financial leases and to any and all other interests in movable property, regardless of their form, entered into for purposes of security. This priority structure would extend to any hybrid secured interest that develops in the future, minimizing the risk of hidden creditors.

490. Exceptions to the first-to-file rule are common even in functionalist laws. Security interests based on possession or control may not require filing, since possession gives notice of the interest

⁵⁸⁸ ADB, Report on RETA 5795: "Insolvency Law Reforms in the Asian and Pacific Region" and "The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms", *Law and Policy Reform at the ADB, Vol. 1, 2000 edition*.

⁵⁸⁹ M. Bridge, R. Macdonald, R. Simmonds, and C. Walsh, *Formalism, Functionalism, and Understanding the Law of Secured Transactions*, *McGill Law Journal*, v. 44, no. 3 (1999) at 567, 614.

⁵⁹⁰ See U. Drobniq, "A Comparative Introduction to Security over Movables and Intangibles," in J. Norton and M. Adenas, *Emerging Financial Markets and Secured Transactions*, (1998), at 5, 7.

and filing may be inefficient. Negotiable instruments are an example. A security interest in a fixture may have priority over an earlier mortgage of real property.⁵⁹¹ A creditor financing the purchase of a specific asset, for example, may receive a priority senior to earlier security interests in order to encourage the growth of the business and remove the debtor from what would otherwise become the monopoly of prior secured creditors. To the extent that priority for a purchase money security interest requires the approval of an existing all-assets secured creditor, however, control rests in the latter.⁵⁹²

491. Some analysts argue for more discrimination in priority, particularly when a creditor holds a security interest in the entire assets of a firm. They argue that the priority of this all-assets secured creditor should be subordinated to certain other creditors. The idea is to give that creditor an incentive to monitor the debtor's relations with general creditors and credit-worthiness generally, and to enforce its rights promptly. Monitoring of this sort would benefit all creditors. Unless it is subordinated, the all-assets creditor would be lax as long as its debt was less than the value of the firm's assets. Subordination requires "clear cut a priori identification of the classes of interests entitled to super-priority." The notion of monitoring is found in "such varied legal institutions as the French doctrine of specificity, the English theory of floating charge priority, the German approach to super-priority for inventory suppliers and even the Islamic emphasis on equity methods of bank financing."⁵⁹³ This notion is interesting, but it would place substantial responsibility on a country's banks as major creditors to firms. At a time when banks in many Asian countries are in crisis and lack the capacity to monitor debtors, that responsibility may be misplaced.

492. The following paragraphs describe priority rules for different types of assets, working from the baseline described above and flagging issues for which countries make exceptions to the rules.

(a) Fixtures

493. If the framework for security interests does not include real estate collateral, the ranking of priority in fixtures should still correspond to the creditor that first in time filed a security interest against the fixture, as against any subsequent mortgagees in the fixture or any other mortgagee in the real estate to which the fixture attached. Mortgagees should receive priority in subsequent real estate fixtures if, and only if, creating and filing the security interest conformed to the framework for security interests in movable property. The contrary rule will limit financing of heavy equipment, as any such financier will face the risk of losing the collateral once it attaches to real estate subject to an existing mortgage. Leaving fixtures finance under the mortgage security interest framework imposes the high costs of land transactions on heavy equipment finance. Reform of security interest in movables would best include fixtures, regardless of whether the local law qualifies fixtures as immovable property.

(b) Security Interests in Account Receivables

494. The priority of security interests in accounts receivable must run from the time of registration, not notice to the account debtor. As the security interest law applies to accounts receivable, a security interest in them will share the same features as inventory, including a possible general description of rotating accounts receivable, present and future receivables, and continuation in proceeds. When the system applies to both inventory and receivables, creditors can rotate the security for a working capital loan back and forth. A creditor can provide working capital used to buy

⁵⁹¹ See, for example, J. Wilson, "Secured Financing in Latin America: Current Law and the Model Inter-American Law on Secured Transactions" *Uniform Commercial Code Law Journal*, vol. 35, no. 3 (2000) at 43, 85.

⁵⁹² Walsh 1999, at 61.

⁵⁹³ Walsh 1999, at 61, 62.

inventory and secured by that inventory. As the inventory is transformed and sold, the creditor can take a secured interest in the accounts receivable in the ordinary course of business. This allows continuous secured credit as firms sell and restock their inventories.

(c) Assignees of Account Receivables

495. Assignment of accounts receivable may occur as collateral for credits or as outright assignment of rights (a sale of the accounts). Distinguishing between the two is so difficult that the law on security interests should apply to any transfer (assignment) of accounts receivable. The law should require an assignee of accounts receivable to file a notice of the assignment in the registry to acquire a priority rank in the accounts against other parties. The priority against accounts receivable dates from the time of filing a notice in the registry, not from the time of the assignment, or from the time the assignee notifies account debtors, as is the case in some of the five RETA countries.

496. In Indonesia, Pakistan, and India, and in reforms in several other countries, where the security interest law does not apply to the assignment of accounts receivable, a debtor may offer accounts receivable as collateral under the security interest law. This security interest has priority from the time of registration, but the law does not give this registered security interest a ranking against assignees of accounts receivable. The same creditor must search for prior assignments and the registry will not contain this information.

(d) Apparent Possession of Collateral

497. While actual possession can serve as an alternative to filing, the system should minimize the rules that grant apparent possession of collateral priority in the collateral. This is because third parties inspecting the inventory cannot readily determine if a prior security interest exists. This, for example, occurs in field warehousing, where the creditor takes apparent possession of collateral by renting the debtor's premises. Such transactions easily have vulnerability to fraud. A debtor need only remove the warehouse signs and pledge the collateral again with another creditor, who may not easily find out about the prior warehouse claim due to its perfection by possession without filing in a public registry. Security interest laws that restrict possession of collateral, as a way to acquire priority, to transactions of less than \$1000 could easily solve this problem. The rules would allow pawnshops, for example, to operate where actual possession is required.

(iii) Publication and Registration

498. The major problem in every country is the very narrow range of security interests in movables publicized by registration. Inefficient registration is a problem. A potential creditor cannot identify other possible claimants to the collateral, or inform later potential creditors of its own security interest.

499. The baseline policy model approach calls for a low cost notice-filing system, with minimal checking by officials only to determine that all blanks on the filing form contain entries (see Table X-2). In contrast, some registration systems require state review even of the legality of the agreement. The choice between a private or public registry must take into account the underlying economic concerns. A profit-seeking organization will have an incentive to operate more efficiently than government agencies. A private supplier knows that failure to improve quality and cut costs can lead to less profit, and possibly business failure and unemployment. A government supplier typically faces a much looser connection between poor performance and subsequent failure or

unemployment. Even a private supplier, however, remains subject to government supervision and rule making. The key issue is whether private profit incentives will sufficiently serve the public interest. If private incentives perform reasonably well, private incentives may free up scarce government resources.

500. The market for filing system services that provide access to the registry, as opposed to the registry itself, can have one supplier (a monopoly) or many suppliers (a competitive market). Although often mixed together, the issue of organizing the market—monopolist versus competitive—is distinct from the issue of control of the suppliers—public or private operation. Private and public monopolies, as well as private and public competitive organizations, are all possible. A country could also organize several state filing agencies that can compete for business among themselves and devise incentives that reward operators of more successful filing systems. Practical issues and issues of economic efficiency come into play.

501. All systems must address the needs of unsophisticated consumers—the innocent, perhaps illiterate, buyer of inexpensive consumer goods. The buyer of these goods normally takes free of a prior security interest in them, since the buyer has no way to know what interests have been registered. Sellers on credit to these buyers have various ways to publicize their security interest in these goods, including title registries and possession.

502. Second, substitutes for registration may be effective in societies where people know each other. But the five RETA countries in this study are big and moving ever further toward economic relations among strangers.

503. Critics note that many countries do not require comprehensive registration,⁵⁹⁴ suggesting that registration is not essential despite the high levels of conflict among various interests in, for example, inventory and accounts receivable. Germany, for example, lacks comprehensive registries. However, the reasons for the failure of various countries to require comprehensive registration do not apply in many Asian countries. For example, Germany relies for discipline and knowledge of claimants on a substitute institution, the *haus* bank. A leading bank serves as the dominant financial institution for the firm or group of firms. Other financial institutions look to this house bank for risk management. The *haus* bank is an institution from which Asian countries are trying to move away. Other countries avoid registration because it sends unacceptable signals to the business community. French debtors are reluctant to disclose certain types of secured transactions—accounts receivable financing, for example—that people will assume signal a debtor is in trouble. This behavior reveals the need for law reformers to be alert to local business practices, but does not counter the arguments for comprehensive registration. Vested interests oppose reform in some countries. Banks in the United Kingdom are reluctant to ask for better law because they fear they will lose some of the benefits they have under existing law. This also is not a compelling economic reason to limit registration.

(iv) Enforcement

504. Enforcement problems are severe in each country, as Chapter VIII shows. Court procedures, on which creditors generally rely, are too slow, expensive, and uncertain. Courts do not enforce claims against movable collateral in a way that is useful to the creditor. Self-help is very limited. Parties either lack or do not use the contractual power to designate acceptable methods of enforcement. Despite the ownership interests in hybrids, they are rarely enforced better than the weak enforcement treatment accorded to strict security interests. Arbitration is not fast enough, or sufficiently independent of the courts, to substitute for court enforcement.

⁵⁹⁴Walsh 1999, at 45 and 62-65.

Table X-2 Registration Systems for Security Interests and Other Claims on Collateral		
Problems Found	Comments	Comparison with Modern Systems
State run registration	Privately run filing would free scarce state resources. State-run entities improve services more slowly.	Most modern registry systems provide regulations for a privately-run system supervised by government; others privatized all filing. They give more efficient low cost filing and data retrieval than state-run registries.
Monopolistic access provider	Legally unique registration is essential, but monopolistic access to the registry will be less efficient than a competitive system	Most modern registry systems have full competition to file and retrieve data (e.g. in the US and Canada); others introduced competition in filing services by licensing private registry agents.
Paper and manual systems	Paper and manual systems are expensive, prone to mistake, and therefore risky for the registry	Most modern systems regulate electronic writing, signatures, and seals for electronic registries or archives, which increase security and public access to data, and lower operating costs
State registry officials review data filed	The secured creditor has most incentive to file correctly; state's review adds costs without immediate economic benefit and legal reviews delay filings.	Modern systems do not review legal validity of data filed; the secured party submits data files, and registry only checks for the completion of all the fields. As "registry" implies a state review in most code countries, could use "archive" instead..
Tax on registration	This regressive tax may not be optimal, as it applies to the key step in the financing chain, affecting costs of access to finance and of credit.	Governments often use filing to generate revenue, but a regressive tax on a non-profit registry makes no sense. Law should license private registry operators for profit, then tax the income.
Stating full amount of credit	This may lead to overcollateralization of future advances (credit lines).	Modern systems do not require stating total credit amount; prior systems in Canada that did so, forced creditors to overcollateralize credit lines.

505. The baseline policy model solution looks to non-judicial processes to bring the total collection time and costs within a range that would permit movable property to serve as collateral for credits. After all, even in industrial countries, courts can take a long time to decide cases. The law must provide for non-judicial repossession, such as repossession of collateral from debtors without disturbing the peace. The law must permit creditor-administered sale of collateral. The reforms may give the debtor many rights, but not the right to prevent seizure. The only defense against the charge of not having paid must be to produce proof of payment.

506. Self-help in developing countries has serious short-comings, according to critics.⁵⁹⁵ It shifts the burden of court action from the creditor to the debtor, but many debtors are not equipped to navigate the treacherous judicial waters. They may not know their rights. They may fear the cost of possible loss. The courts will take such a long time to award civil damages when the creditor fails to comply with enforcement standards that justice will be denied to the debtor. Quebec, for example, sends consumer cases to the courts. Other jurisdictions set statutory damages for consumer cases. Many code countries give the courts a key role executing creditors' enforcement in order to protect against abuse. Unfortunately, the resort to courts slows the process substantially.

507. Self-help requires institutions to enforce it, including professional repossessors subject to common standards. These could help remove the stigma that marks many creditors who try to enforce their claims. Law reform must include assistance to develop these.

508. Enforcement emerges as the most intractable problem for the Asian countries. Even in countries like the United States that rely on self-help, repossession carries a stigma borne of distrust for creditors and their agents. Courts offer some limited refuge. However, Chapter VIII demonstrates the great likelihood that courts in the five RETA countries will fail to protect a debtor in a timely fashion.

(a) Repossession of Collateral: Debtor Protection

509. The system must protect debtors' rights. The range of protection varies.⁵⁹⁶ Typically, it has two aspects: a consumer debtor receives more safeguards than a business debtor; and a debtor is entitled to recover from the secured creditor any loss caused by the secured party's failure to observe the general rules governing harmless repossession. In addition, and consistent with the parties right to contract freely, the law may allow the debtor and creditor to agree on alternative collection measures should the debtor default. The danger lies in much stronger bargaining power of the creditor over the debtor. The law should specifically forbid creditors from using the assistance, including the presence, of any government official such as the police, unless the creditor first obtains a court order.

(b) Sale of Collateral: Debtor Protection

510. To protect debtors against unfair disposition of the collateral, the law should hold creditors to a standard of commercial reasonableness, requiring that a creditor sell goods in a manner customary for dealers of that type of good. Any delay disposing of perishable collateral or likely to reduce the value of the collateral may constitute a failure to act in a commercially reasonable way. Next, the creditor must return to the debtor any proceeds that exceed the security interest. The law penalizes a sale that does not follow the commercial reasonableness standard. These rules are designed to protect the debtor against abuse by the creditor at the same time they serve the interests of both debtor and creditor by providing for the maximum recovery from the sale of the collateral. The law also should allow the secured creditor to collect any deficiency between the balance due and the proceeds of the sale only if he had complied with the legal requirements for the sale, including the requirement of commercial reasonableness.

⁵⁹⁵This discussion draws on Walsh 1999, at 66-67.

⁵⁹⁶See U. Drobniig, "A Comparative Introduction to Security over Movables and Intangibles," in J. Norton and M. Adenas, *Emerging Financial Markets and Secured Transactions*, (1998), at 5, 12.

511. The law should require creditors to notify debtors and junior secured creditors before any sale of the collateral. The law must always give the debtor a redemption period during which it can reclaim the collateral by paying the debt. The law should void any stipulation that allows the debtor to waive its right to redeem the collateral before foreclosure.

512. Whether these rules will protect debtors, given the problems of enforcement, is not certain. It may be that the distinction the rules make between consumer and business debtors is inadequate. Similarly, a simple distinction between non-companies and companies, or between individuals and firms, may be inadequate to the problems.

513. Perhaps the law should make a distinction among debtors that is analogous to the different treatment of unsophisticated and sophisticated investors in capital market regulation. In that field of law, sophisticated investors such as large banks and funds do not require the rigorous standards of investor protection that apply to other investors. They can take care of themselves. Size is a proxy for sophistication, since a large rich unsophisticated investor can hire skilled advisers. Applied to secured transactions, the idea would be that debtors sufficiently large (perhaps in relation to their creditors or perhaps against some absolute asset or income measure) should be subject to self-enforcement by the creditor and bear the burden of litigation or protection through market power. Other debtors, business or consumer, would not have the burden of litigation shifted to them. The obvious drawback of this approach is that it would curtail the flow of credit to small businesses and farmers. This is offered as a suggestion to spur further thought, and not as a proposal.

514. Enforcement of secured transactions in Asian countries requires more attention and thought than it has received in the literature so far.

(v) An Overview of the Baseline Policy Model Approach and the Concerns About It

515. If the weakness of the baseline policy model approach is that it emerges from North American common law traditions, the weakness of its critics' view is that it looks for substitutes that rely on a financial system that, as a matter of local and international policy, is under attack in many Asian countries. One does not need to rely on registration to give publicity and courts to enforce security interests as much in, say, Germany, as the United States because in Germany the big banks can coordinate and enforce risk management. That is, the German *haus* bank system substitutes for key aspects of the US legal system. In the post-financial crisis era in Asia, however, banks and their financial groups are seen as a devastatingly weak link in the economic structure.

516. The question of how much to protect secured creditors against all other claimants, in all circumstances, ultimately rests on decisions outside the competence of the economist or lawyer. A country can decide that it does not want to pursue a certain kind of development. The adviser can, however, point out ways that the country can protect other values without undermining secured credit.

517. How difficult is it to transplant legal concepts and tools from one regime to another? Certainly countries do it, even in this field. Taipei, China grafted a secured interests law from a US model that applied before the Uniform Commercial Code onto its code in 1963, and has worked with the transplant since then.⁵⁹⁷ The review of legal problems in Chapters V - VIII revealed many instances when the five RETA countries were not grouped according to whether they were civil or common law

⁵⁹⁷ See Pistor and Wellons 1999.

countries. A civil law country and a common law country had the same rule, policy, or problem.

D. Conclusion: Steps in a Reform

518. A legal problem requires a legal solution. Reforming the framework for using movable property as collateral requires first reforming the applicable legal framework: the laws that allow taking movable property as collateral; and then reforming the institutional framework involved in making public the existence of security interests, notable by establishing a registration filing system.

519. The most likely components in a reform project should include:

(i) Prepare Diagnostic Study

520. A diagnostic legal and economic study should first identify all issues, and set out the options for reform. Interested parties should receive the study, and incorporate their comments in public discussions. Adding to this paper an economic annex that uses a cost-benefit analysis to measure exactly how the problems in the framework for secured transactions limit economic growth, access to credit and the distribution of wealth in the country often proves useful.

(ii) Fix the Sequence of Reform

521. The study will reveal the parts of the regime for secured transactions that require attention. As discussed above, the continuing debate in law development is whether to take incremental steps or seek across-the-board change. In part, this is a local political judgment. Governments in some countries can change step by step. This has the advantage of allowing each step to be tested before the next step is taken. It has the disadvantage of allowing substantial delay in reforms. The most thorough-going reforms realistically possible should be sought, therefore. The following paragraphs assume broad change. They recognize, nevertheless, a sequential logic to the reforms. The rules must be agreed before the registry is designed, for example.

(iii) Prepare Draft Law

522. After the review of the first draft of the diagnostic paper, a draft law should follow, with full legal and economic annotations that support the new provisions. In this way, the group reviewing the paper can understand precisely the requested changes in the law. Again, the drafting process should include distribution of the draft law to interested parties, and public discussions for incorporating their comments.

(iv) Pass the Draft Law

523. For facilitation of passage of the law, most successful projects link the reform to the secured transactions framework with key structural economic reform programs in the country. This stage could combine with a public awareness campaign program, such as seminars and presentations.

(v) Write Regulations and Choose Operation of a Registry Filing System

524. Once passage of the law occurs, establishment of the institutional framework for filing security interests must take place. The crucial features of such registry system include a system that (a) only files a notice of a security interest, instead of the entire security agreement, (b) permits remote filing into an electronic database; and (c) has private competitive suppliers of access to the registry under the supervision of the state. Implementation of this work usually occurs in two stages:

(a) Drafting Administrative and Technical Regulations for a Registry Filing System

525. After passage of the law, the first and most crucial step before embarking on the financing of a registry operating system, is to establish the registry's regulatory framework. The administrative and technical regulations for a registry do this by defining the type of registry, dividing the public and private functions, giving legal validity to the filing forms and procedures, ensuring public access, and setting out the administrative and technical system of filing, archiving and retrieving information. These regulations, in turn, will most accurately define the size and cost of the registry operating system. It is also useful to draft a registry options paper that discusses the options the regulators considered and facilitates discussion so key political groups understand the reasons for choosing a particular a filing system.

(b) Establishing the Filing System, and Licensing the Registry and Private Access Providers

526. After enacting the regulations, the government could support efforts to establish the operating system for filing in the registry. This system should ensure the use of universal standards and off-the-shelf software, so the basic registry system permits competition by private agents in offering filing and retrieval registry services.

(vi) Training and Public Awareness Campaign

527. Finally, most successful projects accompany all stages with support for training about the new regime as well as discussion seminars that help incorporate the comments from all interests groups.