

## II. PURPOSES OF REGISTRATION

### A. Economic Role of Secured Credit

34. Access to credit at reasonable rates is considered essential to economic development everywhere. For commercial enterprises, financing may be needed to fund capital start-up and expansion costs, or to provide the working capital needed for the acquisition of the goods, services, and information that go into producing the enterprise's product from which its profit is ultimately generated. Consumers, as well, have come to depend on some form of financing particularly for the acquisition of relatively high-value durable goods—for instance, road vehicles—to support their day-to-day lives and livelihoods.

35. The availability and cost of access to credit is a function, in part, of the risk of nonpayment faced by the credit-supplier. Secured credit is a long-established means of reducing the financial consequences of this risk. The basic idea is an intuitively simple one. If the debtor defaults, the secured creditor has the right to look to the value of the debtor's assets that were charged with security as a source of payment. This collateral, more accurately its value, offers a concrete source of alternative funds to back up the debtor's bare promise to pay.

### B. Priority Risk Created by Nonpossessory Charges in Absence of a Movable Registry

36. Taking security reduces risk only if the secured creditor has the legal right to appropriate the value of the collateral to satisfy the secured obligation in preference to the claims of the debtor's other creditors. The distinction between a possessory pledge and a nonpossessory charge is important to the management of this priority risk.

37. In its classic form, a possessory pledge involves delivery of possession or control of the pledged collateral to the secured creditor. The requirement for delivery of possession means that the secured creditor can be confident that the debtor has not already pledged the collateral to another creditor. Dispossession of the debtor also alerts subsequent third parties that the debtor no longer has unencumbered title to the collateral.

38. However, possessory pledges are possible only if the collateral is of a kind that is practically capable of being delivered into the possession or control of the secured creditor. This excludes many types of movable property including the debtor's future assets, as well as purely intangible property, such as the trade receivables owed by a debtor's customers and intellectual property. Even when delivery of possession is physically feasible, the costs of storage and insurance for the creditor are likely to outweigh the economic value of the reduction in risk represented by the value of the collateral.

39. Most importantly, if the debtor had to give up possession, there would be little incentive to use secured credit in the first instance. Commercial debtors need to retain possession of their equipment, inventory and other business assets in order to generate the income necessary to satisfy the secured obligation. Similarly, the objective of most consumer financing is to enable the debtor to have the immediate use and enjoyment of the type of consumer assets typically financed through secured sale or loan credit, e.g., vehicles and appliances.

40. Although they constitute a necessary and useful type of security, nonpossessory charges create priority risks for secured creditors. Because the debtor retains possession of the collateral, third persons, including prospective secured creditors, have no means of knowing which of the debtor's assets are already charged with security. The debtor's assurances and representations are not an objectively reliable source of information. Deliberately, or, more likely, inadvertently, the debtor may fail to disclose the existence of a prior charge in favor of another creditor. The negative consequence of this risk are illustrated by the scenario that follows.

**Box II-1**

**Scenario 1: Increased Priority Risk Created by Legal Recognition of Nonpossessory Charges in the Absence of a Movables Registry**

On 1 June, Debtor obtains a loan from Secured Creditor 1 to finance the acquisition of equipment for his business. Secured Creditor 1 takes a charge in the equipment to secure repayment of the loan.

On 1 July, Debtor, in need of additional financing for his business, obtains a loan from Secured Creditor 2. To secure repayment, Secured Creditor 2 takes a charge in the equipment that Debtor purchased with the money loaned by Secured Creditor 1. Debtor fails to tell Secured Creditor 2 about Secured Creditor 1's prior charge.

Debtor's business falls into financial difficulty and Debtor is unable to repay either Secured Creditor 1 or Secured Creditor 2. When Secured Creditor 2 attempts to enforce its charge against the equipment, it finds out about Secured Creditor 1's prior charge for the first time. Unhappily, the liquidated value of the equipment is sufficient to pay the amount owed to Secured Creditor 1 or Secured Creditor 2, but not to pay the aggregate amount owed to both. In other words, Secured Creditor 2 discovers that it is not a secured creditor after all.

41. Unless secured creditors in the position of Secured Creditor 2 in this scenario have a reliable means of discovering the existence of prior charges, they will need to factor this priority risk into their decision to extend credit. The existence of this additional risk reduces access to secured credit, particularly for debtors without an established credit reputation. Even when secured credit remains available, creditors will naturally charge a premium to cover the adverse economic consequences of the potential loss of value represented by the risk of prior "secret" charges.

42. A secured transactions regime that provides for disclosure of nonpossessory charges by public registration offers an efficient and simple solution to the legal risk posed by this “secret charge” problem. The following scenario illustrates the information-disclosure benefits of a movables registry for secured creditors.

**Box II-2**

**Scenario 2: Role of Movables Registry in Reducing the Legal Risks Posed by Nonpossessory Charges**

On 1 June, Debtor obtains a loan from Secured Creditor 1 to finance the acquisition of equipment for her business. Secured Creditor 1 takes a charge in the equipment to secure repayment of the loan. The applicable secured transactions law provides for registration of notice of such a charge in a public movables registry. Secured Creditor 1 duly registers its charge.

On 1 July, Debtor is in need of additional financing for her business. She applies to Secured Creditor 2 for a loan to be secured by a charge in the equipment purchased with the money loaned by Secured Creditor 1, forgetting to inform Secured Creditor 2 about the existence of Secured Creditor 1's charge.

On receipt of Debtor's application, Secured Creditor 2 searches the records of the movables registry and discovers the existence of Secured Creditor 1's charge. Secured Creditor 2 tells Debtor that her application for credit will be refused unless she either repays Secured Creditor 1 (and Secured Creditor 1's charge is expunged from the registry record), or persuades Secured Creditor 1 to voluntarily subordinate the priority of its charge to that of Secured Creditor 2.

43. In this scenario, the existence of a movables registry enabled both Secured Creditor 1 and Secured Creditor 2 to protect themselves. Secured Creditor 2 was able to search the registry and find out about Secured Creditor 1's prior charge before advancing any funds in reliance on the collateral offered by Debtor. Conversely, by registering its charge in a timely fashion, Secured Creditor 1 was able to protect itself against the risk of Debtor granting a charge in the same item of collateral to a later creditor in the position of Secured Creditor 2.

**C. Registration and Priority Ordering among Secured Creditors in a Movables Registry**

44. Establishment of a registry by itself does not protect a secured creditor against the risk that a debtor has already charged the collateral in favor of another creditor. To create an effective incentive for secured creditors to register promptly, establishment of a movables registry must be accompanied by substantive legal reform ordering the priority of charges according to their order of registration.

45. The need to support registry reform with substantive legal reform to provide for the priority ordering function of registration is illustrated by the scenario that follows.

**Box II-3**

**Scenario 3: Role of Movables Registry in Ordering Priority among Nonpossessory Secured Creditors<sup>3</sup>**

On 1 June, Debtor obtains a loan from Secured Creditor 1 to finance the acquisition of equipment for his business. Secured Creditor 1 takes a charge in the equipment to secure repayment of the loan but does not bother to register notice of the charge immediately.

On 1 July, Debtor is in need of additional financing for his business. He applies to Secured Creditor 2 for a loan to be secured by a charge in the equipment purchased with the money borrowed from Secured Creditor 1. On receipt of Debtor's application, Secured Creditor 2 searches the records of the movables registry. Having satisfied itself that there are no prior charges registered against the equipment, Secured Creditor 2 approves Debtor's application, registers notice of its charge in the movables registry, and advances the loan funds to Debtor.

On 1 August, Secured Creditor 1 registers notice of its charge.

Debtor's business falls into financial difficulty and Debtor is unable to repay either Secured Creditor 1 or Secured Creditor 2.

46. In this scenario, if registry reform is accompanied by legal reform establishing a first-to-register priority rule, secured creditors in the position of Secured Creditor 2 can confidently predict the relative priority of their claims against competing secured creditors by conducting a search of the movables registry. In the absence of a first-to-register substantive rule, secured creditors would not be able to rely on a 'clean' search result to accurately indicate their priority over other secured creditors.

47. In enacting a first-to-register rule, lawmakers must address the impact, if any, of actual knowledge on priority ordering. Should a creditor in the position of Secured Creditor 2 in the above scenario take priority even if it had actual knowledge of Secured Creditor 1's prior charge when it acquired and registered its own charge? Or should cases of actual knowledge constitute an exception to a first-to-register rule?

48. The modern trend is to apply the first-to-register rule without regard to considerations of actual knowledge. This approach operates to reduce litigation on the questions of priority. Proof of the presence or absence of actual knowledge may be difficult to establish. This is especially problematic if the secured creditor is a large multi-department institution with many employees: when does the knowledge of an individual employee or department become the knowledge of the creditor enterprise as whole? In contrast, a straightforward first-to-register rule enables all secured creditors to confidently rely on an external objective event—public registration in a movables registry—to predict the order of payment of their claims. The unregistered charge holder cannot complain of unfairness since, under the rules applicable to the players, it could and should have protected itself by prompt registration.

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<sup>3</sup> This scenario is based on the assumption that the contractual and evidentiary requirements for creation of a charge have already been satisfied. As explained later in the Guide, the operation of the first-to-register priority rule requires a somewhat more refined analysis in a system that permits registration in advance of creation of the charge.

#### **D. Exception to First-to-Register Priority in a Movables Registry for Acquisition Financing Charges**

49. A legal system that permits nonpossessory charges greatly expands the range of collateral capable of being charged by a debtor. The debtor can charge its intangible assets in addition to its tangible assets, and its after-acquired assets in addition to its presently owned assets. This latter facility is considered especially important in enhancing access to credit for commercial borrowers since the asset base of a commercial enterprise is typically in a state of constant flux.

50. Unqualified application of the first-to-register rule of priority means that a secured creditor who takes and registers a charge in the present and future movable property of an enterprise will enjoy priority over subsequent creditors who take and register charges in specific later-acquired assets. In general, this works efficiently and fairly, since the subsequent secured creditor can and should protect itself by searching the movables registry before advancing credit.

51. However, what about the situation where the second registered creditor provides the funding needed and used by the debtor to acquire the very collateral—such as a new item of capital equipment, or new inventory—in which the second charge is granted? In this scenario, unqualified application of the first-to-register priority rule seems unfair. Since it is the second creditor's credit that financed the debtor's acquisition of the additional collateral, why should the first creditor be entitled to claim the value of that collateral simply because it registered first? If this were the rule, the purchase financing credit market would be less accessible and less competitive for borrowers.

52. To avoid giving an unfair windfall to the first-registered creditor, legal regimes that have adopted a general first-to-register rule often create an exception to protect subsequent secured creditors who finance the debtor's acquisition of new assets. The existence of this exception has the additional benefit of enabling a debtor who has granted a general charge on all its present and after acquired movable assets in favor of one creditor to retain practical access to competitive sources of credit to finance later acquisitions.

53. The operation of such an acquisition financing exception to first-to-register priority is illustrated by the scenario that follows.

#### **Box II-4**

##### **Scenario 4: Priority of Subsequent Acquisition Financing Charge over Prior-Registered Charge in Debtor's After-Acquired Movable Assets**

On 1 June, Debtor grants a general charge in favor of Bank in all its present and after-acquired movable property. Bank duly registers notice of the charge.

On 1 July, Debtor approaches Specialized Equipment Financing Company ("Specialized") for a loan to finance the acquisition of a specific item of equipment for use in its business. Specialized agrees on condition that Debtor grant a charge in the equipment as security.

Debtor falls into financial difficulties and defaults in its payment obligations to both Bank and Specialized.

If the applicable priority regime has adopted a first-to-register rule, the Bank in this scenario will have the presumptive right to be paid the value of the Debtor's movable assets in priority to all other creditors. However, if the regime incorporates a special priority rule to protect acquisition financing charge holders, Specialized will be entitled to priority of payment with respect to the specific item of equipment acquired by Debtor with the credit supplied by Specialized.

54. To obtain this special priority, the applicable legal regime will typically require the acquisition financing secured creditor to register notice of its charge within a specified time period (such as fifteen days) after the charge is created. The purpose of requiring timely registration is to enable the first-registered creditor to verify whether an acquisition financing charge exists on any new assets acquired by a debtor by conducting a search of the movables registry before advancing new credit on the security of those new assets.

55. If the collateral is inventory, some legal regimes do not allow any "grace period" for registering, and the creditor is further required to send a notice to any prior-registered secured creditors of its intention to provide acquisition financing. The reason for this added burden in the case of inventory is to protect prior registered creditors who have taken a general charge to finance the working capital of a debtor enterprise, including the ongoing funds needed by the debtor to acquire new inventory. Since such creditors have likely set up a revolving credit arrangement based on the debtor's ongoing acquisition and resale of inventory, it would be impracticable and inefficient to expect them to conduct periodic searches of the movables registry to verify their continued priority.

### **E. Role of Movables Registry in Balancing Rights of Secured Creditors and Buyers**

56. It is inherent in the very idea of security that a secured creditor has the right to follow the collateral into the hands of a subsequent purchaser to enforce its security rights. Otherwise, the debtor would have the unilateral power to terminate the secured creditor's rights simply by selling the collateral.

57. In the case of a nonpossessory charge, however, legal systems may be reluctant to prejudice "innocent" purchasers of an item of collateral that turns out to be subject to a "secret charge." The establishment of a movables registry permits a legal system to protect the interests of both secured creditors and buyers by making registration a precondition to the exercise of a secured creditor's right to follow the asset into the hands of a purchaser.

58. The utility and fairness of making registration a precondition to the right of a secured creditor to enforce its charge against subsequent buyers is illustrated by the scenario that follows.

#### **Box II-5**

##### **Scenario 5: Role of Movables Registry in Protecting Purchasers of Charged Collateral**

On 1 June, Debtor obtains a loan from Secured Creditor to finance the acquisition of equipment for her business. Secured Creditor takes a charge in the equipment to secure repayment of the loan, and promptly registers notice of the charge.

By 1 July, Debtor is facing financial difficulty and decides to sell the equipment to generate quick cash for the business.

Before advancing the purchase price, Buyer searches the records of the movables registry and discovers the existence of Secured Creditor's charge. Buyer refuses to purchase the equipment from Debtor except on condition that Debtor discharges her obligation to Secured Creditor (and ensures that the discharge is entered in the registry records), or on condition that Debtor discounts the purchase price by the amount still outstanding to Secured Creditor.

59. In this scenario, the existence of a movables registry meant that Buyer was able to find out about Secured Creditor's prior charge before advancing any purchase funds, and to protect

itself accordingly. Conversely, by registering promptly, Secured Creditor was able to acquire protection against the risk of a subsequent unauthorized sale of the collateral by Debtor.

60. Once again, it is not the existence of the registry in the abstract that protects the interests of the parties. In order for secured creditors and buyers to be able to rely on the registry to protect their interests, the registry must be supported by a substantive legal regime that makes registration a precondition to the legal effectiveness of a charge against buyers.

61. Legal regimes differ on whether the law should go so far as to protect a purchaser who buys with actual knowledge of an unregistered charge. The current trend seems to favor making registration a precondition to the effectiveness of a charge against all purchasers, regardless of the presence or absence of knowledge. The reasons for this are the same as the reasons for adopting an unqualified first-to-register rule to order priority amongst competing registered charges. Such a rule enables buyers to confidently rely on an external objective event—public registration—to determine whether or not the debtor's title is free from prior charges. It also reduces the need for *ex post facto* litigation to prove the presence or absence of knowledge in order to resolve issues of priority.

#### **F. Effectiveness of Registered Charge in a Movables Registry against Creditors Generally**

62. Should registration be a prerequisite to the secured creditor's right to payment of the value of the collateral in preference to the claims of the debtor's unsecured creditors and their representatives, for instance, the debtor's insolvency administrator? This is the predominant rule in jurisdictions that have established a modern movables registry.

63. Making registration a precondition to the general effectiveness of a nonpossessory charge against third party creditors produces a number of benefits. It creates a powerful incentive for secured creditors to register promptly. It gives judgment creditors and insolvency administrators an efficient means of determining which of the debtor's assets are effectively charged with security, thereby dispensing with the need for them to undertake the trouble and expense of initiating futile enforcement proceedings. It operates to reduce litigation to resolve third person suspicions that the contractual documents creating a charge were fraudulently antedated. It also gives creditors the opportunity at any given time to determine the extent of secured indebtedness of the debtor, knowledge that may contribute to their overall assessment of the debtor's personal creditworthiness.

64. The scenario that follows illustrates the operation of such a rule.

**Box II-6**

**Scenario 6: Role of Movables Registry in Ordering Effectiveness of a Charge against the Debtor's Unsecured Creditors and their Representatives**

On 1 June, Debtor grants a charge to Secured Creditor in specific assets owned by Debtor.

By 1 July, Debtor is in evident financial difficulty and insolvency proceedings are formally commenced.

On 15 July, Secured Creditor registers its charge.

Even though Secured Creditor obtained its charge before the collateral fell under the control of the debtor's insolvency administrator, the charge is not effective in insolvency proceedings since it was not registered when the insolvency proceedings were initiated. Consequently, the liquidated proceeds of the collateral, instead of being paid first to satisfy the secured claim, will be divided among the creditors entitled to participate in the insolvency proceedings in accordance with the insolvency ranking rules applicable to unsecured creditors. In effect, the failure to effect timely registration means that the secured creditor's claim will be demoted to unsecured status.

65. Timely registration should not necessarily immunize a secured creditor from challenge by unsecured creditors or an insolvency administrator. In particular, registration should not protect a secured transaction from attack by other creditors on the basis of generally applicable rules governing unjust or fraudulent preferences, or governing the effectiveness of transactions entered into on the eve of insolvency. In other words, while failure to register results in demoting the secured creditor to unsecured status, registration does not guarantee that this same result will not come about by operation of general bankruptcy and insolvency law policy.

**G. Exceptions to Effectiveness of Registered Charges in a Movables Registry**

66. Although registration should be made a precondition to the effectiveness of a charge against buyers and other third parties, it does not follow that every registered charge should be enforceable against third parties in every circumstance. Countervailing considerations, including the need to protect the reasonable expectations of the local marketplace, may require exceptions to the role of registration in preserving the enforceability of a charge against third parties.

67. For instance, legal regimes invariably provide that a purchaser of charged collateral, who buys in the ordinary course of the debtor's business, acquires the collateral free of the charge, whether registered or not.<sup>4</sup> The reasons for this exception are persuasive. A retail buyer who purchase an item from the inventory of a commercial enterprise cannot be expected to first check the registry to find out about any charges granted by the enterprise in its inventory. On the contrary, the seller's secured creditor will have taken the charge on the understanding that the inventory may be sold free of the charge in the ordinary course of the debtor's business. After all, the secured creditor has no desire to impede the operation of the debtor's enterprise, which is the vehicle for generation of the funds to pay the secured obligation.

68. To preserve commercial negotiability, similar protection from the binding effects of a registered charge is typically extended to purchasers who take possession of money and negotiable documents or instruments (such as checks and negotiable securities) in the ordinary

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<sup>4</sup> For example, see section 53(1) of the New Zealand Personal Properties Securities Act, 1999, reproduced in Appendix B.

course of business.<sup>5</sup> For the same reason, this exception usually protects not just subsequent purchasers but subsequent possessory pledgees as well.

69. The need for any additional exceptions turns on the particular social and economic context of each country. For instance, the presumed level of sophistication and legal literacy of the particular marketplace will determine the extent to which a buyer of noninventory collateral—e.g., capital equipment and consumer assets—should be protected from even a registered charge as long as he or she buys in good faith without actual knowledge of the charge. If the local context suggests that it is unrealistic to expect a buyer to search the movables registry, then universal protection for all buyers may be the most appropriate approach. Other countries may consider it sufficient to limit protection to consumer assets or to transactions that involve a relatively low value asset on the theory that buyers engaged in more sophisticated transactions will have access to the legal advice necessary to understand that a search should be conducted.<sup>6</sup>

#### **H. Should there be Additional Sanctions for Failure to Register in a Movables Registry?**

70. Should lawmakers impose any additional sanctions for nonregistration of a charge in a movables registry? For instance, should failure to register subject the secured creditor to a fine? Should it reduce or eliminate the enforceability of the charge against the debtor as opposed to third parties? The predominant view is that these sanctions are not needed nor efficacious.

71. Experience shows that the negative priority repercussions that follow from nonregistration under the rules outlined in the preceding sections provide a sufficient incentive to ensure prompt registration. Moreover, imposition of additional sanctions would be excessive. The purpose of the movables registry is to protect the informational needs of third parties. That objective is clearly within the appropriate scope of a priority regime that conditions the effectiveness of the charge against third parties on registration. To impose an additional penalty, or to deprive the creditor of the economic benefit of the security as against the debtor, would exceed the policy objectives of the registration requirement.

72. An additional consideration is the wisdom of placing on courts the burden of having to deal with legal proceedings necessitated if penalties were imposed on secured creditors who do not register their charges. There is little commercial or social benefit to be gained from making failure to register an offence.

#### **I. Enforcement of Registered Charges in a Movables Registry**

73. The creation of a movables registry supported by a coherent priority regime will not reduce all legal risk for secured creditors holding nonpossessory security. The effectiveness of a charge also depends on the secured creditor's practical ability to take control of the collateral on the debtor's default in order to realize its value. Consequently, legal reform of secured transactions law at the registration and priority levels should ideally be accompanied by legal reform at the level of maximizing the efficiency and fairness of the enforcement process, including the rules governing the impact of bankruptcy and insolvency proceedings on secured creditors.

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<sup>5</sup> For example, see sections 94, 96, and 97 of the New Zealand Personal Properties Securities Act, 1999, reproduced in Appendix B.

<sup>6</sup> For example, see section 54(1) of the New Zealand Personal Property Securities Act, 1999, reproduced in Appendix B. The full Act and accompanying regulations can be accessed at: [www.ppsr.govt.nz](http://www.ppsr.govt.nz)

74. Although the reform issues relating to registration and priorities are independent of those relating to enforcement, the establishment of a movables registry-based priority regime indirectly contributes to more effective enforcement. Because more than one nonpossessory charge can be created in the same item of collateral, more than one secured creditor may simultaneously have the right to enforce its charge against the same collateral. A movables registry-based priority regime brings order to a multiple-creditor enforcement process because it enables each creditor to discover efficiently and easily what other charges subsist against the same item, and to determine the priority of these other creditors' claim to payment out of the liquidated value of the collateral.