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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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A. General remarks

1. Introduction

1. The legal requirements for a valid and enforceable security agreement are minimal and should be easily satisfied (see A/CN.9/WG.VI/WP.2/Add.4, paras. 36-46). However, efficiency and predictability call for the incorporation of additional terms into the security agreement aimed at covering other aspects of the transaction. For example, revenues deriving from the encumbered assets may be retained by the secured creditor and increase the value of the encumbered asset or may contribute to the payment of the secured obligation. The parties themselves are in the best position to tailor the terms of the security agreement to their own needs and wishes. However, to fill gaps that may arise if the parties do not include additional terms, secured transactions regimes normally include a set of default rules detailing the parties' rights and obligations before default.

2. The legislative imposition of default rules is necessary for an effective, efficient and responsive legal framework governing security rights in movable property. Comprehensive coverage, clarifying the position of the parties by filling potential gaps in the security agreement, constitutes a core principle for an effective regime of secured transactions in personal property, or at least one of its most important corollaries (see A/CN.9/WG.VI/WP.2/Add.1, paras. 11 and 17). In this regard, the Guide pursues a policy shared by many recent legislative reforms (e.g. Quebec Civil Code and art. 9 UCC), regional model laws (e.g. the EBRD and the OAS Model Laws), and international conventions dealing with some aspect of secured transactions in movable assets (e.g. the Assignment Convention and the Mobile Equipment Convention).

3. There are two limitations to the scope of this Chapter. Firstly, it does not deal with the terms required to create a security agreement (e.g. the minimum contents of the security agreement), since they fulfil a different function and are, therefore, addressed in Chapter IV. Secondly, it does not deal with the rights and obligations of the parties to the security agreement after default, since after default different policy issues arise that are addressed in Chapter IX.

4. The initial discussion below is focused on two important policy issues. The first relates to the principle of party autonomy and the extent to which the parties should be free to fashion their own security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second relates to the type and number of default rules to be included, so as to encompass new and evolving forms of secured transactions. The Chapter concludes by outlining recommended pre-default rights and obligations of both the secured creditor and the debtor.

2. Party autonomy

a. The principle

5. To the extent that consumer-protection legislation is not interfered with, party autonomy may be established as a cardinal principle governing the relationship of the parties to the security agreement before default. Adopting party autonomy as a governing principle covering the non-proprietary aspects of secured transactions favours contractual flexibility. While this empowers credit providers with significant choice in fashioning the security agreement, the goal, ultimately, is to provide debtors with wider access to credit at a lower cost.

6. Allowing ample room for contractual flexibility would also contribute to the regulation of transactions between the parties in the longer term, by filling potential gaps in the security agreement. In many cases the security agreement is not regarded as a static, one-shot transaction. The parties may anticipate a dynamic, ongoing financing relationship in which additional funds will be loaned by the secured creditor and property to be acquired in the future by the debtor will be offered as security. Requiring the parties to formalize all subsequent modifications and additions to their initial agreement would impose significant compliance costs, which would ultimately be borne by the debtor. Party autonomy would allow the parties to protect their legitimate interests in secured transactions that form part of a longer-term relationship.

b. Limitations

7. As it is not possible to foresee all the circumstances in which a security right may be required to secure the performance of an obligation, it is advisable to avoid unnecessary restrictions which may hinder the ability of the parties to adapt a secured transaction to their own needs and circumstances. There must be, however, some limitation of party autonomy to prevent overreaching by the secured creditor. Those limits should be clearly drawn on grounds of public policy (*ordre public*) and an overriding principle of good faith and fair dealing, narrowly tailored to prevent any perverse or dysfunctional allocation of burdens in the name of party autonomy.

8. Whereas the secured creditor and debtor should be mostly free to deal with their mutual contractual rights and obligations, such freedom does not extend to the proprietary effects of the security agreement that may impact the rights and obligations of third parties. The notion of party autonomy in this context should be understood within the limits imposed by the wider field of property law.

9. Aside from such reasonable limits, which each jurisdiction will determine on criteria of their own, the parties should be given wide flexibility to:

(i) agree upon the terms of the security agreement;
(ii) define the obligation to be secured and the events triggering its default; and
(iii) determine what the debtor can and can not do with the encumbered assets.

3. Default rules

a. Meaning

10. The rules included in this Chapter are meant to apply automatically in the absence of evidence that the parties intended to exclude them. The conceptual vocabulary used to identify rules "subject to agreement otherwise" varies from country to country (e.g. *jus dispositivum*, *lois supplétives*, non-mandatory rules). These terms, however, have a common purpose as gap-filling law, in the sense that the rule applies only to the extent that the parties have failed to cover the point in their agreement. Whatever the language chosen to formulate these rules, it should make clear that they apply and are enforceable on the condition that the parties did not agree otherwise.

11. As to the number of default rules to be included, the Guide does not include an exhaustive list of the rights and obligations of the parties during the lifetime of the secured transaction. Whereas the law might set forth those rules on which the parties themselves would be most likely to agree, the list of default rules are not meant to operate as a substitute for a standard form. The default rules should cover only the most normal or regular incidents arising during the course of a secured transaction, i.e. the rights and obligations that the legislator fairly infers the parties had assumed despite the absence of an express term in the security agreement.

b. Policy objectives

12. All of the default rules should pursue plausible policy objectives, such as the reasonable allocation of responsibility for caring for the encumbered asset, the preservation of its pre-default value and the maximization of its post-default value. Additional terms in the security agreement, to enhance the protection of secured lenders or debtors, are better left to the parties' initiative without the need to incorporate them as default rules in the law envisaged by this Guide. For example, if the parties would like to include a choice-of-law clause, or if the secured creditor would like the debtor to deposit any insurance proceeds in a given deposit account, or if the debtor who retains possession of the encumbered assets would like to receive a certain advance notice before the secured creditor exercises its right to inspect them, the contracting parties must expressly contract for those additional terms.

13. The default rules might pursue a set of policies fitting the needs and practices of each jurisdiction. However, most jurisdictions are likely to agree on the advantages of adopting default rules on personal property security that are conducive to widening access to credit at a lower price. For example, the party in possession of the encumbered asset should have a duty of preservation and care. This type of rule is meant to encourage responsible behaviour on the part of those having control and custody of the encumbered assets, while at the same time maximizing the realization value of the encumbered assets in the case of default.

c. Types of default rules

14. A distinction may be drawn between those rights and obligations that are common to a secured creditor in possession of the encumbered asset and those pertaining to the debtor in possession of the encumbered assets in the case of non-possessory security.

i. Possessory security

15. In the context of possessory security rights, the pre-default rights and obligations of the parties should at the very least encourage the secured creditor to preserve the value of the encumbered assets, especially if those assets represent income-producing property. The following are among the most important duties and rights conferred on a secured creditor in possession of the encumbered assets.

(a) Duty of care

16. The best way to encourage responsible behaviour on the part of the secured creditor in possession is to impose on the creditor an obligation to take reasonable care of the encumbered asset. The scope and mode of exercise of this duty of care should be clearly stated, in detail. This should include a duty to preserve or maintain the encumbered asset in good condition, as well as to undertake all necessary repairs to keep that asset in good condition.

17. Depending on the circumstances, the duty of care may be discharged in different ways. In some cases, it may be enough for the secured creditor to notify the debtor, giving the encumbered asset back to the debtor, so that the debtor can undertake the acts of preservation. In other cases, the debtor may not be reasonably expected to undertake such acts and it is the secured creditor in possession who must carry out this duty of care.

(b) Right to be reimbursed for reasonable expenses

18. Those expenses that are reasonably incurred in pursuance of the secured creditor's duty of care should be borne by the debtor and the secured creditor should have the right to be reimbursed by the debtor for those expenses. Other types of expenses that the secured creditor chooses to incur should not be chargeable to the debtor.

(c) Right to make reasonable use of the encumbered asset

19. In order to encourage the profitable use of the encumbered asset, the secured creditor should be allowed to make use of or operate the encumbered asset for the purpose of its preservation and maintenance, although always in a manner and to the extent that such use is reasonable.

(d) Duty to keep the encumbered assets identifiable

20. Unless the encumbered assets are of a fungible nature, the secured creditor must keep tangible assets in an identifiable form.

(e) Duty to take steps to preserve the debtor's rights

21. The secured creditor's duty of care of assets, such as the right to payment of money, intellectual property rights and other intangible movables, does not merely consist of the preservation of the document or instrument which embodies such right to payment or intellectual property right. The duty of care in these cases extends to an obligation to take active steps to maintain or preserve the debtor's rights against those who are secondarily liable (e.g. a guarantor).

(f) Duty to allow inspection by debtor

22. An additional obligation of the secured creditor in possession is to allow the debtor to inspect the encumbered assets at reasonable times.

(g) Right to impute revenues to the payment of the secured obligation

23. Proceeds (including monetary profits, the offspring of animals and other "civil" or "natural" fruits) derived from the encumbered asset and received by the secured creditor may, unless remitted to the debtor, be retained by the secured creditor and imputed to the payment of the secured obligation.

(h) Right to assign the secured obligation and the security right

24. A secured creditor should be entitled to assign both its payment claim against the debtor ("secured obligation") and the security right attached to that secured obligation. Where this is possible, the assignee succeeds to all the rights vested in the original secured creditor.

(i) Right to "repledge" the encumbered asset

25. The secured creditor may also be entitled to create a security right in the encumbered asset as security for a debt. That is, the secured creditor may "repledge" the encumbered asset as long as the debtor's right to get the asset back when it fulfils its obligation is not impaired.

(j) Right to insure against loss or damage of the encumbered asset

26. The risk of loss or deterioration of the encumbered assets remains on the debtor despite the creation of a security right (in most legal systems the debtor retains a property right in the encumbered asset). Yet, it is in the interest of the secured creditor to keep the encumbered asset insured in full. Therefore, the secured creditor should be entitled to contract insurance on behalf of the debtor and be reimbursed for that expense.

(k) Right to pay taxes on behalf of the debtor

27. Taxes assessed against the encumbered assets also fall under the responsibility of the debtor. However, a secured creditor should be entitled to pay those taxes on the debtor's behalf to protect its security right in the assets. Such payment should be

regarded as a reasonable charge incurred in the preservation of the encumbered asset for which the secured creditor should be entitled to reimbursement.

ii. Non-possessory security

28. As a key policy objective of an effective secured transactions regime, a secured transactions regime should encourage responsible behaviour by the debtor who remains in possession of the encumbered asset while having granted a security right over those assets (see A/CN.9/WG.VI/WP.2/Add.1, para. 18). Accordingly, the policies underlying the default rules for non-possessory security are aimed at maximizing the economic potential of the debtor's assets (see A/CN.9/WG.VI/WP.2/Add.1, para. 11). Encouraging the economic utilization of the debtor's assets facilitates the generation of revenue for the debtor. Maintaining the pre-default value of the encumbered assets belonging to the debtor is consistent with the objective of maximizing the realization value of those assets for the benefit of the secured creditor.

(a) Duty to keep the encumbered assets properly insured and to pay taxes

29. The duty of care allocated to the debtor in possession includes keeping the encumbered asset properly covered by insurance and making sure that the property taxes are punctually paid. If these pre-default expenses are incurred by the secured creditor, its right to be reimbursed by the debtor is secured by the security right.

(b) Duty to allow the secured creditor to inspect

30. The secured creditor should have the right to police the conditions in which the encumbered asset is kept by the debtor in possession. To this effect, the debtor should be bound to allow the secured creditor to inspect the encumbered assets at all reasonable times.

(c) Duty to account and to keep adequate records

31. When the encumbered assets consist of income-producing property in possession of the debtor, the debtor's duties include the reasonable rendering of accounts regarding the disposition and handling of the proceeds derived from the encumbered assets. This duty should include maintaining adequate bookkeeping records regarding the status of the encumbered assets.

(d) Duty to take steps to preserve rights in the encumbered assets

32. In the case of intangible encumbered assets, such as the debtor's right to payment in the form of receivables, deposit accounts, royalties or rights on account of patents, copyrights, and trademarks, the main aspect of the debtor's obligation of care includes the taking of necessary steps to preserve those rights.

(e) Right to receive revenues

33. In the same way that the debtor is responsible for pre-default expenses and charges, the debtor also receives the benefits from revenue and proceeds derived

from the encumbered asset in the debtor's possession. These proceeds are typically made subject to the security right held by the secured creditor in the encumbered assets.

(f) Right to use, mix, commingle and process the encumbered asset

34. The debtor in possession is typically entitled to use, mix or commingle and process the encumbered asset with other assets, as well as to dispose of the encumbered assets in the ordinary course of its business.

(g) Right to grant another security right in the same asset

35. The power of the debtor to confer a subsequent security right over an already encumbered asset, should also be included as a default right.

B. Summary and recommendations

36. The default rules included in this Chapter seek to clarify the pre-default rights and obligations of the parties to the security agreement. These rules are permissive rather than mandatory, so that the expression, "unless otherwise agreed", should be read as a preamble to each of the rights and duties allocated to the parties. A corollary of the permissive nature of these rules is that the parties may waive or vary the rights and obligations allocated to them in this Chapter, unless such waiver is against public policy or in conflict with an overriding principle of good faith and fair dealing.

37. A secured creditor in possession of the encumbered asset should care, preserve and maintain the asset in good condition. The secured creditor is also bound to undertake all necessary repairs to keep the encumbered asset in such condition. In case of tangible encumbered assets, the secured creditor should keep those assets properly identifiable, unless they are fungible movables.

38. Where the encumbered asset consists of the debtor's right to the payment of money or other intangible assets (e.g. negotiable instruments or receivables), the obligation of care on part of the secured creditor should include the duty to preserve the debtor's rights against persons secondarily liable. The secured creditor should allow the debtor to inspect the encumbered asset at all reasonable times. Upon full satisfaction of the secured obligation, the secured creditor should return the encumbered asset to the debtor.

39. The secured creditor in possession should be entitled to retain as additional security any proceeds deriving from the encumbered asset and to impute it to the payment of the secured obligation unless remitted to the debtor. The secured creditor may also create a security right in the encumbered asset by repledging it.

40. Reasonable expenses incurred by the secured creditor while discharging the obligation of custody and care (including the cost of insurance and payment of taxes) must be reimbursed to the secured creditor. The secured creditor's right to be reimbursed for those expenses should also be secured by the encumbered asset.

41. In the context of non-possessory security, the debtor who remains in possession of the encumbered assets should also be bound by a duty of custody and preservation. In fulfilling this duty, the debtor is bound to incur expenses such as insurance premiums, taxes and other charges.

42. The debtor in possession should be entitled to use, mix or commingle and process the encumbered asset with other assets, as well as to dispose of the encumbered assets in the ordinary course of business. The debtor may also grant a subsequent security right in the encumbered asset.

43. The debtor in possession should also be bound to allow the secured creditor to police the conditions of the encumbered assets at reasonable times and to keep reasonable bookkeeping practices detailing the disposal or handling of the encumbered assets. If the encumbered asset consists of intangible movable property, the debtor's obligation of care extends to asserting or defending the debtors right to be paid, or to take the steps that are necessary to collect what is due to the debtor.