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Possible future work on security interests: Proposal for a Practice Guide to the UNCITRAL Model Law on Secured Transactions

Proposal of the Governments of Australia, Canada, Japan and the United Kingdom of Great Britain and Northern Ireland

Note by the Secretariat

The annex to this note sets forth a proposal of the Governments of Australia, Canada, Japan and the United Kingdom of Great Britain and Northern Ireland for the preparation by the Commission of a practice guide to the UNCITRAL Model Law on Secured Transactions, as received in English, French and Spanish.

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Annex

1. Introduction

At the Fourth UNCITRAL International Colloquium on Secured Transactions (15-17 March 2017), three panels discussed various areas where greater guidance and advice could be given to those involved in actually using the UNCITRAL Model Law on Secured Transactions in a State once it has been enacted. Categories of potential users include secured creditors and grantors (including micro-businesses), their lawyers and advisers, the grantor's other creditors and insolvency representative, transferees of the grantor's encumbered assets, regulatory authorities, judges, arbitrators and those involved in teaching the new regime.

The idea of preparing a practice guide, integrating and refining the ideas discussed at these three panels, attracted wide support among Colloquium participants. Without such a guide, it was feared that even if the Model Law was enacted by a State as recommended, the economic benefits which it aims to achieve (increasing the availability of credit at lower cost by the use of movable property as security for obligations) would not flow. Participants noted that the Guide to Enactment of the UNCITRAL Model Law on Secured Transactions provides essential assistance for legislators enacting the Model Law in a State. However, they observed that it provides insufficient concrete, practical guidance to those actually involved in or affected by the provision or receipt of credit under the Model Law. Nor does it give any advice as to the regulatory and transactional environment required to integrate the new secured transactions regime into the wider economic and policy objectives of the enacting State.

It is therefore proposed that Working Group VI prepare a practice guide along the lines suggested by Colloquium participants. The proposed guide would thus encompass all or most of the matters addressed by the first three Colloquium panels and presented as three distinct possible future work topics in paragraphs 8-44 of A/CN.9/913. As explained in more detail below, the proposed guide would thus include guidance on drawing up the contracts, notices, checklists and other documents needed to enter into and operate secured transactions according to the Model Law. It would also explain the need for users to acquire the practical tools needed to successfully carry out transactions, such as risk assessment, valuation of collateral and extrajudicial enforcement. It would additionally address how to successfully integrate a new regime of secured transactions into an enacting State's broader legal and financial regulation regime and objectives. And while the proposed guide would address the financing of businesses of all sizes, it would pay particular regard to the problems faced in the financing of micro-businesses identified in paragraphs 31-44 of A/CN.9/913.

2. Desirability

There was general agreement among Colloquium participants that matters external to the formal reform and modernization of a State's secured transactions law play a major role in determining whether a State has vibrant and well-functioning secured credit markets that further the overall goal increasing the availability of credit at lower cost. These matters include "capacity-building" in particular among lenders and their advisers, but also among borrowers, other creditors, judges, arbitrators and academics, as well as the development of appropriate related regulatory standards.

Capacity-building means the development of the practical ability to use the tools provided by the Model Law to engage efficiently and profitably in credit transactions with reduced risk of loss from default. It is generally recognized that providing a State with a modern secured transactions law, like the Model Law, does not automatically result in lenders acquiring the practical tools to extend credit in a meaningful way. Rather, creditors often do not embrace transactions newly made

possible on a profitable basis by secured transactions law reform until they have the practical capacity to use the new legal rules effectively. Further, unless others involved in implementing the new system, such as administrators, lawyers, and judges, are able to do so effectively and knowledgeably, the system will not operate properly and creditors will be reluctant to rely on it. Thus, law reform without parallel capacity-building may not be effective in achieving its goal.

For example, empirical evidence suggests that, even in States that have adopted modern secured transactions law, lenders that are not familiar with the financing practices relating to movable property made possible by the new law, such as inventory and receivables financing, keep requiring mainly immovable property as security for credit. As the vast majority of immovable property is often owned by a small percentage of the population of a State, this means that, despite the adoption of a modern secured transactions law, credit may still not be available to the sector of the economy that most needs it, that is, micro, small, medium-size enterprises ("MSMEs").

Particular concerns apply to the financing of micro-businesses, which are a vital part of the world economy (i.e. over 90 per cent of all businesses) and which are critically important in developing economies. The amount of collateral available is usually very limited and its type different to that often provided by larger businesses, and there is heavy reliance on personal guarantees. The business and its personal guarantors are likely to be individuals. The amounts lent are often very small and this may have consequences concerning the cost of the transaction and the behaviour of lenders, both at time of the origination and during the lifecycle of the transaction. Thus, there is a need to consider and explain how secured transactions (under the Model Law) generally work for micro-businesses, and, more generally, how they interact with personal guarantees. The small size of a micro-business also puts the trader in a poor bargaining position vis-a-vis financiers. This often creates problems of over-collateralization. It also can lead to abusive interest rates, especially default interest rates.

There is also the need to ensure coordination between lending against movables and national regulatory environments, notably the capital requirements of the enacting State. Absent coordination, regulated financial institutions are induced to assign the same risk-weighting to transactions secured by movable property and receivables as unsecured credit, thwarting the goal of the Model Law to enhance access to credit.

A practice guide to the Model Law would be a significant step towards ameliorating all these concerns. It could explain the types of transactions and financing practices which can be entered into using the Model Law. It could provide users with guidance as to the contractual and other documentary forms and structures needed to achieve the economic benefits of these transactions. It could also provide guidance on the surrounding legal and practical infrastructure necessary for such financing to work, for example, risk assessment including valuation of collateral, and how to carry out extrajudicial enforcement. This would enable users to acquire the skills and practical tools referred to above. It would also assist those involved in building capacity (whether external agencies or advisors or internal educators or facilitators) in states in which the Model Law is enacted. It could also guide judges and regulators as to the legal and regulatory environment necessary for a modern secured transactions regime to flourish and, in particular, address the specific issues which arise in the critical areas of the financing of micro-businesses and coordination with the capital requirements applicable to regulated lenders.

3. Feasibility

In order to demonstrate the feasibility of the proposed practice guide, this section sets out suggested content. Unlike the Guide to Enactment, which is structured as an article-by-article commentary on the Model Law, the proposed guide takes a more thematic approach, as this would better address the needs of users who have no or

little previous experience of a modern secured transactions law. The suggested content draws heavily on the summaries of the three Colloquium panel discussions in A/CN.9/913, where more detailed discussion can be found.

(a) Best contractual and documentary practices

(i) Types of secured financing enabled by the Model Law

The guide could explain the characteristics and advantages of the different types of secured financing made possible by the Model Law with cross-references to the relevant provisions of the Model Law (e.g. inventory and equipment acquisition financing, revolving loan financing, factoring and forfaiting, securitization, term loan financing). It could also explain how the Model Law accommodates the extension of credit not just by lenders but also sellers and financing lessors, again with cross-reference to the provisions of the Model Law that address and accommodate these types of financing.

(ii) Cardinal issues that must be addressed by the parties throughout the life-cycle of a secured transaction

The guide could discuss issues arising at each point of the lifecycle of a secured transaction (e.g. the initial goals of the secured creditor and grantor, the necessary pre-contractual documents, issues relating to the closing of the deal, and post-closing monitoring of the grantor and the collateral).

(iii) Due diligence

The guide could discuss due diligence issues that must be addressed by prospective secured creditors (e.g. the need to obtain essential information about the grantor and the proposed collateral with sample check-lists; the need to conduct searches in secured transactions and other specialized registries, such as intellectual property registers; and the need to obtain information about judgements and tax or similar statutory liens).

(iv) Clear and simple drafting

The guide could explain the benefits of clear and simple drafting of security agreements, notices and other documents relevant to a secured transaction (e.g. to avoid disputes, ensure that the content is understood by the parties or recipients and takes into account their experience and sophistication). It could emphasize the importance of using plain language drafting techniques and provide concrete examples of ineffective drafting (e.g. avoiding legal jargon while still ensuring that the terms used are compatible with the Model Law, avoiding long sentences and long paragraphs, avoiding difficult-to-read fonts).

(v) Party autonomy and mandatory provisions

The guide could demonstrate how the party autonomy principle in article 3(1) of the Model Law enables contracting parties to adapt their agreements to their needs, by providing examples of particular provisions which the parties may derogate from or vary by agreement and explaining how and why they may wish to take advantage of this flexibility.

(vi) Sample documentation

The guide could include model forms of security agreements for different types of secured financing transactions based on widely acceptable international best practices. It could explain the key provisions of the model forms and the manner in which they relate to the provisions of the Model Law. It could provide model forms for making a security right enforceable against third parties by methods other than registration (e.g. “control agreements”). It could provide guidance on preparing and submitting appropriate notice forms to a registry (e.g. sample collateral descriptions),

and notices to be given to the grantor and third parties in the context of extrajudicial enforcement of a security right. Difficulties in the service of notices on individuals is a particular potential issue which arises in the context of the financing of micro-businesses, and the guide could address possible solutions to this problem.

(b) Risk assessment, collateral valuation, and effective enforcement capacity

(i) Valuation of collateral

The value of the protection against loss that a secured transaction provides ultimately depends on the value of the encumbered asset when it is likely to be disposed of. The guide could therefore explain that it is critical for users to acquire or obtain (e.g. through employing professional appraisers) expertise in estimating the amount likely be received upon its disposition.

(ii) Administration of secured loans

Secured creditors need to build a relationship of trust with their debtors but due diligence requires that they are also able to verify the facts underlying the decision to extend credit on an ongoing basis. Thus they need to develop expertise in account-keeping and in monitoring the risk profile of the debtor and the continued existence and value of the collateral. The guide could explain these matters and provide assistance in building this capacity.

(iii) Extrajudicial seizure, disposition and distribution of proceeds of collateral

The extrajudicial seizure and disposition of encumbered assets on default may be unknown in a State that enacts the Model Law. Thus, the guide could explain the extrajudicial exercise of post-default enforcement rights and, in particular, the protection of the grantor and third-party rights and circumstances in which alternative dispute resolution methods may be available. Again, the particular concerns in relation to micro-businesses could be addressed here. The guide could also discuss secondary markets for the sale of collateral, including electronic platforms and their advantages and disadvantages.

(iv) Collection of receivables

Financing against the security of collateral in the form of receivables or other rights to the payment of money (e.g. debt securities) may not have been common or, indeed, possible, under the law of a State prior to enactment of the Model Law. The collection from the debtor or other obligor of a monetary claim requires different skills and is subject to different legal rules from repossessing and disposing of tangible assets and the guide could provide guidance in building this capacity.

(v) Investment in legal capacity

Modern secured transactions law is complex, and the exercise of rights is governed by complex rules. The Model Law, when enacted by a State, will not operate in isolation from the other laws of the enacting State. Accordingly, users will require expertise in related areas of law, such as insolvency law, and the law relating to personal guarantees and its interaction with the Model Law, since a guarantee is often provided in support of a loan in addition to the provision of security (this is particularly prevalent in the context of financing of micro-businesses).

(c) Regulatory capacity

(i) Secured transactions and capital requirements

The guide could indicate how to ensure coordination between national regulatory environments and the Model Law. In general terms, the Basel Accords — issued by the Basel Committee on Banking Supervision — look at secured credit with favour and security may reduce (risk-weighted) capital requirements. Nonetheless, it is generally recognized that regulatory requirements are overly cautious, if not

sceptical, towards movable property and receivable taken as collateral. It is, in fact, assumed that movable assets cannot be swiftly liquidated — owing to the idea that secondary markets are limited — and that receivables are prone to depreciations. Capital requirements allow for considering movable property and receivables as effective credit protections only if certain conditions are met (e.g., the value of the collateral can be determined through reliable data, the enforceability of security is certain and swift, and a sufficiently liquid secondary market exist). Without understanding and addressing at the national level these relevant issues, lenders may not be prepared to lend or may lend only a higher cost to borrowers.

The guide could illustrate to national regulators how to meet these conditions. Particular attention would be given to the criteria for eligible collateral and past due loans. As a result, sound risk-management practices are promoted, while facilitating access to secured credit at a lower cost.

(ii) Financing of micro-businesses

Some specific characteristics of the financing of micro-businesses under a modern secured transactions regime may demand a particular regulatory response. Inequality of bargaining power often leads to unfair terms in loan and security agreements (such as high default interest rates, unfair termination clauses and definitions of events of default). The guide could discuss ways in which these potential sources of unfairness could be addressed.

The regulation of secured creditor behaviour in relation to lending to micro-businesses would also need to be discussed. Problems here include the fact that the very small size of loans reduces incentives for lenders to do a proper risk assessment and to engage in monitoring, paving the way for the over-collateralization of loans facilitated by the drastic inequality in bargaining power. Deficient monitoring and inefficient reactions to financial distress causes problems for borrowers as well as lenders. The guide could discuss possible solutions to these problems, which include access to more reliable credit rating information (through efficient credit reporting systems), more efficient monitoring practices, more efficient distribution of tasks within financial institutions, adequate implementation of the regulatory framework concerning non-performing loans, and perhaps even redesigned enforcement mechanisms to make them cheaper, quicker and easier.

4. Conclusions

The foregoing has shown that a practice guide to the Model Law is critical if its enactment is to lead to an appreciable increase in the availability of (and/or reduction in the cost of) credit to businesses in the enacting State. Working Group VI has the expertise to prepare such a guide based on its experience in the preparation of the Assignment Convention, the Legislative Guide on Secured Transactions, the Registry Guide, and the Model Law. It would be regrettable if a State were to reform its domestic law in line with the Model Law only to discover that its lenders, businesses and courts were unable to operate it effectively, due to a lack of practical understanding of how the law in the statute book is meant to operate on the ground. Technical assistance initiatives by UNCITRAL and other international agencies have intrinsic limitations. A practice guide would enable these agencies to perform their work far more efficiently and at lower cost.

As the foregoing has also demonstrated, the work that already has been done in preparation for the Colloquium and the resulting summaries in paragraphs 8-44 of A/CN.9/913 can be adapted to serve as the basis for an outline of the content of the proposed practice guide. At its first session, Working Group VI could debate and refine the topics and structure to enable detailed drafting to commence. With commitment from delegates and active engagement between sessions, it is estimated that a draft practice guide could be produced in three sessions.