Prof. Philip Wood – Visiting Professor in International Financial Law, Oxford University, UK
(Special Global Counsel, Allen & Overy LLP; Yorke Distinguished Visiting Fellow,
University of Cambridge; Visiting Professor, Queen Mary College, University of London)

International Developments In The Law Of Security - International Approaches To Security Interests

INTERNATIONAL DEVELOPMENTS IN THE LAW OF SECURITY

INTERNATIONAL APPROACHES TO SECURITY INTERESTS

By Philip R Wood*

Special Global Counsel, Allen & Overy LLP

Visiting Professor in International Financial Law, University of Oxford

Yorke Distinguished Visiting Fellow, University of Cambridge

Visiting Professor, Queen Mary College, University of London

Visiting Professor, London School of Economics & Political Science

Introduction

The three most important risk mitigants in financial transactions are:

(1) insolvency set-off and netting;

(2) the trust, such as settlement systems, custodianship, and the like; and

(3) security interests.

In my view, the arguments in favour of strengthening all of these risk mitigants are open and shut. But the world disagrees. In the case of insolvency set-off and netting, the world is a kaleidoscope of different colours. The case for and against trusts is an argument which has been going on for more than 1000 years and shows no real signs of resolution. In the case of security interests, there is still no consensus on what the future should be. Even the Uncitral Legislative Guide on Secured Transaction in its latest draft enthusiastically proposes the expansion of security interests at their inception but then proposes to impose stays and freezes on enforcement which is the very time that the security is needed. Hence it gives with one hand but takes with the other. This ambiguity and uncertainty is reflected worldwide.

Differences in security interests

There is an enormous disparity in the world in the approach to security interests. In one group of jurisdictions, the traditional English-based jurisdictions, it is possible for a company to create a charge over all its present and future property, including post-commencement property, to secure all present and future debt, to register it only once at the company's register without any necessity to register in title registers, such as a title register for land, and then the security interest is valid against all other creditors, other than certain limited wages and taxes which typically have priority over the floating collateral (mainly inventory and commercial receivables.) If the debtor defaults, then, if the security agreement so provides, the creditor can by letter appoint an accountant or other professional as a receiver (a type of possessory manager) over the collateral without any order of court and the receiver can run the company's operations over the heads of the directors for the benefit of the secured creditor. The receiver is not bound to sell.

This 19th century liberal creation is said to be justified on the grounds that it is for the benefit of the both creditors and debtors. It benefits debtors in that the cost of credit is reduced and that banks tend to stay with a company in difficulties for longer than would otherwise be the case because they are safer. If the situation is hopeless, the seamless change of management means that it is not necessary to turn off the power station. It is possible to continue the business as a going concern without the delays caused by court proceedings or public auction. The business can be sold as a whole, instead of in pieces. Unless the situation is hopeless, it is in the interests of the parties to keep the business going, so the effect is that suppliers have a de facto priority to the extent the business is continuing. Many suppliers also have retention of title clauses which enable them to strip out, ahead of the secured creditor, goods which they have supplied to the company.

From the point of view of creditors, the view taken in these jurisdictions is that the security interest mainly protects banks who (unlike suppliers) are medium-term creditors and represent depositors so that the protection of banks is ultimately the protection of depositors, i.e. the citizen.

There have been a number of inroads on the extreme liberality of the above, including in England, but not Hong Kong.

In any event, in no other jurisdiction, with perhaps a very small number of exceptions, is the above possible. In the United States, for example, while it is possible to have universal security over movables, security interests over land (governed by state law) and Federal property (such as certain intellectual property, US vessels and US aircraft) require further steps and a single filing is not available. In addition receivership is not possible but is displaced by Chapter 11 debtor-in-possession where the management stays in charge and cannot be displaced by a secured creditor's representative. Mortgages over land are debtor-protective in some states.

The concept of the universal super-generic charge has found favour with a number of jurisdictions which reformed their law of security interests after emerging from communism, such as Estonia, Hungary, Latvia and Poland.

At the other extreme are some traditional Napoleonic jurisdictions, particularly for example in South America. In these jurisdictions it is not possible to create security over all present and future assets. Nor is it possible to create security for all present and future debts. In the most traditional jurisdictions enforcement is typically by judicial public auction which causes considerable delays and gives rise to costs. Certain preferential creditors, notably employees and taxes, often rank ahead of security interests on insolvency.

Most Roman-Germanic jurisdictions are between the Anglo-American common-law and the Napoleonic, but this is very much a generalisation and there is a widespread variation of approaches in this group.

Pros and cons of security interests

The policies in favour of security interests include protection of creditors on insolvency, especially creditors such as banks who represent the citizens as depositors, that security encourages capital and the availability of credit, that security reduces the cost of credit, that security encourages the private rescue since the lender is safer and that, from the ethical point of view, security is a fair exchange for the credit: effectively it is a hold on the asset pending payment.

The objections to security interests are that unsecured creditors get less on insolvency so this is a violation of bankruptcy equality, that security confers too much power and that the secured creditor can disrupt a rescue.

Deep policies are involved either way, but choices have to be made. The international tendency seems to be to encourage security and it is probably true to say that security has much greater international recognition than the other two major risk mitigants – insolvency set-off and the trust. But the support is often half-hearted and is frequently countered by corporate reorganisation statutes which, as mentioned, restrict security when it really matters, i.e. on insolvency enforcement.

Classification of main issues

The main legal issues in relation to security interests are the following:

- **Scope** The scope of security interests and in particular whether a universal charge is available. The jurisdictions which restrict scope usually do so by two rather subtle methods. The first is by requiring that the creditor publicises the security interest by possession or control (or its equivalent) of the collateral. This is impracticable in the case of goods, inventory and bulk receivables. Therefore in countries such as Switzerland and Austria, which require a possessory pledge of goods, effectively there is no means whereby the creditor can have a charge over these assets and so the goods are left available to unsecured creditors. In countries, especially in the Napoleonic group and half of the Roman-Germanic group, which require that notice of an assignment of a receivable is given to the debtor (a rather futile publicity mechanism), the infeasibility of this in the case of bulk receivables renders charges over receivables impracticable unless there is some exception or a general enterprise charge is available (as there sometimes is). Note that Belgium abolished this requirement in 1994 and the Netherlands in 2004 and that France introduced a universal business charge in 2006, thereby moving ahead of the numerous Napoleonic countries which have limited business charges, eg. Luxembourg, Spain, Italy and Greece.

The second limitation is the doctrine of specificity which requires that the collateral is specified so as to confer identity. If it is necessary to specify the collateral, the effect is that future collateral cannot be included and has to be added by lists where this is feasible. A subsequent addition of collateral may be set aside as preferential if provided in the suspect period. The doctrine of specificity was dropped in English-based jurisdictions in the 19th century and super-generic descriptions of the collateral are permitted eg. "all my present and future assets". The doctrine of specificity has almost gone in such countries as Germany and the Netherlands but in Germany it is, for example, still necessary to state "all our goods in our warehouse in Frankfurt".

- **Publicity** The publicity needed to validate security interests and whether this can be achieved simply and cheaply. The most efficient method of publicity is by registration or filing in a central debtor indexed register, such as a company's register. The most inefficient is possession or its equivalent by the creditor in respect of each asset, e.g. possession of goods, notice to the debtor in respect of receivables and registration of the creditor in an asset title register for land, securities, ships, aircraft or intellectual property.

The insistence on publicity, except for universal charges, is questionable. If one compares the publicity required for the validity on insolvency (as opposed to priority against other adverse claimants) of the three main transactions of sale, trust and security interests around the world in the main groups of jurisdictions and for land, goods and debts, one perceives astonishing results. New Zealand is the only country in the world which does not require any form of publicity (by possession or the equivalent) or filing in the case of sale, trust or security interest for land, goods or debts but virtually all other countries do for one or other of these assets. The Napoleonic countries are particularly insistent on publicity for the validity of the transfer on insolvency. The common law countries do not require any form of publicity for the sale of land, goods or debts or for trusts of land, goods or debts but are fanatical about publicity in relation to security interests. The Roman-Germanic jurisdictions require publicity by possession for the sale of land and half of them for the sale of debts and for security interests over land and debts, but not for security interests over goods in the case of some countries. They do not permit the trust of any asset, subject to patchy exceptions, because of the absence of publicity and hence the encouragement of the so-called false wealth doctrine.

We cannot all be right on this issue. The whole false wealth proposition (many possessions but no assets) seems irrelevant in the modern world except in the case of universal charges. Most important assets are invisible. Creditors rely on financial statements, as opposed to inspection. The penalty for non-compliance with these requirements is disproportionate because it makes transactions void.

The question of whether publicity is desirable for regulating priorities is a different issue. Most jurisdictions regulate priorities against other property claimants by the first to get the most public possession for value without notice, but there are inroads on this in the case of the article 9 countries, such as the United States, Canada and New Zealand. The English-based company charge registration system is not explicitly a priority system but it can have priority effects.

- **The scope of the secured debt** In some countries secured debt is limited to existing debt.

- **The priority of security interests over preferential unsecured creditors.** These are mainly taxes, employees, insolvency expenses, rehabilitation new money and personal injury and environmental claims. There is considerable international diversity on this issue.

- **Restrictions on enforcement,** in particular the need for a judicial public auction and the imposition of reorganisation freezes.

The main issues in relation to enforcement outside insolvency are whether a private sale is possible as opposed to the inefficiency and delays of judicial public auction, and whether receivership is available. In relation to enforcement on insolvency the main categories of intrusion on security interests in the case of rescue proceedings (and sometimes liquidation proceedings as well) include freezes on enforcement until a reorganisation plan is approved, a right of the administrator to sell, use or lease the collateral, including an exclusive right to realise it, the right of the administrator to substitute collateral, the stopping of unsecured interest, the exclusion from collateral of property acquired by the debtor post-commencement, including post-commencement revenues (revenues which may be crucial to servicing the secured debt), the subordination of the collateral to post-commencement claims (employees, leases, contracts, new money to finance the rescue), the deduction of the administrator's expenses in preserving or disposing of the collateral repair (payroll, etc. - a large item in some cases, especially in Germany) and the subjection of secured creditors to a majority vote on the plan which can reduce their debt or stretch its maturity. Sometimes secured creditors are entitled to adequate protection.

The approach to enforcement – whether in or out of insolvency proceedings – should be looked at as a whole. Restrictions on enforcement take away what was originally granted at the time it is most needed and therefore question the strength of the policy in favour of security interests; The end is as important as the beginning.

- **Transaction costs** In some countries security is regarded as wicked as cigarettes and alcohol and therefore deserving of high taxes. There are numerous countries, especially in Latin America, where the costs are so high that security is unrealistic.

- The vulnerability of the security interest to be set aside as a **preference**.

- The presence of corporate doctrines limiting **financial assistance** to buy a company's own shares or those of its holding company and restricting group guarantees.

- The **priority** of secured creditors over buyers and chargees of the collateral and other claimants.

- The availability of **trustees** of security interests – usually essential for debt novations.

Most of the above contests are concerned with the collision of interests between secured and unsecured creditors. For example, if a universal charge is not available, then there are more assets available for the unsecured creditors. If security interests are subordinated to preferential creditors, then those classes of creditors are protected. If the security cannot cover future loans, then the secured debt may be less. If security interests cannot be enforced on a rescue proceeding, the effect is that critical unsecured creditors, such as suppliers and employees, tend to be paid ahead of the secured creditor so that the priorities are upside down.

Virtually all of the issues relating to security interests can be seen as expressing the views of a jurisdiction one way or another about the relative weight given to protect unsecured creditors.

Classification of main sectors of secured finance

The classification of the main sectors of secured finance is useful in showing the role of security interests in advanced economies. The pattern of secured creditors is different according to the type of economy, e.g. whether advanced or developing. One of the main reasons for the classification is to see whether or not debtor-protective policies in relation to security interests are or are not appropriate.

A brief taxonomy is as follows:

- **Large listed corporate groups** Publicly listed groups of companies usually borrow unsecured under a loan agreement which contains a negative pledge, i.e. a restriction on the creation of security by members of the group and often restricting title finance as well. Senior bond issues by large listed corporates are almost invariably unsecured and generally contain very limited negative pledges - typically restricting security only for marketable debt issues, but not security for bank debt and not title finance. The reason that these corporate groups do not borrowed secured is that they need to diversify their sources of finance and because they have sufficient credit strength to borrow unsecured.

  Hence normally the commanding heights of the economy are outside the net of security.

  These corporate groups do, however, borrow secured in two situations. The first is where they are in financial difficulties when existing creditors may demand security as a condition of survival and as a condition to the grant of fresh emergency credit. The second situation is where the group is taken over in which case the assets of the target group may be used to secure the finance for the takeover, where permitted (often it is not).

  Sovereign states also do not usually borrow secured.

- **Single purpose companies**. These are companies set up to own and operate a project or a single ship, aircraft or property or to make a bid for another company or to act as a securitisation vehicle. These single purpose companies are, contrary to the practice in the 19th and first half of the 20th centuries, now the main vehicles for enterprise finance. The single purpose company is set up for a variety of reasons, including the desire to insulate the shareholders from the risk of the project and conversely to insulate the lenders from the risk of the insolvency of the shareholders (which could crystallise a need to enforce charges over a perfectly good project and to get involved in the insolvency laws of the several shareholders).

In these cases the security is generally universal, where possible. Since the special purpose company typically does not have general creditors, other than those who are wholly involved in negotiating the transaction (which is usually for their benefit), there are normally no special issues about protecting general unsecured creditors. The company is in any event to some degree ring-fenced from other creditors by clauses restricting the business of the company. They often have a negligible number of employees and no pensioners. They do not incur outside debt accept for the single purpose.

The amounts involved in this sector are extremely large.

There does not seem to be any role for publicity by filing or possession or the like in relation to this situation. There appears to be no need for debtor-protective policies. These companies do not need the legislator to tell them what is good for them or how they should run a work out on a rescue: hence the various interferences by rescue statutes also appear inapplicable.

- **Small and medium-sized companies.** These typically do not have the credit strength to borrow unsecured and in addition they have less need to diversify their sources of finance. They tend to have one house bank which takes the maximum security over the assets. They do not have access to the bond markets and in any event corporate law typically prevents them from issuing securities to the public. The finance tends to be domestic. Often the credit is a line, cancellable on demand but in practice outstanding for many years.

  The purpose of security is to increase the availability of capital to this sector and to reduce its costs.

  The sector is extremely large in many economies and attracts considerable political interest, often expressed in debtor-protective policies.

Whether publicity is needed for this sector is questionable. Unsecured creditors can assume that the house bank will have a universal charge. The need for a restrictions on enforcement depends on one's view as to whether responsible banks habitually pounce on companies in the sector and whether there is any point in restraining the banks when they do.

- **Trade finance**. The export and import of goods is typically financed by letters of credit issued by or on behalf of the buyer's bank which takes a pledge over the documents of title to the goods plus the insurances and sometimes other items. The security is short-term, often lasting no more than a few weeks at most. The amounts involved are tiny compared to other sectors. The amounts and assets are so minor that there seems hardly a case for protecting unsecured creditors or for the other paraphernalia of enforcement restrictions. Publicity is irrelevant for such small items and in any event the secured creditor has possession.

- **Wholesale financial markets**. The main categories here are security for the obligations of banks and payment systems, the obligations of participants in securities settlement systems, the obligations of participants dealing with central counterparties established for netting purposes, and collateral for over-the-counter derivatives transactions. The collateral is usually highly liquid, mainly cash and government securities. The finance is often quite short-term – sometimes overnight only. The amounts are extremely large, particularly in financial centres.

  Financial security interests are considered fundamental as a protection against systemic risks so that many advanced states disapply laws which interfere with the security agreement, such as freezes under insolvency rescue statutes, publicity requirements and the priority of preferential creditors, as well as a requirement for judicial public auction enforcement. There are EU directives on these matters.

- **Home loans**. The home loan is secured on the property, plus the insurances. The transactions are mainly domestic and the borrowers are individuals. Home-owners are commonly protected by consumer credit statutes, by official guidelines and by the responsibility of mainstream mortgage institutions.

- **Consumer goods finance**. Some of this is provided by title finance, such as hire purchase for cars and consumer durables. The credit is often quite short-term, e.g. up to three years. The finance tends to be domestic. Consumer credit statutes often provide protection.

- **Title finance**. This section comprises financial leasing, retention of title to goods sold, sale and repurchase, sale and leaseback, securities lending and other. Some of this is short-term but not in the case of big ticket title finance, such as the financial leasing of aircraft. Title finance typically applies to a single asset or a set of assets and is almost never universal.

If one examines the above sectors, it would seem that debtor-protective policies and the desire for publicity appear mainly driven by security granted by small and medium-sized companies, i.e. the ideas underline consumer protection. It seems doubtful that these ideas should influence the whole area of this important risk mitigant. Debtor-protective policies are considered irrelevant in the case of the single purpose company (a huge sector) and wholesale financial markets. Their applicability in other areas is also considered doubtful, or at least worthy of reconsideration.

UCC Article 9 and the Uncitral Legislative Guide on Secured Transactions

Article 9 of the American Uniform Commercial Code is probably the most thorough and comprehensive codification of security interests over moveable property and of their priorities in the world and represents a splendid effort spanning around sixty years until its consummation by almost universal acceptance in the United States, finally around the year 2000.

The basic ideas have been adopted in most Canadian common law provinces and in New Zealand. Australia is considering adopting the principles. The adoption of article 9 was discussed in Britain a few years ago but was rejected.

The Uncitral Legislative Guide on Secured Transactions is in effect a direct descendant of article 9 and of chapter 11 of the US Bankruptcy Code 1978 which is the main US rescue proceeding.

Article 9 and the Guide would be an advance for many jurisdictions in the traditional Napoleonic group and some members of the Roman-Germanic group. It is less liberal and supportive of security interests than the regime in the English common law group and it is considered that the adoption of the article 9 regime would be a set-back in this group in most cases.

Chapter 11 is a reorganisation provision reflecting the pro-debtor mood of the 1970s and the Uncitral Guide reflects that approach in terms of the various stays on security and contracts. As already discussed, the applicability of insolvency stays, having regard to the uses of secured finance in advanced economies, is considered questionable.

Article 9, as the precursor to the Uncitral Guide, has special features which can be best understood by its history.

When work was started on article 9 in the late 1940s onwards, most states of the US had extremely poor regimes for security interests. They had nothing anywhere approaching the simple English universal charge which could cover all present and future assets generically and secure all present and future debts generically. Instead there were a variety of chattel mortgage statutes, accounts receivable acts and various other provisions which in their requirements for specificity, control and possession, their limitations and their problems with enforcement were not all together different from the current regimes in many Napoleonic states with poor security interests. The problems were compounded by very adverse case law, in particular the notorious case of *Benedict v Ratner* (1925) decided by the US Supreme Court where an assignment of receivables not notified to the debtor was set aside as fraudulent. The effect of this decision and the general regime was to torpedo US secured lending based on manufacturing assets such as inventory and receivables. The creditor had to have a degree of control and dominion, which of course was not possible.

As a result of this situation, financiers had to resort to all kinds of title finance transactions instead, e.g. leases, conditional sales, and retention of title, field warehousing, factors liens, factoring of receivables, trust receipts and all the rest

Hence when the draftsmen of article 9 came to prepare article 9 they were faced with the almost universal use of title finance transactions to escape the misfortunes of the law relating to security interests. It was natural that they should resolve to bring all of these devices, which they saw as evasive, within the scope of security interests. The decision was therefore taken that all title finance would be re-characterised and treated as a security interest, including sales and leases of goods, including outright sales of receivables.

This had a number of significant consequences which determined the peculiarities of article 9, nearly all of them resulting from the decision to extend the regime to sales and leases.

As the concept of security interest had to cover sales, leases and the like which were not traditional core mortgages, charges or pledges, the drafting had to be much more complicated, especially when it was dealing with retention of title.

Title finance normally involves distinct assets, such as a piece of equipment or a particular class of assets such as commercial receivables, rather than the assets of the company super-generically and universally, so that article 9 deals with assets separately and creates at least 30 to 40 different classes of assets. It seemed to the legislator that each asset deserved special treatment, which in fact is doubtful.

As each asset was treated separately and because the legislator was not focusing on universal charges, there was a preoccupation with what happened to the proceeds of an asset once it was sold and how the security would flip over into the proceeds. This brought further complications in the drafting.

There is in article 9 an intense interest with dealing with all of the priority questions which could possibly arise. These priority problems are much more likely to arise in the case of security or title finance in respect of discrete assets, such as pieces of equipment, especially if individuals are involved, as opposed to universal charges created by corporations. The classic case is the motor car on lease or hire purchase. This is part of the reason explaining why the article 9 filing system is an explicit priority system, whereas the English-based registration system for company charges is not intended to be a priority system, although it does have some residual priority effects. There are much more likely to be priority contests where financiers take security over separate assets – one over goods, another over receivables and the like so that one would then have to deal with such issues as priority of the proceeds and priority over the bank accounts into which the proceeds are paid.

If this reconstruction is at all plausible, it would provide an explanation of why article 9 often seems so complicated and why the draftsmen adopted the solutions which they did. Article 9 was a creature of its time. The Uncitral Guide is a demonstration of the indelibility of a history which leads to the reproduction of quite conservative model, at a time when there was another model – the English-based universal charge - which in many respects is simpler, cheaper and more liberal, if we leave aside the bad bits of it (e.g. the subordination of the floating charge to preferential creditors, the arguments about what is fixed and floating, and the unavailability of the charge for individuals – the latter is somewhat minor).

One may therefore briefly summarise the more controversial features of article 9 and the Uncitral Guide.

- **Title finance.** The inclusion of title finance, such as sales and leases, means that they are caught by the provisions as to publicity, enforcement, compulsory repayment to the debtor of a shortfall after enforcement and the various stays and other interferences on insolvency. These seem questionable. The issue is not whether the transactions are like security – which often they are – but rather whether the overall regime should be restrictive or liberal and whether the regime should only apply to core charges or to sales and leases as well.

- **Publicity**. Both article 9 and the Guide are quite conservative on the need for publicity to validate the security interest on the insolvency of the debtor. For example, they both require either registration or creditor control in the case of bank accounts, investments and some title registered property. We should be aiming to reduce these methods of publicity, based, as they are, on the outdated false wealth principle.

- **Excluded assets.** There are various exclusions in both article 9 and the Guide, some of which stem from the US constitutional divide between federal and state rights. Consider land, aircraft, intellectual property, ships and the like. It is considered that all assets should be subject to the same principles, subject to whatever modifications are required in relation to the particular asset. In other words the security regime should be unitary, instead of being fissured and fragmented. This is a considerable advantage of the English-based system.

- **Enforcement.** The various good-faith tests and a bureaucracy of compulsory notices on enforcement may give rise to a damages liability for a pure technicality. They assume that secured creditors habitually lie in wait to pounce suddenly without any advance warning, which in my experience is not generally true of regulated banks.

  The various restrictions on enforcement imposed by chapter 11 of the US Bankruptcy code of 1978 and also proposed by the Uncitral Guide appear to be inappropriate. If one examines the particular areas of the use of security interests, the anti-dismantlement policy in the case of a rescue proceeding freezes seems to be of doubtful validity.

- **Assignment restrictions** Both article 9 and the Uncitral Guide contemplate that restrictions on the assignment of commercial receivables are ineffective. Whatever view one may have about this, it is essential that assignments should not prejudice set-off and netting since, if set-off and netting are not effective against assignees, there would be a fatal gap in the set-off and netting protection.

- **Conflict of laws** There are mandatory rules about which law applies to the validity, priority and enforcement of security interest. This is a very large field, but my view is that there should be a move to contract freedom, where appropriate, as opposed to the law of the location of the collateral or the law of the place of the debtor or the law of the place where insolvency proceedings are opened.

The rules in article 9 and the Uncitral Guide on retention of title creditors seem reasonable, if complicated.

For various technical reasons, the proposition that filing deals once and for all for the whole issue of priorities is doubtful. In fact article 9 filing has quite a low impact on priorities.

Conclusion

Security interests are the victim of battles of the past. The security interest regimes in the various jurisdictions all have defects, It ought now to be possible to combine the best international experience so far and to discard the worst.

* The ideas contained in this paper are based on Philip Wood *Comparative Law of Security Interest and Title Finance* (Sweet & Maxwell 2007). This is one of a series of nine books in the author's Law & Practice of International Finance Series, 2007-2008.