

# **Ius Commune Research Project**

Ius Commune and Private Law Programme

## **An Article on Property Law**

### ***Security Interests in Personal Property: the Perspectives of Harmonisation***

**Author: Ihor Olekhov  
University of Edinburgh  
LL.M. Student**

The author wishes to thank Professor George Gretton of the University of Edinburgh for the very helpful comments and encouragement in preparation of this article. The author also acknowledges the support of the British Council and the Open Society Institute (Hungary) in making this research possible. Of course, any inaccuracies made in the article remain the author's sole responsibility.

**Edinburgh, 2002**

## **Abstract**

*The article discusses the perspectives of harmonisation of secured financing law, an area of property law traditionally viewed as ill suited for harmonisation, in the national legal systems and on an international level. The author analyses the intricacies of secured transactions in England, Germany, the United States and Ukraine and comes to a number of unique and unusual conclusions with respect to the harmonisation of the laws governing security interests in these countries. In this connection, the existing approaches to security interests are classified into “form-based” and “in-substance” legal systems based on Article 9 of the US Uniform Commercial Code or its analogues. Further, the author describes the international efforts aimed at harmonisation of secured financing law and recent sector-by-sector initiatives (Convention on International Interests in Mobile Equipment, UN Convention on Assignment of Receivables in International Trade, UNCITRAL Legislative Guide on Secured Transactions, EBRD Model Law and Principles, and Inter-American Model Law). After analysing the case law of the European Court of Justice and EC rules on free movement of goods and prohibition of “measures having equivalent effect”, the author comes to a conclusion that the development of the Community market is destined to attain a level necessarily requiring the harmonisation of secured financing law. In the learned author’s opinion, the most logical and rational route for such harmonisation in the European Union would be conclusion of a new European Convention on Secured Financing.*

## Prologue

“The human species, according to the best theory I can form of it, is composed of two distinct races: the men who borrow and the men who lend<sup>1</sup>”.

**Opmerking:** . . . To be successful, keep looking tanned, live in an elegant building (even if you're in the cellar), be seen in smart restaurants (even if you nurse one drink) and if you borrow, borrow big.' Aristotle Onassis, reported on 20 Aug 1972

---

<sup>1</sup> Charles Lamb, *Two Races of Men*, in *Essays of Elia* (1823).

## CONTENTS

<b>1. INTRODUCTION.....</b>	<b>5</b>
<b>2. OPENING PANDORA’S BOX.....</b>	<b>7</b>
2.1. HARMONISATION OF SECURITY INTERESTS: HISTORICAL BACKGROUND.....	7
2.2. APPROACHES TO HARMONISATION .....	8
2.3. RATIONALE OF SECURITY INTERESTS .....	10
<b>3. SECURITY IN NATIONAL LEGAL SYSTEMS .....</b>	<b>12</b>
3.1. LEGAL NATURE OF SECURITY .....	12
3.2. FEATURES OF SECURITY INTERESTS.....	13
3.3. CLASSIFICATION OF SECURITY INTERESTS .....	17
3.3.1. <i>Possessory Security Interests</i> .....	17
3.3.2. <i>Non-Possessory Security Interests</i> .....	18
3.3.3. <i>“Form-Based” Systems of Security Interests</i> .....	20
3.3.4. <i>“In-Substance” Systems of Security Interests</i> .....	21
3.3.5. <i>Other Classifications of Security Interests</i> .....	22
3.4. TRADITIONAL AND FUNCTIONAL APPROACHES .....	23
3.5. ROLE OF ARTICLE 9 UCC .....	23
3.6. PUBLICITY AND PRIORITY .....	25
3.7. “QUASI-SECURITY” INTERESTS.....	30
3.8. INSOLVENCY .....	31
3.9. COUNTRIES IN TRANSITION.....	32
3.10. PROVISIONAL CONCLUSIONS .....	34
<b>4. INTERNATIONAL SECURITY INTERESTS .....</b>	<b>37</b>
4.1. CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT .....	37
4.2. EC DIRECTIVES.....	39

4.3.	UN CONVENTION ON ASSIGNMENT OF RECEIVABLES IN INTERNATIONAL TRADE	45
4.4.	UNCITRAL'S DRAFT LEGISLATIVE GUIDE ON SECURED TRANSACTIONS ...	46
4.5.	MODEL LAW ON SECURED TRANSACTIONS.....	48
4.6.	INTER-AMERICAN CO-OPERATION .....	48
4.7.	PROVISIONAL CONCLUSIONS: PERSPECTIVES OF HARMONISATION.....	50
<b>5.</b>	<b>CONCLUSIONS .....</b>	<b>52</b>

## 1. INTRODUCTION

In the last decade the world economy has experienced phenomenal growth stimulated, *inter alia*, by the globalisation of world markets and the emergence of new market economies. These developments made the role of security for payment or performance of an obligation even more important than formerly and, crucially, created a need for recognition of a security interest created in one jurisdiction in many others. The diversity and complexity of regulation, or even approach to, security interests in the principal jurisdictions have become cumbersome and unjustified to the needs of flexible world markets. Obviously, both national governments and some international organisations have made attempts to achieve harmonisation of national laws affecting security interests.

Whereas the secured financing law has always been seen as an area ill-fitted to harmonisation<sup>2</sup>, the recent attempts to harmonise national laws have not been fruitless. Some jurisdictions (Canadian provinces, New Zealand) followed the ‘unitary’ approach to security interests adopted since early 1960s in Article 9 of the Uniform Commercial Code, which was enacted in most jurisdictions of the United States (“Article 9 UCC”). Others, like the European Union, have used supranational instruments to address certain aspects of secured financing. In an attempt to promote the development of efficient credit markets, some international organisations adopted model laws for groups of countries (e.g., *EBRD Model Law on Secured Transactions*, *Model Inter-American Law on Secured Transactions*). On a global level, several international bodies have drafted multilateral conventions addressing specific aspects of secured financing (*UNIDROIT Convention on International Interests in Mobile Equipment*, *UN Convention on Assignment of Receivables in International Trade*).

It is thus the purpose of this article to analyse the efforts aimed at harmonisation of secured financing law in different jurisdictions and at the international level. The analysis will focus on (i) the rules governing security interests in personal (movable) property in common law and civil law jurisdictions with an aim to explore the possibilities of harmonisation of security interests, and (ii) the intricacies of international instruments aimed at harmonisation of secured financing law.

---

<sup>2</sup> See section 2.1 below describing the history of harmonisation efforts in secured financing.

For a work of comparative character to capture the features of different legal systems, the choices will have to be made from the very start. We will thus concentrate on the analysis of security interests in several diverse and developed legal systems, namely England, the United States, Germany and Ukraine<sup>3</sup>.

Before proceeding to the core analysis of this article, the author will describe the history of harmonisation efforts and the rationale for such harmonisation. The insight into these areas will necessarily promote understanding of the role that the security interests play in economic development. It will therefore be possible to assess the perspectives of harmonisation of secured financing law.

Having said that, the author needs to make certain qualifications so as to focus his attention on substantial and essential features of the research. Firstly, the scope of this article does not cover security interests in *immovable (real) property*. Where the distinction between personal (movable) and immovable property will be difficult to draw<sup>4</sup>, some inevitable references to the respective security financing devices will be made. Secondly, it is assumed for the purposes of this article that security interests covered include only *consensual* security interests<sup>5</sup> and will not extend to security interests arising by operation of law. Thirdly, this article is arguably one of the first attempts to comprehensively analyse the harmonisation of security interests in diverse and complex jurisdictions at roughly the similar stage of economic development and at an international level. Thus, this article should be perceived as a critical assessment of the harmonisation efforts.

---

<sup>3</sup> There are specific reasons behind this choice of jurisdictions. The first three countries have very sympathetic regime to security interests, while other jurisdictions, in particular Franco-Latin group (e.g., France, Spain, Italy), are less sympathetic to security interests. Moreover, the legal framework used in these countries has significantly influenced the developments of security devices in other countries: (A) Germanic systems of security are used in Switzerland, the Netherlands (with modifications introduced by the 1994 Civil Code) and Japan; (B) some English law-based jurisdictions continue to use the security devices originally developed by English law, so that English-based security is still used in Australia (until recent reforms based on Article 9 UCC) and some other countries; (C) Article 9 UCC has been widely accepted by Canadian provinces and New Zealand. Accordingly, we will focus on the countries that, to use a generalisation, are at the avant-garde of security. Further, the author has chosen Ukraine as a jurisdiction with which he is most familiar, although Ukrainian law governing security interests is destined to undergo radical changes after the imminent adoption of the new Civil Code of Ukraine, hopefully, at the end of 2002 or in 2003.

<sup>4</sup> e.g., security in fixtures, crops or enterprise mortgages.

<sup>5</sup> i.e., agreed to between the creditor and the debtor in the respective security agreement.

## 2. OPENING PANDORA'S BOX

Any analysis of harmonisation of security interests will be incomplete without adequate historical background into the early attempts to harmonise secured financing law. After a brief historical background, we proceed to analyse the rationale behind the security interests and their legal nature. This chapter should provide a foundation for the further analysis of security interests and the international efforts aimed at their harmonisation.

### 2.1. Harmonisation of Security Interests: Historical Background

In 1980s, it was admitted that the area of secured financing law is ill-suited for international harmonisation. After a fruitless attempt to develop an international instrument on secured financing, United Nations Commission on International Trade Law (“UNCITRAL”) terminated a project designed to develop model uniform rules for secured financing by stating that unification of this area of law on an international scale was in all likelihood unattainable<sup>6</sup>. It has been realised that the law of secured financing is dominated by (i) the cultural traditions of the law of property peculiar to the particular legal system, and (ii) public policy choices that vary greatly among states. Therefore, there was no need for a harmonised approach in this area of law which relied on stability and legal certainty as its cornerstones.

**Opmerking:** Ronald Cuming. “The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts UCC, Article 9 and its Progeny” in *Making Commercial Law. Essays in Honour of Roy Goode*, 499-523. Edited by R. Cranston. Oxford, Clarendon Press, 1997. p. 499.

Most international efforts to harmonise commercial law have focused generally on the law of obligations and particularly on contract law. Notably, the 1980 Vienna Convention on Contracts for the International Sale of Goods specifically excludes any property aspects of sales law: its text is silent on matters relating to the passing of property from seller to buyer, reservation of title to goods and proceeds etc. As Sir Roy Goode once stated in respect of this period: “*Where attempts were made to tackle some aspect of the law relating to property in movables they usually foundered, sooner or later, because the goal was over-ambitious and the task too daunting*”<sup>7</sup>.

---

<sup>6</sup> Report of the Secretary-General A/CN.9/131 dated 16 May 1980 (UNCITRAL Yearbook 1981, vol. XI) which was preceded by a comprehensive comparative study of security interests by Professor Ulrich Drobnig in 1975 and reproduced as an Appendix “*International Payments: Study of Security Interests (ST/LEG/11)*” to the Report.

<sup>7</sup> R. M. Goode. “*The Protection of Interests in Movables in Transnational Commercial Law*” in *Uniform Law Studies in Memory of Malcolm Evans*, Uniform Law Review, (1998), p. 454.

Apart from the mentioned UNCITRAL's attempt, others have tried to initiate an international action in this area as well: the 1973 draft *EC Directive on the Recognition of Securities over Movables without Dispossession and of Clauses Providing for Retention of Ownership upon Sale of Movables*<sup>8</sup>, the 1974 *UNIDROIT Draft Convention Providing a Uniform Law on the Acquisition in Good Faith of Corporeal Movables* and the 1989 *UNIDROIT Study on International Regulation of Aspects of Security Interests in Mobile Equipment*<sup>9</sup> and 1981 *European Council Draft Convention on Simple Reservation of Title*<sup>10</sup>.

While stability meant that there have been no changes in the property rules for centuries, the advent of the modern financing techniques necessitated a new type of legal certainty. The stability of the legal form could no longer be relied upon in the circumstances of high flexibility and sophistication of financial markets. Recent developments<sup>11</sup> indicate that the sceptical decision of UNCITRAL has probably proven wrong and that the secured financing law will gradually internationalise in the due course of time.

## **2.2. Approaches to Harmonisation**

As mentioned above, the international harmonisation efforts have focused for the most part on contractual aspects of commercial dealings, while the proprietary aspects of such dealings are much more complex. There are several reasons for this: (i) the range of harmonisation techniques is more restricted in the field of property law than in the field of contract: property rights involve third parties and are frequently state-backed systems for the registration of proprietary interests, (ii) there has been reluctance to formulate rules which might be seen as encroaching on a state's bankruptcy policy, (iii) there are profound philosophical differences between legal families, and even between legal systems in the same family, as to the extent to which

**Opmerking:** The harmonisation of law governing the proprietary aspects of dealings in movables is a great deal more complex than that of the law relating to the contractual aspects.

---

<sup>8</sup> XL/466/73-E.

<sup>9</sup> Study prepared by Z. Cuming, Study LXXII published in *Uniform Law Review* [1990] 62

<sup>10</sup> European Committee on Legal Co-operation, *Draft Convention on Simple Reservation of Title*, Final Activity Report, Document (82) 15

<sup>11</sup> See 1993 *International Convention on Maritime Liens and Mortgages*, 2001 *UNIDROIT Convention on Interests in Mobile Equipment* and 2001 *UN Convention on Assignment of Receivables in International Trade*.

real rights in general and security interests in particular should be encouraged, and these bring in their train differences in legal concepts and characterisations<sup>12</sup>.

The approaches to harmonisation of secured financing could roughly be placed into three categories. Each category is a route for harmonisation of secured financing law in the respective jurisdiction.

- (A) Reception of the statute or model implemented in a jurisdiction or a group of jurisdictions. This approach is characteristic to the common law countries adopting statutes based on Article 9 UCC or its modifications.
- (B) Adoption of an international instrument on secured financing to be implemented in the jurisdictions of the parties to such international instrument. This is a truly international approach with clear advantages. This approach has been followed recently by UNCITRAL in order to adopt two international instruments for particular sectors (see below).
- (C) Development of a set of choice of law rules under which the law applicable to the various issues that arise in the course of secured financing is determined. Although this piecemeal approach appears to have lost its popularity, it has been used in the past for the purposes of harmonisation of secured financing law<sup>13</sup>.

Each of these directions may become dominant in the near future depending on the progress achieved in the respective jurisdiction. At the moment, it appears that Article 9 UCC provides an inspiration for the common law jurisdictions wishing to develop their secured financing law, while, on the international level, work is under way for international instruments aimed at harmonisation of secured financing law.

---

<sup>12</sup> R. M. Goode. “*The Protection of Interests in Movables in Transnational Commercial Law*” in *Uniform Law Studies in Memory of Malcolm Evans*, *Uniform Law Review*, (1998), p. 455-456.

<sup>13</sup> Ronald Cuming. “*The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts UCC, Article 9 and its Progeny*”, in *Making Commercial Law. Essays in Honour of Roy Goode*, 499-523. Edited by R. Cranston. Oxford, Clarendon Press, 1997. p. 500.

### **2.3. Rationale of Security Interests**

It has been stated that a financier who insists on security is not content with the normal remedy for breach of the debtor's obligation to pay<sup>14</sup>. While it is true that a strong borrower is able to dictate the terms and conditions of a loan to the lender, it is also true that all the covenants in the world are no substitute for good old-fashioned security<sup>15</sup>.

As masterly summarised by Philip Wood, the main purposes and policies of security are as follows:

- protection of creditors on insolvency;
- the limitation of domino or cascade insolvencies;
- security encourages capital, e.g., enterprise finance;
- security reduces the cost of credit, i.e., margin collateral in markets;
- he who pays for the asset should have right to the asset;
- security encourages private rescue since the bank feels safer;
- security is defensive control, especially in the case of project finance;
- security is a fair exchange for the credit<sup>16</sup>.

Obviously, the security will reduce the assets available to unsecured creditors upon insolvency of the debtor. Thus, the objective of the secured financing regulation should include resolution of conflicts among secured and unsecured creditors in relation to movable assets: balancing the interests of debtors, creditors and affected third parties.

---

<sup>14</sup> F. Oditah. *Legal Aspects of Receivables Financing* (1994). p. 4

<sup>15</sup> *Bond Brewing v. National Australia Bank* (1990) 1 A.C.S.R. 445.

<sup>16</sup> Philip R. Wood. *Comparative Law of Security and Guarantees*. London: Sweet & Maxwell, 1995. para 1-2.

It is evident that the proven overall objective of secured financing is to increase the availability of low-cost credit. In his study of security and the enforcement institutions in the United States and Argentina, Dr. Heywood W. Fleisig came to the conclusion that the macro-economic risk amounts to only an insignificant part of the exceptionally high interest rates charged by lenders in Argentina, while the greater part can be attributed to the deficiencies in the secured transactions framework. As a result, a borrower in Argentina can hardly ever obtain a loan secured against its movable assets, while in the United States such secured loans amount to nearly 70 per cent of all loans<sup>17</sup>.

In an imaginary world without security, the lenders do not terminate their lending operations, rather they may increase the interest rate charged for the loan or ration the loan advanced to individual borrowers. Whereas in secured lending environment, the lenders will not be exposed to very high risk in advancing substantial loans, for in an unsecured loan the lender will be exposed to a great risk of default. Hence, secured credit makes possible and safe large and expensive projects that would not be possible in any other circumstances<sup>18</sup>.

After brief background information into the nature of security interests, we now proceed to explore the national systems of security interests with an aim to find possible common grounds for the harmonisation and/or unification of secured financing law in these jurisdictions.

---

<sup>17</sup> Dr. Heywood Fleisig. *Economic Functions of Security in a Market Economy* in Joseph J. Norton, J. L. Taylor (ed.). *Emerging Financial Markets and Secured Transactions*. Kluwer Law International (1998). p. 15, 29.

<sup>18</sup> Dr. Heywood Fleisig. *Ibid.* p. 22.

### 3. SECURITY IN NATIONAL LEGAL SYSTEMS

Before analysing the nature of security interests in specific jurisdictions, we first need to explore the legal nature of security. This will allow us to understand better the traditional and functional approaches to security. In turn, we will then be able to decide on the advantages attributable to security interests in different jurisdictions. Having said that, we will proceed to classify security interests based on the understanding of their legal nature in the jurisdictions concerned.

#### 3.1. Legal Nature of Security

In most jurisdictions, security interests have an accessory nature. The security is granted for the performance of an obligation such as payment of moneys or delivery of goods. Therefore, it is very common for security to be granted by a debtor in favour of a creditor. A third party may grant security in creditor's favour and this instrument will usually be referred to as a personal guarantee. Such personal guarantee may be secured by certain property of the third party guarantor and, therefore, be equivalent to security granted by the debtor. We are not concerned with personal guarantees in this article. At the same time, only the German *Grundschild* appears to lack the accessory nature attributable to security devices in every other legal system.

The meaning of security may differ from jurisdiction to jurisdiction. However, the essence of security (security interest) remains the same and usually embodies two aspects:

- the creditor's right to enforce the security by selling the secured asset and using the proceeds in satisfaction of the claim to the debtor ahead of other creditors; and
- the debtor's right of "equity of redemption"<sup>19</sup> i.e., the right to redeem the property by performing the secured obligation.

---

<sup>19</sup> This term is known only to English and other common law lawyers, and is sometimes referred to as the "equitable right to redeem". Other jurisdictions, however, use its equivalents.

**Opmerking:** Most importantly, it appears that most security interests are characterised by what is known to English and other common law lawyers as "equity of redemption" or the "equitable right to redeem". The central element of equity of redemption confers on the debtor the right to repay the debt and redeem the property encumbered by the security interest.

Both civil law and traditional common law countries (i.e., those that have not reformed their secured financing law based on Article 9 UCC) adhere to a formal system of security based on their legal tradition and cultural values. These countries, therefore, have a great variety of security devices<sup>20</sup> serving, in various dimensions, the two functions mentioned above.

### **3.2. Features of Security Interests**

Most developed jurisdictions recognise security interests and establish a framework within which the secured party and the debtor will be able to operate. The legal framework for possessory security interests evolved from pledge (*pignus*) in the Roman law and is surprisingly similar in all traditional jurisdictions, while the legal framework for other security interests has developed in parallel as well as in diverse ways in different jurisdictions.

It appears that security interests have certain features typical for both the civil law and common law jurisdictions. As outlined by Jan Dalhuisen<sup>21</sup>, typical features of security interests in these jurisdictions include the following:

- (a) security interests are normally proprietary in nature;
- (b) security interests create rights *in rem* or proprietary rights in the assets, which rights the secured creditor can maintain against all the world, and, therefore, these rights are retained even if the owner sells the asset whether such assets are in possession of the creditor or not. In French these rights are referred to as the *droit de suite*<sup>22</sup>;
- (c) the earliest holder of a security interest in the asset will have priority over and may ignore all others. In French these rights of the secured creditor are referred to as the *droit de préférence*;

---

<sup>20</sup> The names ascribed to various security devices are numerous, as follows: charge, pledge, mortgage, lien, hypothecation, fiduciary transfer, assignment etc.

<sup>21</sup> Dalhuisen on *International Commercial, Financial and Trade Law*. Oxford and Portland, Oregon: Hart Publishing, 2000. p. 568

<sup>22</sup> This feature of a security interest obviously does not exist in all types of security interests, such as, for example, floating charges under the English law, which allow the chargor to dispose of assets covered by the floating charge without any encumbrances for the buyer.

- (d) security interests allow the secured creditor to seize and repossess the asset upon default of the debtor, sell it and subsequently set off his claim against the proceeds whilst returning the overvalue to the defaulting debtor but retaining an unsecured claim on the debtor for any undervalue; and
- (e) security interests are accessory to the debt and therefore benefit any assignee of the claim, whilst, on the other hand, they are automatically extinguished with the debt upon payment<sup>23</sup>.

Apart from these common features<sup>24</sup>, there are a significant number of differences in the details of security interests, like formalities, possession or publication requirements, the types of assets and debt that can be covered, the potential shift of the security into replacement goods and proceeds, and in the type of disposition.

In English law, a distinguished English lawyer, Professor Sir Roy Goode, defines a security interest as an interest that:

- arises from a transaction to be intended to perform the function of security;
- is a right *in rem*;
- is created by grant or declaration of trust, not by reservation;
- if fixed or specific, implies a restriction on the debtor's dominion over the asset;

---

<sup>23</sup> The German *Grundschild* is practically the only exception to the accessory nature of security interests in that *Grundschild* is a secured borrowing facility that survives the repayment of the debt and is transferable separately from it, i.e., *Grundschild* is not accessory *per se*.

<sup>24</sup> According to a distinguished English researcher, a security interest is normally characterised by the following main features: (i) security interest follows the asset and, if properly constituted, follows in the hands of anyone (subject to certain limited exceptions); (ii) security interest entitles the holder to payment out of the asset or its proceeds in priority to other creditors; (iii) by enforcing the security interest the creditor may recover only the debt, interest, and costs. Lawson, F. H. (Frederick Henry), 1897. *The Law of Property* / 3rd rev. ed. / by Bernard Rudden. Oxford; New York: OUP, 2002. p. 128. This position, however, seems to lack consistency with such devices as floating charges in English law. Under a floating charge arrangement, the chargor is entitled to dispose of the goods in its possession until the charge crystallises. Thus, in effect, the floating charge as a security interest, does not follow the asset (in contravention to (i) above).

- cannot be taken by the creditor over its own obligation to the debtor.

The German Civil Code (*Bürgerliches Gesetzbuch* or “**BGB**”) provides for three types of security, in particular the guarantee (*Bürgschaft*, §765 BGB), the charges on property (*Grundpfandrechte*, §1113), the pledge over goods and rights (*Pfandrecht an Sachen und Rechten*, §1204)<sup>25</sup>. Moreover, mercantile custom has developed on the basis of BGB provisions, and the German courts confirmed two further security instruments, in particular the “fiduciary transfer of title” (*Sicherungsübereignung*) and the “security assignment of receivables” (*Sicherungsabtretung*)<sup>26</sup>.

While most researchers agree that security interests are economically efficient, the justifications of such efficiency vary. In effect, a security interest will quarantine the property encompassed by it, from the claims of the debtor’s unsecured creditors, until the creditor’s claim has been discharged in full out of the property or that property has been exhausted in meeting the creditor’s claim<sup>27</sup>. In other words, the secured creditors receive priority over the claims of unsecured creditors or in the words of a distinguished American scholar Lynn LoPucki: “*Security is an agreement between A and B that C take nothing*”<sup>28</sup>.

**Opmerking:** The effect of a security interest is to quarantine the property encompassed by it, from the claims of the debtor’s unsecured creditors, until the creditor’s claim has been discharged in full out of the property or that property has been exhausted in meeting the creditor’s claim

Although the secured creditors will be able to charge lower interest rate because security reduces their risk, unsecured creditors will be exposed to increased risk and thus will have to charge higher interest rates to the debtor. It follows that the flip side of granting security to a creditor lies in the difficulties of getting credit from other creditors. This problem has been subject to much debate especially in common law countries and has therefore been properly known as the “*secured debt puzzle*”<sup>29</sup>.

---

<sup>25</sup> In addition, other forms of security are available in specially enacted statutes, e.g., the Law Governing Rights over Aircraft of 26 February 1959.

<sup>26</sup> The description of these devices is given below.

<sup>27</sup> PAU Ali, *The Law of Secured Finance*. para. 2-52.

<sup>28</sup> Lynn LoPucki, “*The Unsecured Creditor’s Bargain*” (1994) 80 *Virginia Law Review* 1887, p.1899.

<sup>29</sup> A. Schwartz, “*The Continuing Puzzle of Secured Debt*” (1984) 37 *Vanderbilt Law Review* 1051., See also A. Schwartz, “*Security Interests and Bankruptcy Priorities*” (1981) 10 *Journal of Legal Studies* 1 and J.S. Ziegel, “*What can Economic Analysis of Law Teach Commercial and Consumer Law Scholars?*” in R. Cranston and R. M. Goode (ed.). *Commercial and Consumer Law: National and International Dimensions*. (OUP, 1993), pp. 267-8.

Leaving aside the dispute on whether security is a “Good Thing” or a “Bad Thing”<sup>30</sup>, we must focus on the real rationale behind security. In this respect, five broad theses have been advanced to justify the preferential status of security interests, as follows:

- “monitoring” theory of security interests (including the derivative “free-rider” and “relational” theory of security interests);
- “informational” theory of security interests;
- “conventional” theory of security interests;
- “private property” theory of security interests; and
- “functional” theory of security interests<sup>31</sup>.

Apart from the economic efficiency arguments, Professor Sir Roy Goode and some other researchers put forward another argument justifying security interests, i.e., psychological one. They claim that the concept of transfer of ownership and other real rights responds to the psychological need of human beings to translate personal rights of acquisition into ownership. So long as the creditors’ rights rest purely in contract they feel uneasy, they lack control and the ability to take pride in being an owner<sup>32</sup>.

Before proceeding to analyse the approaches adopted to security interests in different jurisdictions, we need to classify the jurisdictions by the nature of security interests existing in them.

---

<sup>30</sup> It has been argued that even the mere absence of security devices *per se* should not affect the lending as such because of macroeconomic factors. It is true that lenders, banks in particular, cannot ignore lending, which is clearly their principal line of business. A bank must lend to be profitable. See George L. Gretton, “*The Reform of Moveable Security Law*” 1999 SLT 35 304. At the same time, such absence of security devices may result in allocation of financial resources to specific markets (e.g., bonds, T-bills) instead of direct lending to corporate borrowers. Moreover, secured lending is basically the only possible option for borrowers in transition markets to attract significant long-term loans from a developed capital market in another country.

<sup>31</sup> This article does not allow us to describe each of these theories in detail. For more details on each theory, please refer to PAU Ali, *The Law of Secured Finance*. para. 2-54.

<sup>32</sup> R. M. Goode. *Legal Problems of Credit and Security*. 2<sup>nd</sup> ed. London: Sweet & Maxwell, 1988.

### 3.3. Classification of Security Interests

Most legal systems build their classification of security interests based on the dichotomy between possessory and non-possessory security interests. This dichotomy is thus the most common classification of security interests available.

On the other hand, one may classify the existing legal systems of security into those traditionally based on the predetermined “forms” of the security interests developed for various cultural and/or historical reasons, and “in-substance” systems of security interests, which look into the substance (as opposed to the form) of the secured transaction to find the existence of a security.

Of course, there may be other classifications of security interests. However, for the purposes of this article the possessory/non-possessory dichotomy and “form”/“substance” classifications will be of primary importance.

#### 3.3.1. Possessory Security Interests

Pledge is the classical example of a possessory security interest and was well known to Roman law (*pignus*). It is practically the only branch of security interests having well-established and widely accepted rules in most countries<sup>33</sup>. However, possessory pledges are very impracticable for the modern economic demands. A possessory pledge is primarily used for goods which the debtor does not immediately need for industrial or trade purposes but which are dispensable for the time being, such as securities, title documents, precious metals, luxury goods, jewellery etc.

In England, pledge is a common law concept and it requires the creditor to have possession of an asset of the debtor until secured liability has been paid. Thus, security is constituted by the possession of the chattel by the creditor. Although it is possible to document the basis on which the security has been granted (e.g., letter of pledge), but the document does not create a pledge, it only evidences it.

**Opmerking:** This Roman institution has spread over Europe and has been incorporated into all Civil Codes in Europe. Due to its common historical root these code provisions are in substance quite similar to each other. Even the uncodified English common law of pledge does not radically depart from the general European pattern, although it deviates from it in certain respects. Ulrich Drobnig, *Security Rights in Movables*, in Arthur Hartkamp (ed), *Towards a European Civil Code* (2<sup>nd</sup> ed. 1998), p. 512

**Opmerking:** It is true that there are well-established and widely accepted rules for one specific branch of security in movables, namely for possessory pledges. Due to modern economic demands, however, this particular branch has lost much of its relevant economic relevance.

---

<sup>33</sup> Ulrich Drobnig, *Security Rights in Movables*, in Arthur Hartkamp (ed), *Towards a European Civil Code* (2<sup>nd</sup> ed. 1998), p. 511. The reasons for such uniform approach in civil and common law systems are prosaic: both systems were concerned with the possibility of fraud on creditors and, therefore, were hostile to non-possessory security rights.

If the creditor loses possession of the chattel before the secured liability has been paid, the letter of pledge is worthless<sup>34</sup>. Although the disadvantages of the English pledge are manifest, but it is still used in practice, particularly in financing of international trade. The reason lies in its advantage over other forms of security interest: a pledge is not registrable against the debtor<sup>35</sup>. In practice, pledge is often confined only to documentary intangibles.

In Germany, the pledge (*Pfandrecht*) is the classical and practically sole consensual security device available. §§1204 to 1258 of BGB provide for only one form of security interest over movable property (*bewegliche Sache*) the pledge (*Pfandrecht*). Its main purpose is to secure the performance of an obligation<sup>36</sup>.

### 3.3.2. Non-Possessory Security Interests

The development of non-possessory security interests was spurred by the modern economic demands. Although Roman law recognised non-possessory security interests known as a *hypothec* or mortgage, the development of non-possessory security interests in movables was precluded by the principle of publicity: the creditors had to be protected against “false wealth” of the debtor. The advantage of the non-possessory security is that the debtor may retain the charged goods. Ironically, this branch is legally least developed and in this area legal development has been most varied between the various countries<sup>37</sup>.

---

<sup>34</sup> See *Ex p Hubbard, re Hardwick* (1886) 17 QBD 690 (CA), *Donald v. Suckling* (1866) LR1 QB 585

<sup>35</sup> *Ex p Hubbard, re Hardwick* (1886) 17 QBD 690 (CA); pledge is not a charge in terms of s.396 of the Companies Act 1985.

<sup>36</sup> Generally, German law permits two categories of pledges: contractual (*Vertragspfandrechte*) and statutory (*gesetzliche Pfandrechte*) pledge or lien. Under §1205 of the BGB the pledge is not valid unless there is: (A) a security agreement (*Einigung*) between the debtor (*Schuldner*) and creditor (*Gläubiger*) to create the security interest; and (B) delivery (*Übergabe*) of the assets by the debtor to the creditor.

<sup>37</sup> Non-possessory security was almost non-existent in the 19<sup>th</sup> century and, therefore, it has not appeared in the continental civil codes until the last decade of the 20<sup>th</sup> century. See Ulrich Drobnig, *Security Rights in Movables*, in Arthur Hartkamp (ed), *Towards a European Civil Code* (2<sup>nd</sup> ed. 1998), p. 515

Typically, non-possessory security interests have a variety of different names and classifications developed by judicial practice or based on the specific cultural experience of the legal system, e.g. charge, mortgage, lien, hypothecation, fiduciary transfer, assignment etc.

Under English law, mortgages and charges are usually (but do not have to be) non-possessory securities. Apart from priority contests among secured creditors, there is rarely any practical significance in the distinction between mortgages and charges, and the distinction between them is commonly eliminated in the drafting of debentures<sup>38</sup>. However, the distinction between legal and equitable mortgage has significant importance<sup>39</sup>. While a legal mortgage is available in relation to property in existence and owned by the debtor at the time the mortgage is created<sup>40</sup>, in equitable mortgage it is possible for the debtor to create security not only over its existing assets, but also over assets which it subsequently acquires.

In Germany, non-possessory security devices have developed through interpretation of the property provisions of BGB in the course of mercantile practice, which was confirmed by the courts. These devices include the transfer of ownership or the assignment of claims ("*Forderungen*").

---

<sup>38</sup> *London County and Westminster Bank v. Tompkins*, [1918] 1 K.B. 515, 87 L.J.K.B. 662 (C.A.); and *Re Bank of Credit and Commerce International S.A. (No. 8)*, [1996] Ch. 245, [1996] 2 All E.R. 121 (C.A.). Also, Michael Bridge, Macdonald, Simmonds and Walsh "*Formalism, Functionalism and Understanding the Law of Secured Transactions*" (1999) 44 McGill L.J. 567. p.32

<sup>39</sup> Richard Calnan. *Taking Security in England*. in Michael Bridge and Robert Stevens. *Cross-border security and insolvency*. Oxford [England]; New York: Oxford University Press, 2001. p. 21

<sup>40</sup> *Lunn v. Thornton* (1845) 1 CB 379.

(A) *Fiduciary Transfer of Title (Sicherungsübereignung)*

The fiduciary transfer of title is a creation of security interest in the goods in favour of the security holder by the security provider through the transfer of title to the security holder, provided that the security holder can exercise the rights conferred on it only in accordance with the “security purpose”. Further, §929 of BGB provides for the delivery of goods as a condition of title transfer, but such delivery is substituted by the security holder and the security provider agreeing that the latter shall possess the goods for the former as custodian free of charge.

**Opmerking:** . Constructive possession

(B) *Fiduciary Assignment (Sicherungsabtretung)*

A fiduciary assignment (*Sicherungsabtretung*) is an unconditional assignment to the security holder of trade receivables owed to the security provider. The security holder is able to collect the receivables payable to the security provider, provided that the security holder exercises this right within the “security purpose”. The most important types of security assignment are the “global assignment” (*Globalzession*) and the assignment of receivables within the framework of an “extended reservation of title” (*verlängerter Eigentumsvorbehalt*).

**Opmerking:** . The account debtor is only under a duty to make payments to the security holder after he has received a deed containing the assignment or he has been notified in writing by the security provider of the assignment.

3.3.3. “Form-Based” Systems of Security Interests

“Form-based” systems of security interests are traditional system based on *numerus clausus* of security devices, i.e., only a certain number of prescribed forms of security interests available for the parties to the transaction. Most European countries (including England) adhere to the “form-based” classification of security devices.

Under English law, there are four principal types of security interest which can be created by agreement between the debtor and the creditor: a pledge, a contractual lien, a mortgage and a charge<sup>41</sup>.

**Opmerking:** Certain types of security interest (most notably common law and equitable liens) arise by operation of law, without the necessity for any agreement between the parties.

Although BGB expressly recognises only the pledge as a security device, judicial practice developed a whole range of security devices satisfying the demands of modern commerce<sup>42</sup>.

### 3.3.4. “In-Substance” Systems of Security Interests

“In-substance” systems of security interests are essentially based on Article 9 UCC. Of particular importance in Article 9 UCC is the concept of a “unitary” security device and the notice-filing system.

In 1962, the American Law Institute and the National Conference of Commissioners on Uniform State Laws (the “NCCUSL”), both non-profit institutions responsible for the drafting and ultimate enactment in all states of the Uniform Commercial Code, introduced a “unitary” security device, incorporating all of the security interests that previously had been dealt with separately. In the summer of 1998, the NCCUSL adopted a Revised Article 9 with significantly different provisions from the previous versions. The effective date of the Revised Article 9 has been postponed until 1 July 2001<sup>43</sup>.

---

<sup>41</sup> See *Re Cosslett (Contractors)* [1998] Ch. 495 per Millet LJ. It is even possible to find cases which recognise something which is not really a security as, in fact, operating as though it were a security, e.g., *Banque Financiere de la Cite v. Parc (Battersea) Ltd.* (1998), [1999] A.C. 221, [1998] 1 All E.R. 737 (H.L.). These security devices have been developed by case law and no statute exists laying down a *numerus clausus* of the consensual security devices in England. It follows that, at least potentially, the number of security devices in England may be expanded. In practice, secured creditors prefer to keep to the existing forms of security devices proven by hard practice.

<sup>42</sup> These devices have already been mentioned while describing non-possessory security (*Sicherungsübereignung und Sicherungsabtretung*).

<sup>43</sup> See J. J. White and R. S. Summers, *Uniform Commercial Code* (2001) 5<sup>th</sup> ed. p. 510

The concept of the notice-filing system introduced by the UCC was adopted in many common law countries and in certain international instruments ever since<sup>44</sup>. Section 9-109(a) provides that (in general) it applies to a transaction (regardless of its form) that by contract creates a security interest in personal property or fixtures. All notice-filing systems apply not only to charges created by companies but also to security over personal property created by individuals and unincorporated businesses. They also apply widely to any transaction which functions to create a secured transaction, i.e., “quasi-securities”.

“In-substance” system of security interests are often described as a functional approach. Such functional approach is aimed at replacing all security rights or “quasi-security” rights with a single definition of a security interest.

### 3.3.5. Other Classifications of Security Interests

Most legal systems distinguish between corporeal and incorporeal security as well as tangible and intangible security. Such distinction becomes important if one considers the implications of taking intangible security, which in most systems may be accomplished, for the most part, by an assignment. For our purposes, this classification as well as other classifications do not appear to have a substantial difference.

---

<sup>44</sup> In the UK the notice-filing system was recommended in 1971 by the Report of the Committee on Consumer Credit (1971) Cmnd 4596 (the “Crowther Report”). Currently, there is a discussion on introducing the notice-filing system in England and Wales and, possibly, Scotland. See Law Commission Consultation Paper No. 164 “*Registration of Security Interests: Company Charges and Property other than Land*”, 2002.

Nine out of ten Canadian provinces as well as three territories have followed the notice-filing approach based on the Model Personal Property Security Act, which in turn was based on Article 9 of the UCC. New Zealand Personal Property Securities Act 1999, which came into effect on 1 May 2002, is also based on Article 9 of the UCC. The Australian Personal Property Security Law Reform Committee is considering reforms to the law of security based on the notice-filing system.

In November 2001, the joint conference of UNIDROIT and ICAO concluded a Convention on International Interests in Mobile Equipment and a Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment.

### **3.4. Traditional and Functional Approaches**

Despite the obvious differences between civil and common law jurisdictions, the differences between them are not of cardinal importance when it comes to the analysis of security interests. On the contrary, the difference between traditional and functional jurisdictions should be emphasised. The traditional systems are those that adhere to the *numerus clausus* of security devices, i.e., a number of prescribed forms of security interests available for the parties to the transaction. Unlike the traditional approach, functional approach emphasises not the form of the transaction, but its substance.

The core of the functional approach to identification of transactions falling within the underlying regime of Article 9 UCC is the extended (unitary, functional) definition of security interest. Section 1-201 (37) of Article 9 UCC provides that a security interest is “*an interest in personal property or fixtures that secures payment or performance of an obligation*”. Further, section 9-102(1) provides that the Article 9 regime applies to any transaction (regardless of its form) that is intended to create a security interest in personal property or fixtures, and section 9-202 provides that the regime applies “*whether title to collateral is in the secured party or in the debtor*”. Therefore, it is clear that the locus of the title to the collateral and the form of the transaction are not to be relied upon in determining whether or not a security interest exists<sup>45</sup>.

### **3.5. Role of Article 9 UCC**

A distinguished civil lawyer Ulrich Drobnig, has depicted Article 9 as being the “*most modernised, rational and comprehensive system of security interests in the present world*”<sup>46</sup>.

---

<sup>45</sup> Under the UCC as well as Personal Property Security Acts adopted in Article 9 UCC-based jurisdictions (Canada, New Zealand), there are two distinct types of security interests: true security interests and deemed security interests. A true security interest is a right *in rem*, a charge held by the secured party to secure payment or performance of an obligation. A deemed security interest is an interest in personal property that does not secure performance of an obligation. It is deemed to be a security interest so as to induce public disclosure of its existence.

<sup>46</sup> Comment quoted by Diamond (1989) 42 C.L.P. 231 at 241. The comment comes from the report Study on Security Interests that Professor Drobnig prepared for UNCITRAL; see UNCITRAL Yearbook (1977), vol.8, p.171 at s.2.6.2.3

There is no doubt that adoption of Article 9 UCC is the most significant event in the development of secured financing law in the 20<sup>th</sup> century. Article 9 was developed with a view to harmonise the rules applied in the states of the USA. However, Article 9 has become an inspiration for the reformers in common law countries seeking to modernise their secured financing law. Moreover, the rules of Article 9 are influencing the development of international secured financing law (e.g., EBRD Model Law on Secured Transactions, UNIDROIT Convention on International Interests in Mobile Equipment, etc).

As masterly summarised by one researcher, there are four features in Article 9 that have the potential to become the basis of a significant degree of international harmonisation of secured financing law, as follows:

- (A). A functional approach to characterisation of secured transactions;
- (B). Automatic attachment of security interest in the after-acquired property;
- (C). A functionally-oriented priority structure; and
- (D). Notice filing<sup>47</sup>.

The essence of Article 9 is the adoption of a unitary concept of security which replaced the complexity of security forms and devices that prevailed under the prior law. This unitary approach is derived from the drafters' perception that all security interests perform an identical function and should be subject to an identical legal framework<sup>48</sup>. Consequently, a security interest is defined in purely functional terms as an interest in personal property which secures payment or performance of an obligation.

**Opmerking:** ... and the respective Personal Property Security Acts.

---

<sup>47</sup> Ronald Cuming. "The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts UCC, Article 9 and its Progeny", in: *Making Commercial Law. Essays in Honour of Roy Goode*, 499-523. Edited by R. Cranston. Oxford, Clarendon Press, 1997. p. 501

<sup>48</sup> Article 9 eschews the formalist, *numerus clausus* approach, endemic in most other national secured financing systems. It proceeds on the practical assumption that transactions, whatever their form, that serve the same function in the market (and, consequently, give rise to the same problems of third party protection and need for *inter patres* regulation) should be subject to the same regulatory regime. The flexibility that is required in modern business financing

Article 9's unitary concept of security is typically described as reflecting a "substance over form" philosophy<sup>49</sup>. However, the drafters' goal was far more ambitious: they sought nothing less than to detach the legal entailments of security from conventional property analysis.

For the purposes of harmonisation of secured financing law, Article 9 UCC appears to have a few deficiencies. Firstly, Article 9 requires total re-conceptualisation of financing devices that traditionally are not viewed as secured financing devices (title retention clauses, leases of movables etc), although, in practical effect, they operate like security devices. Secondly, Article 9 requires a bifurcated approach to characterisation of certain types of transactions: since a title retention clause or lease function like security devices, a seller or a lessor is no longer the owner of the goods sold or leased, but has a security interest in such goods. Accordingly, the approaches of Article 9 may not be acceptable to traditional views on security devices. Therefore, some reformers will be induced to accept only a part of Article 9 approach. While traditional security devices will be assimilated in a uniform type of a security interest, the "untraditional" security devices will continue to be outside such regime of secured financing (e.g., conditional sales contracts, security leases, English hire-purchase agreements, German *Sicherungsübereignung*)<sup>50</sup>.

### **3.6. Publicity and Priority**

It has been suggested that a modern system of registration of security interests should perform at least two basic functions: (i) to provide public notice, in particular to the persons who are thinking of extending secured lending, credit rating agencies and potential investors, (ii) to determine the priority of securities<sup>51</sup>. We will proceed to analyse each of these functions separately.

---

necessitated the removal of the rigidness endemic to the pre-Article 9 document filing systems through the substitution of a notice filing system. See Ronald Cuming. p. 501

<sup>49</sup> Michael Bridge, Macdonald, Simmonds and Walsh "Formalism, Functionalism and Understanding the Law of Secured Transactions" (1999) 44 McGill L.J. 572.

<sup>50</sup> Ronald Cuming. "The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts UCC, Article 9 and its Progeny", in: *Making Commercial Law. Essays in Honour of Roy Goode*, 499-523. Edited by R. Cranston. Oxford, Clarendon Press, 1997. p.523

<sup>51</sup> Law Commission Consultation Paper No. 164 "Registration of Security Interests: Company Charges and Property other than Land", 2002. para. 3.44 . The consultation paper has also

(A) *Publicity*

Each legal system has to deal with the problem of the debtor's "false wealth" or, in other words, the debtor's attempts to conceal the existence of a security interest in its assets in order to obtain additional funding<sup>52</sup>. It follows that the differences in the approaches to publicity requirements between various jurisdictions are of significance.

The registration requirement is aimed at promoting transparency of a security interest in an asset. A potential creditor can have confidence that any charge it files would have priority over any earlier charge that does not appear on the register and any subsequent charge.

The publicity requirements for the creation of possessory security differ from the requirements of non-possessory security in that the debtor is not dispossessed of the collateral in the latter case. To make up for the loss of publicity, it is usual to introduce a substitute for publicity so as to inform interested persons about the existence of charges upon certain assets of the debtor. This requirement is normally a condition for the validity of the non-possessory security, at least *vis-à-vis* third persons.

The most popular and effective substitute for publicity is the requirement of registration of the security interests. In "substance-based" systems virtually any security interest requires perfection for its existence and validity, i.e., such security interest should be registered in the respective register.

---

suggested that the current registration scheme in England and Wales is "*unnecessarily complicated, incomplete and restrictive*".

<sup>52</sup> As masterly put by Philip R. Wood, in the case of "false wealth" "*the secured creditors allied themselves with unsecured creditors for separate reasons, but with a unity of result*". Philip R. Wood. *Comparative Law of Security and Guarantees*. London: Sweet & Maxwell, 1995. p. 110

In spite of the obvious differences in approaches to security interests, some traditional systems also have registration systems<sup>53</sup>. Several of these jurisdictions are even contemplating possible reforms of their registration systems to make them more comprehensive and efficient (England and Wales, Australia).

However, the German legal system characteristically lacks public notice-filing system in its entirety<sup>54</sup>. In Germany, non-possessory security devices have developed through interpretation of the property provisions of BGB. These devices include the transfer of ownership or the assignment of claims ("*Forderungen*").

The publicity requirement appears to be most developed in "in-substance" systems. In these countries, any security interest requires perfection for its existence and validity. Such perfection is effected through notice-filing with the respective register. The notice-filing systems based on Article 9 UCC rest on three principles, as follows:

- (A) filing is not necessary in relation to a specific transaction, but is a notice that a person has taken or intends to take a non-possessory security over a designated asset or class of assets;
- (B) thus the secured party can file a notice to protect the security interest either before or after the security is created, with (once all the other elements of a perfected security agreement are in place) priority normally going back to the time of filing of the financing statement;
- (C) as a consequence of this, and also to reduce the burden of filing and to allow for a purely automated system, transaction documents are not filed and particulars to be filled are kept to a minimum, it being

---

<sup>53</sup> e.g., English registration of company charges under the Companies Act 1985.

<sup>54</sup> Although the German legal system is repulsive to the very concept of registration, it requires registration of security interests in certain circumstances e.g., security in the agricultural tenant's inventory requires the deposit of the security agreement at the local court at the location of the farm.

left to a searcher to get the information she wants from the company or chargee<sup>55</sup>.

By way of conclusion, one may argue that publicity through notice filing has many advantages over limited registration or the absence of registration as such. The specific absence of registration requirement under German law has been prompted not so much by the disbelief in the publicity requirement (BGB is usually very protective to good faith), but by the mere absence of non-possessory security devices in BGB due to historical reasons.

Thus, German practitioners had to develop non-possessory security through interpretation of property provisions in BGB in order to meet business demands in credit. In other words, despite its costs, the UCC public-notice filing enhances economic efficiency and achieves a more balanced compromise of the conflicting interests than the German system, which lacks any fundamental policy in this regard<sup>56</sup>.

(B) *Priority*

The main purpose of any security is to grant the secured creditor a preferential position over unsecured creditors. The rank between several secured creditors is, as a rule, determined by the time of creation: *prior tempore, potior jure*. This time-honoured principle not only applies between several creditors with contractual, or with contractual and statutory, security rights but also *vis-à-vis* execution creditors<sup>57</sup>.

---

<sup>55</sup> See Law Commission Consultation Paper No. 164. para. 4.9. Also, see generally J. J. White and R. S. Summers, *Uniform Commercial Code* (2001) 5<sup>th</sup> ed.

<sup>56</sup> Jens Hausmann. *The Value of Public-Notice Filing Under Uniform Commercial Code Article 9: A Comparison with the German Legal System of Securities in Personal Property*. The Georgia Journal of International and Comparative Law. Summer, 1996. p. 428

<sup>57</sup> Ulrich Drobniq. *Security Rights in Movables*. in Arthur Hartkamp (ed), *Towards a European Civil Code* (2<sup>nd</sup> ed. 1998). p. 513

In a notice-filing system determining priority as between registered charges is significantly easier than in traditional systems as it would generally be determined by the date of filing, although there are certain exceptions to this rule (e.g., purchase-money security interest). In such systems, the distinctions between legal and equitable interests as well as constructive or actual notice do not play any role.

In terms of priority, there is a significant difference between the English floating charge and the floating lien operating under Article 9 UCC. Such floating lien is a fixed security interest on shifting assets, but, unlike the floating charge, the time when the charge crystallises does not determine the priority position of the secured party. As the priority is determined by the date of filing of the financing statement, the floating lien gives a stronger position than a bare English floating charge, which until the point of crystallisation will always rank behind a later created fixed charge<sup>58</sup>. At the same time, English floating charges are often used together with negative pledge clauses, which in practice has the same effect as the floating lien, i.e., because the negative pledge clause will give priority to the floating charge as against subsequent secured parties, even before it crystallises<sup>59</sup>.

The priority rules in traditional systems tend to be overburdened with detail and lack any concurrent policy approach. Thus the task of comparing comprehensively the priority rules is destined to be daunting. The scope of this article does not allow to analyse the priority rules of each jurisdiction in greater detail.

---

<sup>58</sup> Law Commission Consultation Paper No. 164. para. 4.128

<sup>59</sup> It appears that the Law Commission in its Consultation Paper No. 164 recommends to make this position a rule for future floating charges in England and Wales. Thus, a floating charge should no longer give a company authority to create subsequent fixed charges that automatically get priority over an earlier floating charge.

### 3.7. “Quasi-Security” Interests

“Quasi-security” interests are devices that perform the economic function of a security interest without, as a general rule, conferring on the obligee rights *in rem* in respect of the property of the obligor. Significantly, “quasi-security” interests have a special position because the holders of such “quasi-security” interests have priority over earlier “securities”, but their absence might hinder businesses in obtaining vendor credit in future. We will limit our review only to retention of title or “Romalpa” clauses in view of their significance for the purposes of this article<sup>60</sup>.

A simple retention of title or Romalpa clause is an agreement between a vendor and purchaser that legal title to the goods sold is not to pass to the purchaser until the purchase price has been paid in full. However, a number of “complex” Romalpa clauses are used in practice: (i) if the title is reserved in the vendor until the purchaser has discharged all its liabilities to the vendor – “all-moneys” or “current account” reservation of title; (ii) if the ownership interest of the vendor is extended to the proceeds of any on-sale of the goods – “proceeds” reservation of title; (iii) if the ownership interest of the vendor is extended to a manufactured product in the goods supplied – “aggregation” reservation of title.

In Germany, reservation of title (*Eigentumsvorbehalt*) is a hybrid of statutory law and business practice. The reservation of title is created by the parties agreeing that the agreement necessary to pass title in the goods pursuant to Article 929 BGB shall be subject to the condition precedent that the purchase price for the goods is paid in full. There are three types of reservation of title in Germany: simple reservation of title, enhanced reservation of title (*erweiterter Eigentumsvorbehalt*)<sup>61</sup> and extended

---

<sup>60</sup> A good overview of such “quasi-security” interests such as debt subordinations, flawed assets, negative pledges, Quistclose trusts, “Romalpa” clauses and set-off agreements is provided in Ali, Paul A. U. *The Law of Secured Finance: an International Survey of Security Interests over Personal Property* / Oxford: Oxford University Press, 2002. pp. 175-203.

<sup>61</sup> i.e., the transfer of the title in the goods is not only made subject to the full payment of the purchase price, but also the repayment of all receivables arising out of the business relationship (“current account” reservation of title) or even repayment of all receivables owed by the purchaser to the security holder’s group companies.

reservation of title (*verlängerter Eigentumsvorbehalt*)<sup>62</sup>. None of such reservation of title constitutes a security device under German law.

Significantly, retention of title clauses are qualified differently in traditional and functional jurisdictions, and even differently in traditional jurisdictions themselves. In England simple reservation of title does not constitute a security interest, while a purported extension of ownership interest may be characterised as registrable security interest under the Companies Act 1985<sup>63</sup>. Under Article 9 UCC and its counterparts in the functional jurisdictions, the retention of title will be a “security interest”.

### **3.8. Insolvency**

It has already been mentioned that one of the reasons for the lack of harmonisation in secured financing is the reluctance of states to formulate rules, which might be seen as encroaching on a state’s bankruptcy policy. Thus, the co-ordination between secured transactions and insolvency law regimes is of substantial importance.

As masterly stated by Professor Sir Roy Goode: “*It is the bankruptcy that provides the acid test of the efficacy of real rights in general and security interests in particular, and it is the protection of such rights from bankruptcy creditors that is a primary concern of the holders of such rights*”<sup>64</sup>. Moreover, it has been stated that bankruptcy laws which freeze or delay or weaken or de-prioritise security on insolvency destroy what the law created<sup>65</sup>. The scope of this article does not allow us to analyse insolvency law implications on security interests in more detail.

---

<sup>62</sup> i.e., permits the purchaser of the goods to on-sell the goods, but the proceeds of sale owed to such purchaser from the on-sale are assigned to the original seller. Therefore, title in the goods sold under reservation of title is replaced with title in the receivables deriving from the on-sale of the goods.

<sup>63</sup> In England, the leading case for simple Romalpa clauses is the decision of the English Court of Appeal in *Clough Mill Ltd. v. Martin* [1985] 1 WLR 111, for “all-money” Romalpa clauses the leading case is *Armour v Thyssen Edelstahlwerke AG* 1990 SLT 891, 1991 SCLR 131, [1991] 2 AC 339, for “proceeds” clauses the leading case is *Compaq Computer Ltd. v. Abercorn Group Ltd.* [1991] BCC 484, for “aggregation” clauses is *Modelboard Ltd. v. Outerbox Ltd.* [1992] BCC 945.

<sup>64</sup> R.M. Goode. “*The Protection of Interests in Movables in Transnational Commercial Law*” in *Uniform Law Studies in memory of Malcolm Evans*, *Uniform Law Review*, (1998), 453-465.

<sup>65</sup> Philip R. Wood. *Comparative Law of Security and Guarantees*. London: Sweet & Maxwell, 1995. para 1-1

### **3.9. Countries in Transition**

Transitional countries in Eastern Europe, like Ukraine, present a challenge for secured financing. On the one hand, these countries have their own legal traditions premised on traditional civil law approaches to security and property law in general. On the other hand, security has not been used in their economies until the last decade and, essentially, these countries had to develop their secured financing laws from scratch.

In Ukraine, secured transactions have hardly been used prior to independence due to several reasons. Firstly, in a state-ruled command economy there was no need for security as such because of centralised funding and virtually complete negligence to the very concept of corporate personality: there were “enterprises” (economic units centrally managed by ministries), not “companies” under the old Soviet law. Secondly, repulsive approach to private property meant that that consumer credit as such was very limited. Therefore, there was practically no business need for security interests *per se*<sup>66</sup>.

To stimulate the development of credit markets as part of Ukraine’s efforts to transform into a market economy, in 1992 the Verkhovna Rada of Ukraine (Ukrainian Parliament) adopted the Law of Ukraine “*On Pledge*” (“*Pro Zastavy*”)<sup>67</sup>, which remains (with amendments) the principal legislative act governing secured financing devices (pledges, mortgages (*hypotec*), pawns and charges) to date. Leaving aside the details of the Ukrainian Pledge Law, one should only mention important characteristic features of secured financing regime in Ukraine, as follows:

- (i) creation of non-possessory pledges over different types of movable property used as collateral, including “*goods in circulation or processing*” (inventory)<sup>68</sup>, claim rights<sup>69</sup>, securities (stocks and bonds) and after-acquired property<sup>70</sup>;

---

<sup>66</sup> One may even argue that although Ukrainian civil law has largely followed the approach of BGB, unlike in Germany, there has never been a business need to develop something like fiduciary transfer or fiduciary assignment.

<sup>67</sup> Law of Ukraine “*On Pledge*” dated 2 October 1992, as amended.

<sup>68</sup> Title III of the Ukrainian Pledge Law.

- (ii) creation of a *hypotec* (mortgage) over an “*integrated property complex*” of an enterprise<sup>71</sup>. Although this device was intended to be used only in respect of an ephemeral “*integrated property complex*”, this does not preclude from drafting a mortgage agreement so that all the assets of the company will be included in the “*integrated property complex*”. Therefore, it should be possible to create an enterprise mortgage over the after-acquired property of the whole “*integrated property complex*” of a company<sup>72</sup>;
- (iii) registration of security in movable property in the State Register of Security in Movable Property<sup>73</sup> (the “Register”). The Register was introduced in 1998 as part of the programme to reform the law of security in Ukraine. Article 18 of the Ukrainian Pledge Law provides that the registered holder of a security interest in an asset has priority over the unregistered holder of a security interest in such asset or over subsequent registered holders of a security interest in such asset. The Register is maintained by a specialised department of the Ministry of Justice of Ukraine and is operated by commercial banks and public notaries. The Register is easy to use and relatively inexpensive.

**Opmerking:** In this respect, the new Russian Civil Code is a bad example to follow. [While the 1995 Russian Civil Code is based on traditional market concepts, the definition of Law an “integrated property complex” has been maintained, although with certain modifications.]

---

<sup>69</sup> Article 4 and Title IV of the Ukrainian Pledge Law. Claim rights are interpreted broadly and will include practically any kinds of legal “book debts” (receivables).

<sup>70</sup> Article 3, 4 of the Ukrainian Pledge Law.

<sup>71</sup> Although the Ukrainian Pledge Law provides no definition of an “*integrated property complex*”, its meaning may be found in other Ukrainian legislative acts and in the reviews of judicial practice published by the Ukrainian High Commercial Court. From a historical perspective, an “*integrated property complex*” was a concept known to the old Soviet legal system and was used to indicate an economic unit (e.g., a factory, a plant) rather than a legal person. Thus, an “*integrated property complex*” is typically defined as an enterprise with a complete production circle which is a separate unit or department of a company. In view of the fact that most state enterprises in Ukraine have already been “corporarised”, i.e., transformed from economic units into legal persons, the definition is probably a relic of Soviet past which will not (or should not) be maintained in the New Civil Code.

<sup>72</sup> virtually an equivalent of a floating charge.

<sup>73</sup> Article 15-1 of the Ukrainian Pledge Law, Decree of the Cabinet of Ministers of Ukraine No. 1185 “*On the Procedure of Operation of the State Register of Pledges of Movable Property*” dated 30 July 1998, as amended. See also Decree of the Cabinet of Ministers of Ukraine No. 1806 “*On Conclusion of the Memorandum of Understanding between the Cabinet of Ministers of Ukraine, the National Bank of Ukraine and the Government of the United States of America in respect of the Establishment of the State Register of Pledges of Movable Property in Ukraine*”, dated 16 November 1998.

The legal regime established by the Ukrainian Pledge Law is destined to change with the imminent introduction of the New Civil Code of Ukraine. Articles 610 through 635 of the Draft Civil Code of Ukraine<sup>74</sup> lay down the basic provisions on security interests, while a specialised law is supposed to govern specific security interests.

By way of conclusion, one may argue that the reform efforts in transitional countries have to share the same strategy for reform: both should introduce a comprehensive framework that addresses all stages of a security interest (creation, enforcement, publicity and enforcement), and accompanying the reform with an institutional filing system for security interests<sup>75</sup>. This may result in certain harmonisation of security interests similar to the international harmonisation of security interests analysed in the next chapter.

### **3.10. Provisional Conclusions**

Firstly, despite the use of security devices in most developed jurisdictions, there is still much controversy in respect of the justification of their preferential status. Neither of the existing theories explains all the intricacies of security interests. In practice, however, security interests prove economically beneficial by promoting larger loans to borrowers at lower interest rates. Further, it appears that the psychological justification of security interests is very convincing if one takes into account the irrational behaviour of the financial markets<sup>76</sup>.

Secondly, in spite of the differences between legal systems, there are certain features of security interests which are common to virtually any security interest in any jurisdiction<sup>77</sup>. It follows that a security interest: (i) is typically a proprietary right or right *in rem* following the asset in the hands of anyone and maintained against all the world (*droit de suite*), excluding, of course, floating security interests, (ii) entitles the secured creditor to priority over or even ignorance of any other creditors (*droit de*

---

<sup>74</sup> Draft Civil Code of Ukraine, 1996 (adopted in second reading by the Verkhovna Rada).

<sup>75</sup> Nuria de la Peña. "Reforming the Legal Framework for Security Interests in Mobile Property" in *Uniform Law Review*, (1999), 353.

<sup>76</sup> See generally Andrei Shleifer. *Inefficient Markets*. OUP, 2000.

<sup>77</sup> excluding, of course, "quasi" or deemed security interests.

*préférence*), (iii) by enforcing the security interest the secured creditor is able to satisfy her justified claims to the debtor upon the debtor's default<sup>78</sup>, (iv) entitles the debtor to "equity of redemption", i.e., to redeem the asset upon payment or performance of the underlying obligation, and (v) is accessory to the underlying obligation<sup>79</sup> and, therefore, automatically extinguished upon discharge of the obligation.

Thirdly, apart from these typical features, the secured financing law in traditional countries appears to lack a consistent approach to conceptualisation of secured financing devices<sup>80</sup>. In most states, this area of law appears to be based on an uncoordinated collection of devices and concepts grounded in formalism and traditional legal doctrine. Some civil law jurisdictions have been forced to stretch and distort the concepts of ownership in order to attempt to meet the needs of modern business activity (e.g., Germany). None of these approaches appear to provide a conceptually sound basis for rationalisation of the entire area of secured financing.

Fourthly, a striking similarity between the rules governing possessory security in so diverse European jurisdictions convinces that there are potential prerequisites for adoption of uniform rules in these jurisdictions. Upon the foundation of the Roman law pledge (*pignus*), these legal systems were able to create a uniform regime for possessory security even without any co-ordinating effort on their behalf. One may therefore conclude that despite evident diversity and seeming impossibility of harmonisation in the area of non-possessory security, such harmonisation may be possible through an appropriate co-ordination among these countries.

Fifthly, modern economics demands developed non-possessory security interests, which have developed in various jurisdictions differently based on the traditions of their legal cultures and economic circumstances.

---

<sup>78</sup> if the proceeds of the assets' sale prove insufficient, the creditor will still be entitled to claim the difference from the debtor.

<sup>79</sup> In case of assignment of the underlying obligation, the assignee will benefit from the claim to the security interest.

<sup>80</sup> Ronald Cuming. "The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts UCC, Article 9 and its Progeny" in *Making Commercial Law. Essays in Honour of Roy Goode*, 499-523. Edited by R. Cranston. Oxford, Clarendon Press, 1997. p. 522

Sixthly, from the perspective of security interests legal systems may be classified into traditional or “form-based” systems, and “in-substance” systems based on the unitary, functional approach to security interests.

Seventhly, the modernised, rational and comprehensive system of security interests in Article 9 UCC appears to be the most significant event in the development of secured financing law at present. It follows that any development or harmonisation of secured financing law will follow the path treaded by Article 9 UCC or its adherents.

Eighthly, the rigidity endemic to the pre-Article 9 UCC document filing systems was substituted for an efficient notice filing system. This significantly promotes the flexibility of the secured financing law that is required by modern business.

Ninthly, registration of security interests should perform two basic functions: (i) provide public notice, (ii) determine the priority of securities.

Tenthly, the registration requirement promotes transparency of a security interest in an asset since any creditor can have confidence that any filed security interest would have priority over any earlier security interest that does not appear on the register and any subsequent charge.

Eleventh, determining priority as between registered charges in a notice-filing system is significantly easier than in traditional systems as it would generally be determined by the date of filing, although there are certain exceptions to this rule (e.g., purchase-money security interest).

Twelfth, proceeding from these conclusions one may argue that it is high time to develop a comprehensive model law for secured financing, which will harmonise secured financing law in developed countries. This law will provide a number of benefits, economic in the first place. Such new model law should necessarily be based on the advantages of a unitary, functional approach to security devices based on Article 9 UCC. At the same time, it appears that retention of title clauses proved to be inexpensive and convenient devices for day-to-day business financing. Some form of this useful device should be maintained in the new model law, possibly through a relevant exception. To understand the perspectives of such new model law, we proceed to discuss the international efforts to harmonise security interests.

## **4. INTERNATIONAL SECURITY INTERESTS**

We have already mentioned the efforts undertaken at an international level aimed at the unification of security interests. International or cross-border security interests, it is submitted, should be considered as the routes for future harmonisation of secured financing law on regional and global levels. The most significant of these are the Cape Town Convention on International Interests in Mobile Equipment, the New York Convention on Assignment of Receivables in International Trade, and EC Directives. We will also look at the UNCITRAL's initiative to develop a comprehensive legislative guide on secured transactions.

Although such international initiatives as the EBRD Model Law on Secured Transactions and Model Inter-American Law on Secured Transactions do not address cross-border or international security interests *per se* and would rather fit into the previous chapter, these instruments are, first and foremost, international efforts aimed at harmonisation of secured financing law. Such international character of these instruments justifies their analysis in this chapter.

### **4.1. Convention on International Interests in Mobile Equipment**

In November 2001, the joint conference of UNIDROIT and ICAO concluded a Convention on International Interests in Mobile Equipment (the "Cape Town Convention") and a Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment.

The principal objective of the Cape Town Convention is to provide a system under which interests in high-value equipment will be recognised by the courts of states to which the equipment is taken. As masterly summarised by Professor Sir Roy Goode in respect of its draft, the Cape Town Convention has four primary objectives: (i) to give international protection to security interests in high-value, uniquely identifiable mobile equipment; (ii) to provide the holders of such interests with a basic range of default remedies that can be expeditiously exercised; (iii) to provide a regime by which those interests can be perfected by registration, thereby enabling third parties to discover their existence; and to lay down rules for the recognition and priority of those interests, both within and outside the debtor's bankruptcy. At the heart of the

convention are the provisions for the creation of an autonomous international interest in mobile equipment, an interest constituted by the convention itself and not derived from or dependent on national law. This interest, if created in accordance with the very simple formalities prescribed by the convention, will be enforceable against the debtor whether or not the interest has been registered. But registration will be necessary to ensure priority over subsequent interests, including those of creditors in the debtor's bankruptcy<sup>81</sup>.

The Cape Town Convention aims to establish a regime under which interests in the equipment can be taken and registered in an international registry. The Cape Town Convention is to be treated as the source of law applicable to at least the creation, registration, and priority status of an interest in equipment. Such sound system of security interests in movable property will provide a key building block in financing the acquisition of high-value equipment.

The Cape Town Convention is unique in that it will provide a body of substantive law that would, for the most part, displace domestic law that regulated interests in the kind of equipment to which it applies. Article 2 of the Cape Town Convention provides that it will apply to three different types of security transactions with uniquely identifiable objects<sup>82</sup>: security agreements, title retention agreements and leasing agreements. There are no differences among these transactions with respect to registration requirements or priority rules. Article 29 provides that a registered interest has priority over any other interest subsequently registered and over an unregistered interest.

---

<sup>81</sup> R. M. Goode. *“Transcending the Boundaries of Earth and Space: the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment”* in *Uniform Law Review*, (1998), p. 60.

<sup>82</sup> Para 3 of Article 2 of the Cape Town Convention provides that it will apply to three categories of uniquely identifiable objects, as follows: (a) airframes, aircraft engines and helicopters; (b) railway rolling stock; (c) space assets. Each of these assets should be designated in the respective protocol to the Cape Town Convention. To date, only the Protocol on Matters specific to Aircraft Equipment has been adopted.

The definition of “security agreement” in the Cape Town Convention clearly embodies the functional approach of Article 9 UCC. Article 1 of the Cape Town Convention defines “security agreement” as “*an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure the performance of any existing or future obligation of the chargor or a third person*”.

The Cape Town Convention is probably one of the most important documents to be ever concluded in field of private commercial law. The Cape Town Convention will bring significant economic gains estimated conservatively at several billion dollars annually<sup>83</sup>. The studies conducted by the World Bank on the micro- and macroeconomic benefits of the Cape Town Convention have shown a clear correlation between the adequacy of a country’s legal regime governing non-possessory security interests in movables and the country’s economic development. A legal framework which facilitates creation, perfection and enforcement of security interests provides confidence to lenders and institutional investors both within and outside the country concerned, making it possible to convert illiquid loans into liquid securities and to attract domestic and foreign capital<sup>84</sup>.

#### **4.2. EC Directives**

In the European Union the harmonisation of secured financing law must be necessarily implemented through the legal framework of EC legislation. However, the European Community Treaty (the “EC Treaty”) does not expressly provide a legal basis for the harmonisation of secured financing law. In this respect, the Community law rules on private property rights focus, for the most part, on intellectual property.

The differences between the legal systems of secured financing in the Member States are aggravated at the enforcement stage. In private international law, the questions of property law are governed by the principle of *lex situs*, i.e., the law of the place (*situs*) where the property (i.e., collateral) is located. In case of movable property, the

---

<sup>83</sup> Heywood Fleisig. “The Proposed UNIDROIT Convention on Mobile Equipment: Economic Consequences and Issues” in *Uniform Law Review*, (1999), 254.

<sup>84</sup> R. M. Goode. “*The Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment: the Next Stage*” in *Uniform Law Review*, (1999), 265-274

collateral can move between countries and the question arises which law should apply the law of creation of the security interest or the law of the *situs* of the collateral. Obviously, the regime of security interests would be different in these countries.

It appears, however, that any differences in secured financing may be viewed as impediments or hindrances to trade in the internal (common) market of the Community. To implement the Community policy in this respect, Articles 23 and 49 of the EC Treaty guarantee free movement of goods and services in the internal market. It follows that any restrictions on free movement of goods or provision of services in the Member States are prohibited.

Moreover, Article 28 of the EC Treaty prohibits quantitative restrictions on imports and all measures having equivalent effect. Accordingly, any non-recognition of a security interest arising under the law of a Member State may be interpreted as a restriction on free movement of goods or a “*measure having an equivalent effect*” under the EC Treaty<sup>85</sup>.

In the famous case “*Dassonville*”<sup>86</sup>, the European Court of Justice has defined measures having equivalent effect in a very broad manner, as follows: “*All trading rules enacted by a Member State which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions*”.

The broad definition in the *Dassonville* case has been subject to a number of qualifications in subsequent cases, which, however, provide additional arguments in favour of the unification of secured financing law in the Member States. In *Cassis de Dijon*<sup>87</sup>, the Court formulated the “*country of origin*” rule, whereby goods lawfully produced and marketed in the country of origin can be introduced and marketed in the

---

<sup>85</sup> In particular, non-recognition of a retention of title clause in a sale contract involving sale of goods from one Member State to another can almost certainly be interpreted as a “*measure having an equivalent effect*” under the EC Treaty. See Eva-Maria Kieninger. “*Securities in Movable Property within the Common Market*” in *European Review of Private Law*, 4 (1996), p. 52-53. Also, Eva-Maria Kieninger. *Mobiliarsicherheiten im Europäischen Binnenmarkt: Zum Einfluss der Warenverkehrsfreiheit auf das nationale und internationale Sachenrecht der Mitgliedstaaten*/1.Aufl. Baden-Baden: Nomos Verl.-Ges., 1996.

<sup>86</sup> Case 8/74 *Procureur du Roi v. Dassonville* [1974] ECR 837.

<sup>87</sup> Case 120/78 *Rewe-Zentral-AG/Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

same way throughout the Community, unless there are mandatory requirements of public interest<sup>88</sup> justifying the restriction. Further, the *Cassis de Dijon* rule was applied in *Oosthoek*<sup>89</sup> case, where it was held that “*legislation which restricts or prohibits certain forms of advertising and certain means of sales promotion may, although it does not directly affect imports, be such as to restrict their volume because it affects marketing opportunities for the imported products*”.

It follows that such means of “*sales promotion*” as the granting of credit or payment of the purchase price in instalments may fall within the formula of this case and, therefore, any legislation governing the creation, implementation or enforcement of security interests may restrict the volume of imports<sup>90</sup>.

In the landmark decision in the *Keck*<sup>91</sup> case, the Court held that “*the application to products from other Member States of national provisions restricting or prohibiting certain selling arrangements is not such as to hinder directly or indirectly, actually or potentially, trade between Member States within the meaning of Dassonville so long as those provisions apply to all relevant traders operating within the national territory and so long as they affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States*”.

Thus, the Court has articulated a twofold test for the application of “*measures having equivalent effect*” rule. Firstly, there is a distinction between the product itself and “*certain selling arrangements*” used for promotion and marketing of the product in a Member State (*Dassonville*, *Cassis de Dijon* and *Oosthoek* cases). Secondly, such “*certain selling arrangements*” have to affect the promotion and marketing of both domestic and imported products in order to constitute “*measures having equivalent effect*” (*Keck* case).

---

<sup>88</sup> In particular, mandatory rules in a Member State relating to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer.

<sup>89</sup> Case 286/81 *Oosthoek's Uitgeversmaatschaappij BV* [1982] ECR 4575.

<sup>90</sup> The formula in *Oosthoek* case has been subsequently applied in several cases, including Case C-126/91 *Schutzverband gegen Unwesen in der Wirtschaft/Yves Rocher GmbH*, EuZW 1993, 420.

Moreover, the differences in the rules on security interests in the Member States can obviously distort competition by influencing the decision of the parties in respect of a particular business transaction.

One may thus conclude that the national laws and regulations governing security interests together with the *lex situs* rule do represent a measure having an equivalent effect under Article 28 of the EC Treaty, which cannot be justified by any of the mandatory requirements<sup>92</sup>.

At the same time, the Court has already examined the effectiveness of a retention of title clause in its *Krantz*<sup>93</sup> decision, where it held that “*the possibility that nationals of other Member States would hesitate to sell goods on instalment terms to purchasers in the Member State concerned because such goods would be liable to seizure by the collector of taxes if the purchasers failed to discharge their Netherlands tax debts is too uncertain and indirect to warrant the conclusion that a national provision authorising such seizure is liable to hinder trade between Member States*”. This decision, however, remains controversial and may soon be re-considered<sup>94</sup>.

At present, there are two directives aimed at harmonisation of secured financing law in the European Union, as follows:

- (A) Directive 2002/47/EC on Financial Collateral Arrangements of 6 June 2002<sup>95</sup> (“Financial Collateral Directive”); and
- (B) Directive 2000/35/EC on Combating Late Payment in Commercial Transactions of 29 June 2000<sup>96</sup> (the “Late Payment Directive”).

---

<sup>91</sup> Cases C-267-268/91 *Bernard Keck and Daniel Mithouard*, EuZW (Europäische Zeitschrift für Wirtschaftsrecht) 1993, 770 [1995] CMLR 101.

<sup>92</sup> Eva-Maria Kieninger. *Ibid.* p. 62.

<sup>93</sup> Case C-69/88 *H.Krantz GmbH & Co. v. Ontvanger der Directe Belastingen and Staat der Nederlanden* [1990-1] ECR 583.

<sup>94</sup> Eva-Maria Kieninger. *Ibid.* p. 63.

<sup>95</sup> Official Journal, L 168, 27/06/2002 p. 43

<sup>96</sup> Official Journal, L 200, 8.8.2000. pp. 35-38

Following the Commission proposal, on 6 June 2002 the European Parliament and the Council adopted the Financial Collateral Directive. The aim of the Directive is to create a Community regime for the provision of securities and cash as collateral under both security interest and title transfer structures including repurchase agreements. The policy behind the Financial Collateral Directive is that publicity requirements for perfection in differing jurisdictions are perceived as impractical, difficult and inconvenient when applied to financial markets<sup>97</sup>. The Financial Collateral Directive seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral<sup>98</sup>.

The Financial Collateral Directive proposes a simplified framework in order to create legal certainty. It is presumed that this will contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community<sup>99</sup>. There are two specific measures designed to achieve the aims of the Financial Collateral Directive: (i) to permit agreements allowing the collateral-taker to re-use the collateral by on-pledging, and (ii) to allow specifically for collateral substitution<sup>100</sup>.

On 29 June 2000, the European Parliament and the Council adopted the Late Payment Directive with an aim to combat late payments in commercial transactions on an economic rationale that one out of four insolvencies is due to late payment<sup>101</sup>. Article 4 of the Late Payment Directive provides that the Member States are to allow the seller to retain title to goods until they are fully paid for if a retention of title clause has been expressly agreed between the buyer and the seller before the delivery of the goods. Since the retention of title has been available not in all Member States, the

---

<sup>97</sup> See Proposed Directive on Financial Collateral Arrangements, FAQ.

<sup>98</sup> e.g., such as by eliminating the so-called re-characterisation of such financial collateral arrangements (including repurchase agreements) as security interests.

<sup>99</sup> These measures will also support freedom to provide services and the free movement of capital in the single market in financial services.

<sup>100</sup> The Member States are required to bring into force the laws, regulations and administrative provisions necessary to comply with the Financial Collateral Directive by 27 December 2003 at the latest. The Commission is to report on the progress achieved by the Member States with the Financial Collateral Directive not later than 27 December 2006.

<sup>101</sup> Directorate General For Enterprise. *A Guide for Businesses: Combating Late Payments in Commercial Transactions*, Directive 2000/35/EC

Late Payment Directive obliges Member States to introduce such device in their national legislation by 8 August 2002.

The development of secured financing law in the EU should become an example for harmonisation of this area of law globally. Although there are no projects aimed at such harmonisation at the moment, any substantial future dispute on the differences between secured financing techniques in the Member States will trigger the development of a new project. The analysis of the complex case law confirms the possibility of such development. Moreover, the economic analysis of the benefits conferred by uniformity of security devices in the Member States is yet to be conducted. The studies conducted by the World Bank on the benefits of the Cape Town Convention confirm that such uniformity can bring definite economic gains<sup>102</sup>.

From a perspective standpoint, the harmonisation of secured financing law in the European Union may follow either of the following ways:

- (A) adoption of an EC directive or regulation addressing the relevant issues; or
- (B) conclusion of a convention between Member States.

In view of the numerous differences in approaches to security interests in the Member States and the absence of an express legal basis for Community action, option (B) will be more advantageous. Moreover such European Convention may be open for signature by non-Member States and can serve as a basis for harmonisation of secured financing worldwide.

The contents of the new European Convention should necessarily embody the approach of Article 9 UCC to security interests. The advantages and sophistication of Article 9 UCC have proven effective and should be seen as an example for future development of secured financing law. Thus, the new European Convention should provide for (i) uniform and functional definition of security interest; (ii) creation of European Registry of security interests and effective system of notice filing; (iii) special rules for retention of title clauses.

---

<sup>102</sup> See generally H. W. Fleisig. "The Proposed UNIDROIT Convention on Mobile Equipment: Economic Consequences and Issues", in *Uniform Law Review*, (1999), pp. 253-264.

At the same time, retention of title clauses have become an integral part of practically all major European jurisdictions. The benefits of the reservation of title are obvious: this is a purely contractual device that creates a proprietary right and does not require registration. Therefore, it is very convenient for the parties to the transaction to create such device with minimal costs. If the new European Convention will include a unitary or functional definition of a security interest, the preservation of the reservation of title may be done through (i) simple registration (notice) rules; (ii) exemption of the retention of title from registration (notice) requirement. In the latter case, it may be useful to adopt the Latin approach of ascertaining the date of the agreement<sup>103</sup> in order to avoid possible violations of the exemption. All Member States should already have introduced the retention of title clause in their legislation, the application of which has been mandated by the Late Payment Directive.

#### **4.3. UN Convention on Assignment of Receivables in International Trade**

On 12 December 2001, the United Nations General Assembly adopted the Convention on Assignment of Receivables in International Trade (the “New York Convention”). The New York Convention applies to cross-border assignments of receivables (both international and domestic), whether the assignment is absolute or by way of security, where the assignor (including a security provider) is located in a contracting State.

Article 2 of the New York Convention broadly defines the term “receivable” to mean any contractual right to payment of a monetary sum<sup>104</sup> except for the assignments expressly excluded from its ambit<sup>105</sup>.

---

<sup>103</sup> In Italy and Spain any agreement creating a right *in rem* or a “quasi-security” interest (e.g., retention of title) requires a *data certa* (Articles 1524(1), 2704 Codice Civile) or *fecha cierta* (Article 1227 Código Civil), an ascertainable date. In Spain, *fecha cierta* can be acquired through legalisation of the agreement by a notary public or a stockbroker (*agente di cambio y bolsa*), or through registration.

<sup>104</sup> The term is broader than the common law concept of “book debts”.

<sup>105</sup> The following assignments are expressly excluded from the ambit of the New York Convention: (A) assignment for consumer (personal, family or household) purposes (Article 4(1)(a)); (B) assignment made as part of the sale or change in the ownership or legal status of the business out of which the assigned receivables arose (e.g., a merger or buy-out) (Article 4(1)(b)); (C) assignment of receivables where the receivables relate to transactions on a regulated exchange, financial market transactions governed by netting agreements (other than termination payments), foreign exchange transactions, inter-bank payment systems, investment securities held by intermediaries, bank deposits, letters of credit or independent guarantees (Article 4(2)).

Following an assignment<sup>106</sup> under the New York Convention, the assignee obtains a proprietary interest in the assigned receivables and any proceeds. As a general rule, the priority of competing interests in assigned receivables will be determined pursuant to the law of the Contracting State in which the assignor is located (Article 22). There is also a possibility for a Contracting State to adopt a menu of three alternative priority regimes, which a State may adopt in place of its domestic rules of priority. The New York Convention provides for the establishment of a registration system. In case of registration, the priority of the right of an assignee in the assigned receivable is determined by the order in which data about the assignment are registered, regardless of the time of transfer of the receivable. If no such data are registered, priority is determined by the order of conclusion of the respective contracts of assignment. The scope of this article does not allow us to describe the New York Convention in greater detail.

#### **4.4. UNCITRAL's Draft Legislative Guide on Secured Transactions**

To stimulate development of secured financing, UNCIRAL adopted a Draft Legislative Guide on Secured Transactions (the "Draft Guide") with an aim to create "*an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, such as the form of the instrument, the exact scope of the assets that can serve as collateral...*"<sup>107</sup>. The assumption was that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade<sup>108</sup>.

---

<sup>106</sup> Article 9(1) through (3) defines the events when assignment may not be prohibited contractually, but such limitations are still allowed in all other cases.

<sup>107</sup> *Draft Legislative Guide on Secured Transactions*. UNCITRAL, 12 February 2002.

<sup>108</sup> It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. It was also stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable. Furthermore, in order to ensure the optimal benefits from law reform, including financial-crisis prevention, poverty reduction and facilitation of debt financing as an engine for economic growth, any effort on security interests would need to be co-ordinated with efforts on insolvency law.

Leaving aside the details of the Draft Guide until it has been finalised, we will only set out the key objectives and themes of efficient secured transactions regime outlined in the Draft Guide, as follows:

- (A) Utilize full value of assets to obtain credit<sup>109</sup>.
- (B) Obtain security in a simple and efficient manner.
- (C) Validate non-possessory security rights.
- (D) Establish clear and predictable priority rules.
- (E) Facilitate enforcement of creditor's rights in a predictable and timely fashion.
- (F) Provide for equal treatment of domestic and non-domestic creditors.
- (G) Recognise party autonomy.
- (H) Encourage responsible behaviour by enhancing transparency<sup>110</sup>.

It is hoped that the Draft Guide will provide useful guidance for the development of the laws on secured transactions in the countries wishing to achieve practical economic benefits.

---

In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential. *Draft Legislative Guide on Secured Transactions*. UNCITRAL, 12 February 2002.

<sup>109</sup> In this connection, the Draft Guide emphasises three principles: (i) broad range of assets to serve as encumbered assets, (ii) broad range of obligations to be secured, (iii) the benefits of the regime available to a broad array of debtors, creditors and credit transactions.

<sup>110</sup> The scope of this article does not allow to explore the key objectives of the Draft Guide in detail. For further details, see *Draft Legislative Guide on Secured Transactions*. Report of the Secretary General. UNCITRAL, 12 February 2002.

#### **4.5. Model Law on Secured Transactions**

In 1993 the European Bank for Reconstruction and Development embarked on a project aimed at modernising the secured financing law in the countries of central and Eastern Europe. The result of the project was adoption of the Model Law on Secured Transactions (the “Model Law”) in 1994, and the General Principles of a Modern Secured Transactions Law in 1997.

The Model Law has been modelled on Article 9 UCC to a significant extent. Article 1.1 of the Model Law defines a “charge” as a single form of consensual, *in rem* right in property that is granted to secure a debt. The charge has been designed to subsume all prior forms of security devices such as pledges and mortgages. The charge may encumber any number of items of property and extends to property acquired by the debtor after execution of the charge agreement. However, the Model Law continues to provide special treatment for agreements with title retention clauses. Article 9.1 of the Model Law provides for “unpaid vendor’s charge”, which is similar to partial re-characterisation of title retention clauses in Article 9 UCC. Article 9.1.1 through 9.1.2 provide that title retention clause in a contract for the sale of movables must be treated as a charge. Therefore, title is not to be seen as being retained by the seller, it is transferred to the purchaser and in its place the vendor receives a charge.

#### **4.6. Inter-American Co-operation**

On 8 February 2002, the Sixth Inter-American Specialized Conference on Private International Law of the Organisation of American States approved the Model Inter-American Law on Secured Transactions (the “Inter-American Model Law”). The objective of the Inter-American Model Law is to regulate security interest in movable property securing the performance of any obligations whatsoever, present or future, determined or undetermined of any nature. The state adopting the Inter-American Model Law is supposed to create a unitary and uniform registration system for movable property security in order to give effect to the Inter-American Model Law.

Under Article 6 of the Inter-American Model Law, if the security interest is non-possessory, the contract creating the security must be in writing and the security interest takes effect between the parties from the moment of the execution of the writing, unless the parties otherwise agree. However, a security interest in future or after-acquired property encumbers the secured debtor's rights (personal or real) in such property only from the moment the secured debtor acquires such rights.

Pursuant to Title III of the Inter-American Model Law, the rights conferred by a security interest take effect against third parties only when the security interest is publicised. A security interest must be publicised by registration or by delivery of possession or control of the collateral to the secured creditor or to a third person on its behalf. Accordingly, even an acquisition security interest (i.e., purchase money interest) must be publicised by filing of a registration form that refers to the special character of this security interest and that describes the collateral encumbered by this security interest. Equally, a security interest granted by the secured debtor in receivables owed to the secured debtor is publicised by registration.

Thus, the Inter-American Model Law embodies to a significant extent the approach of Article 9 UCC.

#### **4.7. Provisional Conclusions: Perspectives of Harmonisation**

Based on the above discussions, one may come to a number of conclusions relating to the harmonisation of secured financing law on the regional and global levels.

Firstly, the existing efforts of harmonisation confirm that the harmonisation of secured financing law on a global and regional levels is likely to develop on a sector-by-sector basis. There is a clear demand for the uniform global regulation of security interests in certain goods, for instance, high value mobile equipment or receivables. The Cape Town Convention and the New York Convention, as soon as they enter into force, are destined to become the most substantial developments of secured financing law to date. These conventions should serve as an example for harmonisation of secured financing law in other sectors. Of course, notwithstanding the difficulties and the costs of international harmonisation, the gains of the new regime are predetermined to be economically very beneficial. Moreover, if the international harmonisation on a comprehensive level will take place, it will enable to create an effective international regime in place of the current diverse and multi-complex national regimes. The international harmonisation of intellectual property law may well serve a good example for the unification of general property law (or certain aspects thereof) at an international level<sup>111</sup>.

Secondly, it may be possible to develop a new European Convention on Security Interests. The analysis of the case law of the European Court of Justice confirms that the differences in the approaches to security interests in the Member States can be seen as “*measures having equivalent effect*”, which restrict trade between Member States in the Community market. Thus it is only a question of time before the Court has examined a case and thus created an incentive for the Member States to develop a uniform approach to security devices in the European Community.

Moreover, the Financial Collateral Directive and Late Payment Directive acknowledge the tendency towards unification of certain sectors of the Community market: financial services, vendor credit sales. If true unification of the Community market is within reach, true harmonisation of secured financing law will follow.

---

<sup>111</sup> See, for example, a substantial number of the WIPO-administered treaties establishing an international regime for the protection of intellectual property rights at <http://www.wipo.org>

The new European Convention on Security Interests should necessarily embody the approach of Article 9 UCC to security interests. The advantages and sophistication of Article 9 UCC have proven effective and should be seen as an example for the future development of secured financing law. Thus, the new European Convention should provide for (i) uniform and functional definition of security interest; (ii) creation of European Registry of security interests and an effective system of notice filing; (iii) special rules for retention of title clauses<sup>112</sup>.

Thirdly, it appears that both the Cape Town Convention and the New York Convention follow the notice-filing or registration system based originally on Article 9 UCC. The application of the Cape Town and the New York Conventions in practice is destined to show the advantages of such a system and the clear economic gains resulting from a uniform regime governing the security interests covered.

Fourthly, after elaborating successfully the Cape Town Convention and the New York Convention, UNCITRAL has proceeded to work on a comprehensive Legislative Guide on Secured Transactions. The Guide is supposed to serve as a guideline for development of a flexible and effective legal framework for security rights. Such framework could serve as a useful tool to increase economic growth.

Fifthly, two projects are contributing to the development of secured financing law on the regional level: the EBRD *Model Law on Secured Transactions* and the *Inter-American Model Law on Secured Transactions*. Both instruments appear to be modelled on Article 9 UCC and establish unitary and uniform registration systems for movable property security interests.

---

<sup>112</sup> Although §9-103 of Article 9 UCC provides for the automatic perfection of purchase money security interests in consumer goods (i.e., conditional sales, retention of title), it may be sensible to retain this exception for any contracts with a retention of title clause in the new European Convention for economic and convenience reasons. For details of the automatic perfection of purchase money security interests in consumer goods see J. J. White and R.S.Summers, *Uniform Commercial Code* (2001) 5<sup>th</sup> ed. para. 22-6.

## 5. CONCLUSIONS

Based on the above discussions, one may come to a number of conclusions on the perspectives on harmonisation of secured financing law on a global and regional levels.

Firstly, comprehensive harmonisation of secured financing law presents enormous challenges: this area of law is encumbered by differences in cultural traditions, formalities and even the substance of the transactions to a very significant extent. However, recent attempt at the international level have shown that the economic results of harmonisation may outperform the political choices of the countries concerned (e.g., Cape Town Convention, the Financial Collateral Directive and Late Payment Directive) and that a comprehensive harmonisation of secured financing law may be within reach.

Secondly, it appears that the rules governing possessory security have common roots in the Roman law institution of *pignus* (pledge) and are phenomenally similar in the jurisdictions adhering to the traditional approach to security interests. Upon this foundation, one may argue, it should be possible to develop a common institution for non-possessory security devices in these jurisdictions. There is no doubt that the *ius commune* of the European Union will gradually come to the development of such device(s) for the European countries. It remains to be seen when the realities of the common (internal) market will reach the level of economic integration requiring comprehensive regulation of security interests.

Thirdly, the basic model for harmonisation should focus on non-possessory security, which will embody a broad range of assets as collateral, including book debts and inventory. This is one of the cardinal principles of the UNCITRAL Guide on Secured Transactions and the EBRD Principles of Secured Transactions.

Fourthly, the analysis of the complex case law of the European Court of Justice indicates that a potential future dispute on the differences between secured financing techniques in the Member States will trigger a new project aimed at a comprehensive harmonisation of secured financing law. Such dispute is most likely to be based on provisions of the EC Treaty establishing free movement of goods and prohibiting

measures having equivalent effect. The economic analysis of such harmonisation is yet to be conducted, but undoubtedly its results will only emphasise the benefits of harmonisation. Moreover, there is a clear tendency towards unification of secured financing in certain sectors of the Community market: financial services, vendor credit sales. If true unification of the Community market is within reach, true harmonisation of secured financing law will follow.

Fifthly, the national laws and regulations governing security interests together with the *lex situs* rule do represent a “*measure having an equivalent effect*” under Article 28 of the EC Treaty, which cannot be justified by any of the mandatory requirements. Due to the lack of a clear legal basis for Community action for harmonisation of secured financing law in the European Union, it appears that the harmonisation should result in the conclusion of a new European Convention on Secured Financing. Such European Convention should be open for signature by non-Member States and can serve as a basis for harmonisation of secured financing worldwide.

Sixthly, a new European Convention or any other international harmonisation effort is destined to embody the approach of Article 9 UCC to security interests. The Cape Town Convention and the New York Convention confirm this tendency and the advantages and positive experience of Article 9 UCC. In essence, a new international instrument should provide for (i) uniform and functional definition of security interest; (ii) creation of a single registry of security interests and effective system of public notice filing; (iii) special rules for retention of title clauses (exemption allowing to ascertain the date of the security agreement). In other words, this international instrument should integrate the two heterogeneous regimes available in most countries (i.e., pledge and ownership rights) into a modernised law on secured financing.

Finally, it is clear that harmonisation of secured financing law on a global level has already followed a sector-by-sector approach, whereby certain sectors achieve really worldwide exposure (Cape Town and New York Convention). The author hopes that such projects would stimulate a comprehensive harmonisation on a global level (e.g., more serious instrument than the Draft Guide) and would create favourable conditions for sustainable economic growth in the countries availing themselves of the harmonised approach.