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# General Principles of a Modern Secured Transactions Law

*John L. Simpson<sup>1</sup> and Jan-Hendrik M. Röver<sup>2</sup>*

## I. Introduction.

In 1992 the European Bank established a secured transactions project to encourage and assist in the introduction of workable laws on secured transactions in the countries of central and eastern Europe. Following the production of a Model Law on Secured Transactions in 1994, a number of country projects emerged across the region. Drawing on the experience gained from this work we have attempted to develop a number of general principles which can be applied in secured transactions law reform. This article represents an initial attempt to set out those principles in a single coherent text. We have divided the principles into two tiers: fundamental principles which underlie any modern secured transaction law and practical rules which are of general importance to the successful implementation of the law.

The term 'security' is capable of many interpretations. In this article we are dealing with proprietary security which attaches to an asset and supports a monetary claim. We do not cover personal security such as suretyships and guarantees nor do we embrace the wider United States' concept of looking at any transaction (regardless of its form) which is intended to create a security interest.

The economic justification for security is not within the scope of this article. We start from the assumption that security is a good thing. It facilitates the granting of credit which stimulates economic activity and permits a more efficient use of assets. There are many forms of credit for which security can be granted but the classic example is the loan and in the following analysis for the sake of simplicity we often refer to 'lender' and 'borrower'.

## II. Purpose of Security and Objectives of Reform.

The purpose of security is to reduce the risk of giving credit by increasing the chances of the lender recovering the amounts that become due to him. By doing so, security increases the availability of credit and improves the terms on which credit is available: the offer of security influences the lender's decision whether or not to lend, it also changes the terms on which he is prepared to lend (typically by increasing the amount of the loan, by

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extending the period for which the loan is granted and by lowering the interest rate). The economic value of security can be formulated in a simple rule which links the economic value to the risk reduction achieved by security: the more the risk of giving credit is reduced, the greater the value of the security to the lender and the greater the security's economic effect. A reduction of the risk of the lender is of most immediate value to the lender but benefits flow at the same time to the borrower and to the economy generally.

The objectives of the reformer should be to ensure that: 1) the law permits the creation of effective security which is capable of achieving its purpose of reducing the risk attached to the credit; and 2) the benefit of any law which provides for secured transactions is maximized by encouraging the use of security in the widest possible range of circumstances.

These objectives are closely linked. When it is recognized that security reduces the risk of giving credit, its use will be encouraged. It is convenient however to separate those fundamental principles which we consider essential if a modern security law is to operate effectively at all from the practical rules that are likely to influence the extent to which a secured transactions law is actually used. By analyzing security in this way we may cut across traditional legal distinctions: our intention is to provide for those in transition economies a practical introduction to reform in this area of law.

Any reform must also ensure adequate protection of the person giving security and third parties. This article concentrates on the ways in which a secured transaction can enhance the economic benefits flowing directly from the giving of security and therefore does not address protection matters. They are however important and any reform should take account of the need to achieve a fair balance between the competing but legitimate interests of debtor, secured creditor and other parties.

### **III. Effectiveness of Security Law; Ensuring That Security Achieves Its Purpose.**

When a lender is given security over an asset the advantage he thereby obtains depends on the 'security right' that he receives in that asset and in particular on: the essential qualities of the right; the certainty of the right; the means of recovery of the debt from the secured asset; and the cost of creating, maintaining and exercising the right.

#### **A. ESSENTIAL QUALITIES OF THE SECURITY RIGHT.**

The function of the security right is to enable the secured lender to realize value from the assets that have been given as security: this normally means to sell those assets and to use the proceeds from the sale to satisfy his debt. The way in which a security right is created varies between different legal systems. In common law countries a security right is often established in two stages: first, between the parties (attachment); and second, against third parties (perfection). In civil law countries the security right as a right in rem becomes effective between the parties and against third parties simultaneously. Irrespective of how the nature of the security right is analyzed three qualities are essential.

First, the right is a right in rem: it gives the holder of the right an entitlement to realize the charged property through enforcement procedures. That entitlement is limited to the recovery of the secured debt and can only be exercised when there has been a failure to pay the secured debt.

Second, as a right in rem it can be exercised not only against the person who grants it but also against any person who subsequently acquires an entitlement to the charged property. Where the security right is possessory and the lender holds the assets given as security the possibility of third parties acquiring an entitlement in the charged property is limited. The fact that the lender is in possession of the assets gives them notice that he has rights in them. However where the borrower remains in possession of the assets (the most important kind of security in economic terms), it is essential that effective means are established to make third parties aware of the existence of the security. This is needed both to protect the lender against third parties who may claim rights in the secured assets and to alert the third party who may wish to acquire those assets that the lender has rights in them. The most widely accepted way of doing this is by registration.

Lastly, the security right should give the secured lender priority over other creditors. Ultimately, all creditors have a right to be satisfied from their debtor's assets. If the debtor fails to pay they can commence bankruptcy proceedings and the court (or a person appointed for the purpose) will realize the assets of the debtor and distribute them amongst the creditors. The essential quality of a security right is that it gives the secured creditor a first priority (subject to other security) in the secured asset ahead of all other creditors. This priority continues notwithstanding the insolvency or bankruptcy of the debtor.

#### B. CERTAINTY OF THE SECURITY RIGHT.

As with any legal right, certainty is an essential element. Where there is a lack of certainty as to a security right, there will be a lack of certainty as to the extent to which the security right reduces the risk of the lender and the security will be of less value to the lender. A secured lender needs to have certainty in many respects.

First, a secured lender needs certainty as to the existence of the security right. He must know what has to be done to create the right, when it is created and when and how it may cease to exist. The person who has granted the security right or a third party who claims rights in the secured assets should not be able to terminate or adversely alter the right without the consent of the secured lender.

Second, a secured lender needs certainty as to his priority against other persons with rights in the secured assets. The most frequent example of this is other lenders holding security rights in the same assets; each of the lenders must know where he stands vis-à-vis the others.

Third, a secured lender needs certainty as to the time when the security right can be exercised. At the moment when the security right is granted, the secured lender has no immediate entitlement to realize the secured assets; he only has a contingent right to do so upon the occurrence of a particular event (normally the failure of the borrower to perform his obligations). It is important for the lender to know precisely at what time his passive security right becomes an active one.

Lastly, certainty must exist as to the way in which the security right can be exercised. When a security right becomes an immediate active right, the secured lender needs to know what he is entitled to do in exercising his right. A security right which in principle may entitle the lender to a fast and high value recovery on exercise can be much reduced in value if the law providing the right or the procedures for its exercise are such as to create doubt as to how much will in reality be recovered and when.

### C. MEANS OF RECOVERY OF THE DEBT FROM THE SECURED ASSET.

A security right which cannot be exercised is of little value to a lender. It is the ways in which it can be exercised which, more than anything else, will determine its value. The security right is the right of the lender to recover money due to him out of the assets given as security. If the right enables him to recover a high value from the assets in a short space of time the security right will be more valuable to him than if it only enables recovery of a low value, or if recovery takes a long time, or if he does not know when he starts to exercise his right how much he is likely to recover and how long it is likely to take.

Exercise of security rights is a complex topic which involves competing goals (and not least the need to protect a borrower from unreasonable action by an unscrupulous lender). For the security right to be of maximum value to the lender, it must enable him to obtain maximum value from the secured assets. That is, the more he knows he can recover from the security the greater the influence on his decision to lend or the terms on which he is prepared to lend. Also, he must be able to recover money from the secured assets rapidly. He is exercising his security right because money due to him has not been paid: it is obviously important to him to obtain payment as fast as possible. A security right which takes one week to exercise is of greater value than one which takes five years.

In addition, the procedure for exercise must give him certainty as to his recovery and must continue on the insolvency or bankruptcy of the borrower in a way which does not reduce or delay recovery.

Naturally these issues are influenced by the type of asset that is given as security; the amount and time of recovery from a cash balance in a bank account is easier to determine than for crops still growing in a field. A secured transactions law should aim to maximize the amount, the speed and the certainty of recovery irrespective of the asset that has been given as a security.

### D. COSTS OF CREATING, MAINTAINING AND EXERCISING THE SECURITY RIGHT.

The costs of creating, maintaining or exercising a security right should be kept to a minimum since they reduce the value of the security right to the lender. The best way to ensure that a secured transactions law is of little practical use is to impose high costs on the security right. In order to keep costs low the system for operation of secured transactions must be kept simple and cost effective. Specifically the means of creation, registration, and enforcement of the security right as well as insolvency proceedings in respect of security must be simple and efficient.

Also, the cost to the parties to secured transactions should not exceed the reasonable cost of the service they receive. No taxes or duties (in whatever form) should be imposed at any stage on a secured transaction. Fixed or scale fees or charges should reflect the cost of providing the service to the parties.

## IV. Encouraging the Use of Security in the Widest Possible Range of Circumstances.

The second tier of benchmark principles which should lie at the foundation of a modern security law is composed of practical rules of general importance which encourage the use of security. These rules do not alter the fundamental principles discussed in section 3 above but they aim to remove restrictions which may reduce the use of security and to

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ensure that the law allows secured transactions to be structured in a manner that responds to the practical requirements of the market. In any security transaction there are four key elements: the person giving the security; the person receiving it; the debt that is being secured; and the asset that is being given as security. We set out the practical rules by reference to these elements.

A. PERSON GIVING SECURITY.

1. *Any Person May Give Security Over His Assets.*

The use of security is encouraged if any person may grant security and secured transactions are not limited to certain types of persons. That means that any natural or legal person should in principle be able to grant security if and to the extent that he owns assets.

Explicit restrictions of types of persons giving security are relatively rare in national security laws although many are implied by limitations on the assets suitable as security. Some limitation on the type of persons that can give security may also be required to protect consumers.

The person giving security must be the owner of the secured assets. Because the security gives the right to sell assets which is a power attached to ownership, only the owner of assets can create security. Laws often recognize ownership of things and rights only to a limited extent particularly as far as immovable property and the assets of enterprises are concerned and rely in this respect on lesser rights than ownership. The new Russian Civil Code for example makes reference to the right of full economic jurisdiction. If only such lesser rights are held (for example, in a building) by the person giving the security, it is these rights that can be secured. This should, however, not be confused with the outright security over the building which the borrower does not own.

2. *Person Receiving Security; Security May Be Given to Any Person to Whom the Secured Debt Is Owed.*

The second principle is the mirror-image of the principle applying to persons giving security. By including a wide range of persons receiving security, a security law can encourage its use. It is unfortunate if provisions on security are limited to one group of creditors, such as banks, as this discriminates against other creditors for no good reason and thereby prevents economic benefits of secured transactions from being accessible to all economic agents.

Although any type of person should be able to receive a security right, this person must be the creditor of the secured debt. This is a necessary corollary of the notion that security secures the performance of another obligation.

B. SECURED DEBT.

1. *Security Can Be Given for Any Present or Future Debt or Debts.*

In principle it should be possible to grant security not only for present debts but also for future debts; i.e., debts which are created or become owed by the debtor after the creation of the security right. Should the security right for a future debt be created immediately or only at the time the debt is owed to the chargeholder? The answer should be that

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security is created immediately and consequently immediate priority is acquired. Where security is only created at a later time it does not give the lender adequate certainty as to his right: he cannot be expected, for example, to commit to making further advances if he does not know what priority his security will have. The disadvantage to the borrower of the security covering undetermined future amounts can be offset by requiring the security to be capped at a maximum amount.

A principle which fundamentally broadens the scope of security is the principle that security should be able to be given not only for a single debt but also for several debts. This gives the parties flexibility in the way that they define the debt secured by the security right.

### 2. *Security May Be Given for a Changing Pool of Debt.*

The secured debt can be static (a fixed amount which does not change) or dynamic (fluctuating). The composition and the amount of the secured debt can change during the life of the security for many reasons. This is the case, for example, where the secured debt is an overdraft facility combined with a current account, or fluctuating amounts under a revolving credit, or a credit line under a trade supply agreement.

Since the parties should be able to create security for a changing pool of debt, they consequently must be able to describe and identify the debt not only specifically but also generally by reference to a general class description.

## C. ASSETS GIVEN AS SECURITY.

### 1. *Security Can Be Given Over All Types of Assets.*

A secured transactions law is of maximal use when it deals with all types of assets. Security can be created in either movable or immovable things or in rights. Security over immovable assets is often provided for separately under the laws relating to land but the principles for a secured transactions law are essentially the same whatever the nature of the secured asset.

Security in rights plays an ever increasing role in security and must therefore be properly addressed in a secured transactions law. The importance of rights as security is, for example, visible in project financing. The essence of the project financing is that it relies on a stream of revenues which will be generated once the project is finalized. The most important part of the lenders' security is likely to be on those receivables, in other words security in rights.

### 2. *Security Can Be Given Over Assets Which Are Acquired Subsequently.*

Taking security over future assets should be encouraged. Future assets may not yet exist. This is the case for example where finance is secured by a building which still has to be built or by the future revenue to be generated by a power plant. Alternatively, future assets may already exist but not yet be owned by the person giving security. In both cases the person giving the security will only acquire the secured assets after entering into the security agreement. In modern financing, the parties do not only look to assets which are already owned by the person giving security but also to assets which will be owned by him in the future. Future assets can be a key element of the security.

In these cases, the person giving security is not the owner of the secured assets at the time the parties enter into the charging agreement and therefore, the secured transactions law has to create a special rule which allows a non-owner to create security in future assets and determine the time of creation. The rule may take a number of forms. A practical solution is to provide that the security is not created until the assets are acquired but for priority purposes it is deemed to be created at the time that formalities for creation of the security are completed.

### 3. *Security May Be Given Over a Changing Pool of Assets.*

Like the secured debt, the secured assets can also be static or dynamic. Where the secured assets are static, the creation of security in single assets makes perfect sense. Where, however, the secured assets are dynamic, as in a pool of assets which constantly changes its composition throughout the lifetime of the security, creation of security in single assets causes severe practical difficulties. Inventory and accounts receivables financing, for example, rely on the possibility of creating security in ever-changing pools of assets.

It is not sufficient merely to allow security to be taken over a changing pool of assets. In addition, the parties must be permitted to describe and identify the assets generally. Only this gives the parties the flexibility necessary to create security in assets which cannot be individually specified at the time of the security agreement. The manner of identification of secured assets depends on the nature of the secured assets. If the security is dynamic, for example where the assets of a whole enterprise are secured, then it is impossible to describe and identify specifically every asset which the enterprise comprises because assets change constantly. A general description and identification must be possible which identifies the class but not each member. Each class of things or rights is made up of members identifiable in their own right but subject to change without affecting the continued existence of the class.

If on the other hand a security is taken over a single right or thing then there should be no difficulty in identifying the property specifically. Identification may, therefore, be either specific or general.

## E. USE OF SECURED ASSETS.

### 1. *The Person Giving the Security May Hold and Use the Secured Assets.*

Practical restrictions often arise because the person giving the security is denied access to, or use of, the secured assets. The economic advantage obtained by him as a result of the security is then reduced. An adequate system of secured transactions must therefore allow for secured assets to remain in the possession of the person giving security and give him the right to make use of those assets even though they have been given as security. Financing enables the person giving security to acquire assets and security would make financing in many cases futile if it would deprive him of their use. All modern secured transactions laws recognize this. Use of secured assets can take three different forms which have to be dealt with differently by secured transactions laws.

The basic form of use is mere enjoyment of the secured assets. The borrower may purchase several machines for his factory over which he has given security. He clearly wants to work with these machines. It will be in the interest of the lender to allow the bor-

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power to use the machines as this will enable the borrower to earn income to pay interest and to repay capital on the loan.

A second form of use is the 'consumption' of secured assets, for example, in a manufacturing process. Raw materials, components and spare parts are only useful to the borrower as long as he can use them to produce new things. The purpose is, therefore, consumption and it may on first sight appear strange that security is taken over this kind of property at all. However if one takes the case of the stockpile of raw materials at a factory, this may have significant value and provide good security to a lender because the consumed stock is being constantly renewed.

The extent to which the security continues after consumption will depend largely on the extent to which the materials remain legally identifiable from each other. This question has to be interpreted by reference to the relevant law of things and property.

By extension, the right of use may include a right to sell the secured assets. As security is a property right, it will in principle continue even if the person giving security has transferred the secured assets to a third party. However there are cases where third parties are relying on the fact that there is no security in the property (for example when they acquire the property in the course of normal trade) and the law must provide legal mechanisms to protect them. This is of particular importance where security is given over a changing pool of assets such as trading stock. There are two different situations which have to be distinguished.

First, the person giving security may have a right to transfer secured assets free from security. This right may be granted to him by operation of law or by agreement. In either case, a third party will acquire free from any security even if he had knowledge about the existence of the security. The security terminates upon the transfer of the secured assets and acquisition by a third party.

On the other hand, the person giving security may have no right to sell secured assets free from security. In this situation it is important to strike a balance between protecting the value of the lender's security and protecting innocent third parties who act in good faith. If the transfer does not fall under the provisions of third party protection, the property may be acquired by the third party but it will remain encumbered by the security.

Although it will be necessary in many situations for possession of the secured assets to remain with the person giving security, it is also desirable to retain the traditional possessory security of movables. Where, for example, the security is over gold bars or negotiable instruments, it may be in the interest of the person receiving security to take possession over the gold bars or negotiable instruments. Possession in these circumstances may give the lender a more valuable security at little inconvenience or cost to the borrower.

As illustrated, it can be seen that there are different interests involved and that it is difficult to give clear rules which apply to all cases. The parties must remain free to determine by way of agreement the extent to which the person giving security has the right to use the secured assets. Account has to be taken both of the need of the lender to know that the assets are 'secure' and the need of the borrower to carry on business and generate a revenue stream in order to pay interest and repay the loan.

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## V. Conclusion.

The parties to a secured transaction should be given wide flexibility to agree to the terms of the security right. A number of principles have already indicated that the parties should be given wide contractual flexibility to arrange the security right and other contractual relationships. It has been mentioned that the parties should be able to define the debt, that they should be able to define the secured assets and that the person giving security should be able to grant rights to transfer secured assets free from security.

The law cannot foresee all the circumstances in which security may be required. It is therefore preferable to avoid unnecessary restrictions which may hinder the ability of the parties to adapt security to the circumstances of their particular transaction.

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