

1997

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Recommended Citation

John A. Spanogle, *A Functional Analysis of the EBRD Model Law on Secured Transactions*, 3 LAW & BUS. REV. AM. 82 (1997)
<https://scholar.smu.edu/lbra/vol3/iss2/5>

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A Functional Analysis of the EBRD Model Law on Secured Transactions¹

by John A. Spanogle²

I. Introduction.

This article is intended to present a functional analysis of the EBRD Model Law on Secured Transactions. The functional analysis is the primary presentation method of the common law tradition in evaluating proposed legislation. It examines both the goals and the practical effect of the proposed statutory provisions. For proposed commercial legislation, this means evaluating what economic activity it seeks to promote, and then attempting to determine whether it is likely in fact to facilitate such economic activity. Each provision is examined to ascertain in what ways it obstructs or facilitates the economic activity sought; and then is compared to alternative approaches that might better obtain the perceived goals. Thus, the analysis concentrates more upon suggesting compromises between competing economic interests than in arranging the harmonization of competing legal doctrines.

Other scholars, primarily those from the civil law tradition, will present conceptual analyses of the EBRD Model Law in this collection of papers. This article is intended to present a wholly different, but complementary approach. In fact, many of the problems which are raised and discussed in a functional analysis are the same ones raised and discussed in a conceptual analysis. And, as the paper presented by Professor Kreuzer clearly shows, each type of analysis often reaches the same conclusions, even though starting from very different foundations and assumptions.

The recommended goal of the enactment of the EBRD Model Law is to set up a commercially useable secured financing system. It is not necessary to try to set up a perfect secured financing system. It is only important to establish a commercially usable system to gain experience under it and to realize what the full range of its benefits can be. Such a system can be improved later, relying on that experience and the impetus gathered from the initial benefits.

There are two questions which should be asked in any functional analysis of the EBRD Model Law on Secured Transactions: 1) what conduct does society seek to encourage from such a creditor by enacting this Model Law?; and 2) will this Model Law induce the potential creditor to take such action?

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1. Parts of this paper are based upon memoranda submitted by the author to the World Bank. However, the views expressed in this paper are solely those of the author, and are not attributable to the World Bank. All rights reserved.
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II. What Conduct Does Society Seek from a Potential Secured Creditor by Enacting the EBRD Model Law?

The purpose of the EBRD project to write a Model Law on Secured Transactions is to present a device for cost-effective asset-based financing to Central and Eastern Europe. If secured financing is effective, there should be a difference between the credit terms given to a borrower who gives collateral and a borrower who gives none, when each is otherwise equally creditworthy. The borrower who grants security to the lender *should* get a better rate, greater credit availability or a longer duration loan, because the secured creditor has less risk. If the debtor defaults in his payments, the secured creditor should be able to realize on the *value* of the collateral, and be repaid through the proceeds of the collateral.

What is meant by a commercially effective secured financing system? The basic economic definition is that the collateral must have sufficient economic value to a potential secured creditor to induce that creditor *either* (1) to give credit at a preferential interest rate *or*, (2) to make more credit available than the creditor would have granted if the loan was unsecured. In many legal regimes, creditors take security on all loans, but consider the collateral to have no actual economic value. In such loans the interest rate is the same as it would have been for unsecured credit, instead of being lower; and the amount available is also the same, so there is no benefit to the debtor from its grant of the charge.

Thus, the conduct sought by society from a potential secured creditor is not merely that it receives a benefit by taking an interest in the collateral. Instead, the conduct sought by society is that a potential secured creditor gives benefits to the debtor in return for obtaining its interest in the collateral. What is the underlying economic rationale for such conduct by the potential secured creditor?

One type of effective secured financing system is one in which a creditor makes secured loans at a lower interest rate than unsecured loans because of the protection it perceives to be given by the collateral (assets). The interest rate demanded by creditors depends in part upon their assessment of the risks involved in making a particular loan. If the security from collateral can reduce risk of loss after non-payment, a lender can reduce the interest rate charged on a secured loan. In other words, the goal is a two-tier interest rate system, with lower rates being charged for secured loans than for unsecured ones.

Alternatively, a secured creditor can make a larger secured loan to a debtor than it would make on an unsecured loan, again because of the perceived protection of the collateral. There are many ineffective secured financing systems in this world, in which the lender takes a security in the debtor's collateral, but perceives no significant protection arising from the collateral. In ineffective systems, this secured creditor charges the same interest rate, and grants no more credit, than it would for an unsecured loan.

We all wish to avoid creating an ineffective system, and that will depend upon whether creditors perceive that secured loans involve significantly less risk that the loan funds will be lost. That perception, in turn, depends upon whether the creditor determines that it will receive adequate protection from the collateral, or from the proceeds of the sale of the collateral, if the debtor cannot make the payments. The creditor makes this determination by: 1) appraising the value of the collateral; 2) determining the cost of obtaining protection; 3) determining the cost of enforcing his interest; 4) determining how much of that value will be obtained by sale of the collateral after default; and 5) determining whether and how much of that value will be paid to the secured creditor. If the creditor believes that only 10% of the value of the collateral will be paid to it through the sale process, it will

require the debtor to put up collateral worth ten times the amount of the loan before considering the collateral to have any value to it. Only then will the creditor determine that the collateral gives enough protection from risk of non-payment to reduce the interest rate charged.

In addition, the potential secured creditor will want to know whether its interests are protected from, and take priority over, the claims of the third parties both before and after any default by the debtor.

III. How Effectively Does the EBRD Model Law Induce a Potential Secured Creditor to Give Value for the Collateral?

This analysis approaches the EBRD Model Law from the perspective of a potential secured creditor. There are five basic questions which a potential secured creditor will ask in evaluating its position, and the worth of the collateral to it, under any secured financing regime: 1) does it cost a lot to *create* an enforceable charge?; 2) does it cost a lot to *enforce* the charge?; 3) does enforcement of the charge provide real commercial *value* for the creditor?; 4) can potential secured creditors determine, with certainty and at little cost, *before* the loan is made, whether any other creditor will have a better claim to the charged property (collateral)?; and 5) is the secured creditor protected from the claims of third parties, including other creditors, the trustee in bankruptcy, purchasers and statutory claimants?

In addition, secured financing should be available to all creditworthy borrowers from a wide range of different types of creditors, to provide competition in this lending marketplace.

A. DOES IT COST A LOT TO CREATE AN ENFORCEABLE CHARGE?

In different jurisdictions, there are various types of non-possessory registered security interests, ranging from the chattel mortgage to the former American "trust receipt," to the current British "charge." The primary concept underlying all of them is the creation of a secured financing device which uses a registry to give public notice of the financing, so that all creditors can know the current financial position of a potential borrower before a loan is made to the borrower. For these devices to be legally useful, "constructive notice," not "actual notice," concepts must be applied to all secured creditors who lend to a particular debtor. Otherwise, a subsequent creditor or purchaser could claim to have made a loan "in good faith" without looking at the public register and thus without actually knowing of prior charges on the property. Constructive notice concepts impute knowledge of a public filing to all the world, including subsequent creditors, whether they have actual knowledge of it or not.

The commercial usefulness of these financing devices has usually depended upon three subsidiary concepts: the collateral should be allowed to be described generally; after-acquired property should be covered by the security interest; and the debt should include future advances. Thus, the commercially useful financing device, in addition to having registration and constructive notice concepts, will allow the secured creditor to claim an interest in a shifting stock of generally described goods without day-to-day accounting of the balance outstanding.

The registered charge proposed by the EBRD Model Law achieves these goals. It requires the registration of a "registration statement." (Art. 8) The registration statement

may be a different document than the credit agreement between the parties (the "charging instrument"). This is an important feature, allowing the parties to give public notice of the existence of their secured transaction without revealing all of the financing terms of that transaction. However, at a minimum, the registration statement must disclose the existence of the secured transaction and identify the parties, the collateral, and the secured debt. The collateral may be described either generally or specifically. If generally described, it can include after-acquired property conforming to the general description. The secured debt may also be described either generally or specifically and this allows a generally described debt to include future advances up to a stipulated maximum amount.

The registration system is only outlined in the Final Draft of the Model Law. (Art. 34.) It attempts to reduce the time delay problems associated with the registry courts of Central and Eastern European countries by: 1) limiting the number and type of issues which can be examined by the registrar; and 2) by requiring the time of presentation for registration to be marked and used for priority-setting, rather than the time of the registrar's approval. The registrar may reject a registration statement if it "does not comply with the requirements of" the Model Law, and the drafters have attempted to keep those requirements simple. They basically require only the "identification" of the parties to the transaction, the secured debt and the charged property. That probably simplifies the requirements of registration as much as language can achieve, although registry courts in Central and Eastern European countries have shown a remarkable ability to find unexpected items to investigate. In particular, the concept of "identification" of the parties is not defined and could be abused but the Model Law drafters have made the principle crystal clear.

For lenders, the ease of creation of the charge is handled well. A lender needs to obtain from the debtor a signed charging instrument and a signed registration statement. Each document is simple, and registration is straightforward. However, the Model law does not say anything about registration fees. Stamp and other taxes can exceed 2%, and be a significant cost barrier which inhibits the use of secured financing. Thus, they should be discouraged. The Model Law should provide that registration fees are limited to the actual cost of registration, rather than being regarded as a revenue source. It seems clear that neither the charging instrument nor the registration statement need to be notarized, but (especially for civil law countries) this fact should be stated expressly.

B. DOES IT COST A LOT TO ENFORCE THE CHARGE?

The only provisions on enforcement of charge allow the chargeholder to enforce the charge only if "there is a failure to pay." (Art. 22.1.) No other breach of the creditor-debtor agreement seems to create any powers over the charged property under the Model Law. Such breaches can include failure to insure the property, failure to maintain it, removal of the property from the statutory jurisdiction, use for illegal purposes, and failure to collect accounts or present instruments or enforce rights, etc. Upon the happening of any of these events, the status of the chargeholder toward the property depends upon the contract (charging instrument) between the parties. The drafters of the Model Law assume that this contract will be long and complicated, and will spell out not only a series of "events of default," but will also incorporate an "accreditation clause" making the entire secured debt immediately payable if any events of default occur. With such a contract, the credit can begin enforcement against the charged property any time payment of the total outstanding

balance is demanded and not paid.

After a "failure to pay," the chargeholder must first deliver an "enforcement notice" to the debtor (Art. 22.2), and then register that enforcement notice within seven days. (Arts. 22.4 and 33.1.6.) The delivery and registration of the enforcement notice entitles the chargeholder both to take "protective measures" and to "realize the charge." "Protective measures" (Art. 23) include taking possession of the charged property, using a "[bailiff]" to take possession, immobilizing it, or any "measures as agreed with the chargor." (Art. 23.6) There are no limitations on the latter power, and the Model Law does not specify whether the "agreement" can be boiler-plate clauses in the charging instrument or must be a negotiated, post-default arrangement. If it is the former, it may be expected to be fairly draconian since the contract will be drafted by the creditor.

The possibilities under the Model Law for litigation, and the delay and uncertainty created by litigation, are enormous. The debtor or third parties can seek court intervention to declare the enforcement notice invalid (Art. 22.4.2), resolve disputes between debtor and creditor over the creation, validity and enforceability of the charge (Art. 29.1), resolve priority disputes between chargeholders, determine whether improper protection measures were taken (Art. 29.5), order "appropriate" protection measures (Art. 23.5), determine whether the chargeholder obtained a "fair price" (comment to Art. 24.3.1), and invalidate clauses in the charging instrument. (Art. 24.2.)

To summarize, the Model Law takes many steps to reduce enforcement costs. After a default, the chargeholder delivers an enforcement notice to the debtor, then registers it. The chargeholder is then permitted to take possession voluntarily or to immobilize the charged property. If the debtor resists, the chargeholder can obtain the assistance of a "[bailiff]" without first obtaining a court order. The debtor does have many opportunities to litigate several aspects of this process. The chargeholder may obtain further enforcement devices by stipulating them in the contract. It is not clear whether these further devices are limited in any way which could be abusive.

C. DOES ENFORCEMENT OF THE CHARGE PROVIDE REAL COMMERCIAL VALUE FOR THE CREDITOR?

There is always some uncertainty about valuing collateral. The collateral may be difficult to appraise because it has a limited market or depreciates over time, or is subject to fashion or technological obsolescence. At the time the loan is made, it may be difficult to determine the amount of value that will be obtained at a later sale after default, because a) market conditions can change, b) the mercantile expertise of the people running the sale may be limited, and c) the results of "distress sales" are somewhat unpredictable.

Under the Model Law, the chargeholder controls the manner of the sale of the repossessed charged property (Art. 24.4.), but is required to realize a "fair price." (Art. 24.3.1.) This would be a positive step in most Central and Eastern European nations, where court enforcement officers usually are the only persons allowed to sell property free and clear of prior encumbrances. This provision of the Model Law will permit use of the private sector to seek prices closer to market value. The sales by court officers are recognized as "distress sales" and bring distress sale prices. Under the Model Law, normal commercial processes will be available, and can bring normal commercial (albeit wholesale) prices.

However, it is not until sixty days after delivery of the enforcement notice, that the chargeholder "may" sell the charged property. (Art. 24.) There does not seem to be any provision requiring the chargeholder to sell repossessed charged property. Thus, the only

protection for the debtor's equity interest in the charged property is the sixty day period when apparently it may redeem the property by tendering the total outstanding balance. Experience under most Common Law systems has indicated such redemption will be unlikely. The effect of the delay if the charged property is fresh produce, fish, trendy clothes, or a volatile stock would be unfortunate for both creditor and debtor, but no exceptions are stated in the Model Law. A new bureaucracy called a "proceeds depository" is created to disburse the sale proceeds. A buyer of the repossessed charged property gets good title only if the sale proceeds are paid into the proceeds depository.

Most of the enforcement mechanisms seem designed primarily for a special type of charge called an "enterprise charge" (Art. 5.6), which can be taken over the entire assets of a corporation. (Art. 6.6.) Many components of the Model Law are driven by the needs of the enterprise charge, and the Model Law drafters may have contemplated it as the normative registered charge. The provisions on "enterprise charge administration" (Art. 25), which concern enforcement of enterprise charges, are as long and more detailed than the enforcement provisions for all other forms of charges. (Arts. 22-24.) The provisions on the proceeds depository administration are of equal length and detail. (Art. 27.)

Thus, in realizing value, the Model Law is helpful in permitting the chargeholder to control any sale of the repossessed charge property, so that it can maximize the value received if it chooses to do so. It is unclear whether the chargeholder is required to sell after repossession. There are two major restrictions in the Model Law on any such sales. One is that the sale cannot occur until sixty days after the enforcement notice is delivered. The value of the charged property could fall rapidly during that period for a wide variety of reasons. The second is that a bureaucracy called a Proceeds Depository is created, and usually must be used, and its costs may reduce the value received by the chargeholder.

D. CAN POTENTIAL SECURED CREDITORS DETERMINE, WITH CERTAINTY AND AT LITTLE COST, BEFORE THE LOAN IS MADE, WHETHER ANY OTHER CREDITOR WILL HAVE A BETTER CLAIM TO THE CHARGED PROPERTY?

Under the EBRD Model Law, between "registered charges," the first to register has priority over all other registered charges, regardless of the actual knowledge by later chargeholders concerning prior registration. Thus, the doctrine of constructive notice is applied to all creditors who obtain a registered charge. Such registered chargeholders will need to check the registry to determine whether there are any prior registered charges or risk having only a secondary priority to the charged property.

Any person is permitted access to the registry, after paying the necessary fee, to ascertain whether there are any registrations of prior charges. An important point is that one is not required to prove any particular relationship, or obtain any permission, in order to search for public record information on a potential borrower. Such ease of access to information is a necessary condition for the operation of constructive notice concepts. However, there are no time limit provisions on how quickly the registrar must "accept" a registration statement. Since loan funds will not be disbursed until after such acceptance, delays of the length now occurring in Central and Eastern European registry courts could still be a problem. There are also no provisions on the liability of the registrar, or the entity maintaining the register, for mistakes, negligence or other risks in handling the registration applications, information or access.

The types of registry indices or other recall capabilities are also not specified. Finally,

the issue of the amount of fees for registering statements or accessing information is not addressed. Some Central and Eastern European countries may be planning to use these registries to raise significant amounts of money, and they should be warned, at least in the commentary, that the economic growth effect could be short-circuited by an overcharging registry system.

However, not all charges need to be registered under the EBRD Model Law, and these unregistered charges can have a "super-priority" which will defeat the interests of the registered chargeholder. One such exception is the "unpaid vendor's charge"; another is the possessory charge.

The unpaid vendor's charge is an unregistered title retention device, similar to the conditional sale or the Romalpa clause. Commercially, it creates problems because it arises out of the manipulation of doctrines concerning "legal title," and there is no public notice of the encumbrance. Usually it protects creditors who sell goods on credit, but not creditors who lend money. The former offer credit which is "tied" to sales only of their products, and which is usually only short term credit. On the other hand, under an effective secured financing system, the latter can provide long-term financing for all necessary costs of starting an enterprise.

Under the EBRD Model Law, an "unpaid vendor" obtains an unregistered charge which gives that vendor priority over all registered charges. The unpaid vendor gets such priority (a superpriority) whether it registers the charge or not, and whether its charge arises before or after registration of other charges. (Art. 17.3.) This is truly a "superpriority" for the unpaid vendor. Further, there is no public disclosure of the existence of the unpaid vendor's charge, so it is a secret encumbrance from the perspective of any potential lender of funds. An unregistered "unpaid vendor's charge" lasts for six months or until the vendor is paid. It can be converted into a registered charge at any time during that six months. A chargeholder who is an unregistered unpaid vendor has all the enforcement powers of a registered chargeholder.

The only requisite for a credit seller to obtain an "unpaid vendor's charge" is that there be a "written agreement" between the credit seller and the debtor-buyer stating that the credit seller "retains title" to the goods until paid. This condition is easily met, without bargaining between the parties or any actual agreement, by a boiler-plate printed clause in seller's "order acknowledgement form." In most transactions, it will be the last form sent by one party to the other, and its terms will control the agreement. (CISG Art. 19(1).) Thus, in many transactions, not even the debtor will be actually aware of the existence of the unpaid vendor's charge.

The combination of non-registration of the unpaid vendor's charge and its superiority over registered charges causes problems to the secured transactions system created by the EBRD Model Law. One problem is that no lender with a mere registered charge can grant a debtor any real security value for the debtor's inventory unless the lender is willing to supervise the debtor's purchasing and bookkeeping operations to ensure actual payment of all suppliers. This would be very labor-intensive and increase the cost of inventory secured financing unreasonably. The same is probably true for loans on the debtor's equipment, although probably less labor-intensive and costly.

Thus, registered chargeholders which are mere lenders and not sellers of goods have only subordinate rights to inventory and equipment. That should make them hesitant to enter into the type of long-term, general-purpose financing arrangements which can arise under secured transactions legislation. On the other hand, "trade creditors" and other

credit sellers are well protected and should be expected to increase their sales and credit activity.

The "possessory charge" is the traditional pledge, but under the Model Law there are new twists to the doctrines and new problems. Almost every jurisdiction, including the Central and Eastern European nations, recognizes the security interest in which the creditor receives physical possession of the collateral from the debtor. It is believed that the public, and other creditors, receive sufficient public notice of the creditor's interest from the change of physical possession, and creditors are aware that they should check who has physical possession before they grant credit based on ostensible ownership of property. The difficulty is to restrict use of this device to only those transactions in which there is actual transfer of physical possession. Over the years, most jurisdictions that do not have effective registry systems have developed many sophisticated doctrines based on agency or trust concepts which purport to be pledges but involve no transfer of physical possession. Such doctrines allow secret encumbrances which can destroy the utility of a registration system.

The EBRD Model Law is silent on one important issue. Many Central and Eastern European nations have enlarged their concepts of "pledge" and "possession" because they had limited effective registered financing devices. Thus, they have developed many sophisticated concepts of "constructive possession," in which the debtor keeps actual possession of the collateral, but the creditor obtains a constructive possession recognized by the courts of those nations, but which is not expected by a common law attorney.

The solution to such problems would have been for a possessory charge to require actual physical delivery by the debtor of the charged property to the creditor, and retention of that property by the creditor or an agent which is not the debtor nor related to the debtor. Only by such restrictions could the Model Law have provided sufficient public notice of its possessory charge and have overcome the current "constructive possession" doctrines. The Model Law does not provide any such restrictions, however, and in fact encourages the continuation of constructive possession concepts and their attendant secret encumbrances.

First, the Model Law does not require any physical delivery by the debtor of the charged property to the creditor to create a possessory charge (even though the property must be "capable of delivery"). Instead, the Model Law only requires that one of three persons obtain "possession" of the property "before or after the date of the charging instrument." (Art. 10.1.) "Possession" is not restricted to actual, physical possession, but can still include constructive possession. Second, this "possession" may be obtained by any one of three parties. One is the chargeholder. A second is "a person nominated by the chargeholder," and the debtor is not excluded from that category. The third is "a person holding on terms agreed between the chargeholder and the [debtor]," and neither the debtor nor any agents of the debtor are excluded from this category.

The result of such statutory language is clear. The courts will read these provisions as not requiring actual physical possession of the charged property by the creditor or a known agent of the creditor, but as allowing use of any device which allows a finding of technical possession by anyone designated by the creditor, or by both parties, including the debtor. This merely continues the fictions of constructive possession doctrines and gives no public notice of a possessory charge to those who choose to register their charges. Well-advised creditors will seek to avoid registration and its incumbent fees when a simple agreement will suffice which nominates the debtor as the agreed person to hold posses-

sion. Thus, the Model Law's possessory charge subverts the non-possessory registered charge both because it provides a substitute which is too widely usable, and because it promotes secret encumbrances which destroys the heart of the registration system.

The EBRD Model Law is really a tale of two different kinds of creditors, credit sellers and lenders, which are given different status and rights. To understand the problems, a distinction must be made between these two types of creditors. A bank is a lender of money to a debtor, but a manufacturer becomes a creditor by selling goods on credit and becoming (in the words of the Model Law) an "unpaid vendor." The bank or other lender will get its rights to the collateral from the debtor through the secured financing agreement. The credit seller (unpaid vendor) will get its rights to the collateral by "retaining title" to the collateral when it is sold and delivered to the debtor. Lenders have two costly choices: 1) to try to re-arrange the transaction so as to pass title through them; or 2) to supervise the debtor's financial operations enough to ensure payment of all trade creditors.

A credit seller can determine, before shipping goods to the debtor, that its claim to the charged property will have priority over those of all other creditors, because of the superpriority given to credit sellers under Article 17.3.

A lender can determine, before making a secured loan, whether its claim to the charged property will have priority over the claims of all other lenders, because of the first to file priority rule of Article 17.2. It cannot check the registration files and be certain whether there are any credit sellers with unpaid vendor's charges which have priority over its claims to inventory or to equipment, because those charges need not be registered; in effect they are secret liens.

The economic effect is likely to be that lenders either will not attribute any serious value to inventory or equipment as charged property, or they will have extra costs and risks in obtaining charges on such property, and these will be passed on to the debtor. Under the first approach, lenders will take charges on inventory and equipment, but will not reduce rates or make more credit available because of the problematic nature of any actual economic recovery from such property. Such use of secured credit would not be cost effective.

Under the second approach, lenders could require the debtor to engage in periodic "pay-out and pay-over" transactions to obtain protection from unpaid vendor's charges, but such transactions are labor-intensive, costly, and not a cost-effective use of secured financing. Alternatively, lenders could devote much time and energy toward designing transactions which route "title" through them to the debtor, using bills of lading and other devices. The law of conditional sales and trust receipts has numerous examples of success and failure of such attempts. But these transactions, while imaginative, are not only risky but also costly, and should be eschewed if possible.

- E. THE SECURED CREDITOR SHOULD BE PROTECTED FROM THE CLAIMS OF THIRD PARTIES, INCLUDING OTHER CREDITORS, THE TRUSTEES IN BANKRUPTCY, PURCHASERS AND STATUTORY CLAIMANTS.

The Model Law provides a concrete set of rules to determine priority among creditors, although the secret superpriority given to the unpaid vendor is troubling as discussed above. The registered chargeholder is protected against subsequent registered chargeholders. The non-possessory registered chargeholder gives public notice of his encumbrance over the charged property. Thus, among registered chargeholders, there is no problem

concerning "secret encumbrances." However, there are two other types of charges created by the EBRD Model Law, the unpaid vendors charge and the possessory charge, each of which can create a secret encumbrance, of which there is no public notice. The registered chargeholder is not protected from claims of the credit seller who has obtained an unpaid vendor's charge. That result has a negative impact on creating an effective secured financing system for lender credit under the EBRD Model Law. (See discussion of Question 4, above.)

If charged property is sold, the chargeholder does not automatically have any interest in the sale proceeds. (Commentary to Art. 5.10.) That restriction makes restrictions on the sale of the charged property quite important. The Model Law offers effective protection against purchasers of goods covered by a charge. Under the Model Law, buyers of charged property are also subject to constructive notice concepts, and they will hold the charged property subject to a registered charge. (Art. 21.)

There are, however, several exceptions to this doctrine, the most important of which concerns the buyer of inventory from a merchant. If the buyer purchases charged property which is inventory, then that buyer will take the goods free and clear of the charge, but purchasers of other charged property, such as equipment, will take the property subject to a charge. (Art. 19.2.) This exception is necessary if any merchant is to sell its inventory. That is the balance struck in most viable secured financing systems.

It is not known whether the interests of registered chargeholders will be protected in insolvency proceedings. The drafters were instructed not to include insolvency law provisions within the Model Law because the insolvency law of the affected nations was so varied and was also likely to change. Thus, the EBRD drafters did not include provisions relating to insolvency proceedings, so that important issue is still undecided. Since that is the primary risk to many creditors, the utility of the charge created by the Model Law remains in doubt until that issue is firmly resolved on a state-by-state basis.

They did draft four basic principles to guide local adaptation and a commentary which emphasizes the need to protect the chargeholder in insolvency proceedings. One of those principles, however, accepts the idea that other creditors (the tax authorities, employees) may rank ahead of the chargeholder. If that is accepted, the charge of the Model Law may be of little value. The resolution of this issue also depends upon the nature of the chargeholder's interest. If it is a "right in rem" (Art. 1 commentary), then obtaining protection in insolvency proceedings becomes feasible. However, if it is merely a right to share in proceeds after a "failure to pay" and the successful exercise of "protective measures," some of those steps have not occurred in the typical insolvency proceedings, and the tax authorities can argue for higher priority to the sale proceeds.

To sum up this description of the registered charge, the Model Law creates a non-possessory registered charge which has the requisites for legal viability and commercial usefulness. Registration is required and constructive notice concepts apply to protect its priority against subsequent registered charges. The registered charge can cover after-acquired property and apply to future advances. Registration seems easy and straightforward, although the fee structure is not specified and a greedy one could ruin the system. The chargeholder has a reasonable arsenal of enforcement devices, some of which could be abused, but in many situations their use is dependent upon the inclusion of an acceleration clause in the original contract. Although the registered chargeholder is well protected against subse-

quent registered chargeholders and most buyers (but not buyers of inventory), he remains vulnerable in insolvency proceedings and to subsequent non-registered chargeholders, such as credit sellers.

IV. How Would the EBRD Model Law System Work in Practice?

As a first step, this EBRD project takes many useful steps to acquaint Central and Eastern European countries with the basic concepts concerning secured transactions. It acquaints them with: 1) registration of secured transactions; 2) constructive notice to later purchasers through such registrations; 3) inclusion of after-acquired property and some types of future advances in the secured transactions; 4) valid general descriptions of charged property; 5) enterprise charge administration; 6) granting priority of some interests in their order of registration; 7) consensual enforcement of charges through direct creditor contact with debtors; and 8) distribution of proceeds of sale of the collateral primarily to the creditor, rather than to the taxation authorities and other unsecured creditors.

Even enacting only part of the Model Law's provisions will be helpful to provide experience in secured transactions and the economic utility of those transactions. If the cost of the transaction is higher than it should be, the fact will become apparent with use, and later legislatures can enact cost-effectiveness amendments. In other words, these nations will get initial experience with low-level transactions, allowing entrepreneurs to obtain goods (equipment and inventory) on credit. If that is the EBRD's economic goal, then it can be accomplished.

However, as the final legislative step, although the system drafted by the EBRD provides some security to creditors, there are serious gaps in the protections available to secured lenders. The Model Law is based upon the doctrinal distinctions between those who provide goods on credit (credit sellers), and can retain title, and those who provide "only" the funds (lenders). This distinction is pervasive and affects many aspects of the Model Law. These concepts are based on title manipulation devices, and give enough of a preference to credit sellers to discourage lenders from participating in this market.

The EBRD Model Law does not treat these two types of creditors equally. Instead, it has one set of rules for lenders and a different set of rules for credit sellers (unpaid vendors). It leaves unpaid vendors virtually outside the system, insofar as the system is designed to protect all creditors against the possibility of double-financing. While the lender must register its interest, and has priority in the time order of its registration, an unpaid vendor gives no notice, public or private, of his security interest to other creditors. No public registration is required. There is no private notice to other creditors who have already loaned money to the debtor (possibly to acquire the unpaid vendor's goods) and publicly registered their interests. Further, the unpaid vendor has priority over all registered charges (a superpriority).

The result can be seen when a hypothetical lender attempts to take a security interest in a debtor's inventory. To be certain of the priority of his interest, he must investigate and determine that all vendors who sold the current inventory to the debtor have been paid in full. However, as that inventory is in turn sold by the debtor and then replaced, the lender can still lose the priority of its interest on the newly purchased inventory, unless it investigates each new transaction with each vendor to determine that the vendor has been paid in

full. If the lender does that, it will be labor-intensive and expensive, and the cost will be passed on to the debtor. It is more likely, however, that the lender will simply devalue the security and give the debtor neither a better interest rate nor more credit availability than an unsecured loan.

If the economic goal, however, is to have significant impact on the private economy by providing significant amounts of new funds to entrepreneurs at low, secured credit rates, then the analysis must be more guarded. The type of credit which will be enhanced by this law is seller credit (trade credit), not lender credit. Seller credit is usually low-limit and short-term credit, and often is tied to the purchase of specific goods and binds an entrepreneur-debtor to particular suppliers, which has an incidental possibility of monopoly problems. In other words, the EBRD Model Law promotes seller credit at the expense of lender credit, tying the entrepreneur-debtor to particular suppliers of goods at potential monopoly rates, and discouraging banks and other lenders from engaging in such business.

A lender considering making a secured loan to an entrepreneur under the Model Law risks that others have better priority to the collateral. This is due to two types of limitations on the concepts of the Model Law. One is the fact that it has different rules for lenders and credit sellers. This means, as discussed above, that the lender must vigilantly supervise the debtor's purchasing and payment policies or risk losing the collateral to an unknown, unregistered "unpaid vendor."

The second limitation is that the Model Law does not seek to cover all of the asset-based financing methods. There are many of these, including financial leasing, factoring and trust receipts.

Thus, a lender which seeks to lend on the basis of inventory, accounts and equipment may find that it has no commercially useful protection. The inventory that it thought the debtor purchased with the loan funds is in fact subject to an unregistered unpaid vendor's charge, as discussed above.

The equipment that it thought the debtor purchased with the loan funds is in fact leased from an equipment leasing company. It will have no notice of this fact in the registry, but the leasing company has a better claim to the equipment than does the lender.

The accounts may have been sold to a factor, or the revenue stream may have been sold to third parties, which can deprive a lender of its claim to accounts. Neither the current law in Central and Eastern Europe nor the Model Law will provide the lender any certainty of protection or enhance the lender's position because of the failure to cover sales of accounts or chattel paper.

V. Conclusion.

The EBRD Model Law on Secured Transactions provides a fairly workable registered charge system. The system is available to all creditors and debtors; the charge is easy to create and enforce; the creditor controls sales of the collateral after repossession; and the first chargeholder to register has priority over later registered charges. The EBRD drafters did not include insolvency proceeding provisions in the Model Law itself, but plan to do so on a state-by-state basis. Until the principles announced in the Model Law are drafted into statutory provisions, it is impossible to judge the total utility of the whole system. A system which subordinates the chargeholder to the tax authorities and other creditors in

insolvency proceedings would be less effective.

However, after providing a fairly workable registered charge system, the EBRD Model Law presents only a partially developed, poorly integrated set of provisions on other types of financing devices, ranging from the unpaid vendor's charge to factoring to financial leasing. The Model Law provides two "loopholes" to the registered charge concept, which severely undermine the registered charge system. The loopholes arise out of the possessory charges and an unpaid vendor's charge, and the Model Law would be more effective if both were omitted from its provisions. The possessory charge is poorly defined and therefore not limited to its appropriate uses. The unpaid vendor is given an unregistered charge with superpriority over all registered charges, which will make non-vendor lenders hesitate to place any significant value on any charged property which the debtor purchases from any vendor. This will impede inventory and equipment loans by lenders and limit competition in this market. Thus, the debtor would get little benefit from such secured transactions, and the registration system is evaded and subverted.

It is important to concentrate on those provisions in the Model Law which are necessary to the effective operation of the registered charge itself. For example, the Model Law seeks to persuade the countries of Central and Eastern Europe to adopt registries which have the necessary attributes of low cost, certainty, accuracy, speed in registration and speed in retrieval of information. It also seeks to persuade these countries to adopt enforcement mechanisms which obtain quick value in an efficient manner - realizing a high proportion of actual value and keeping administrative costs low, and allowing the secured creditor to control the sale of the collateral to promote efficiency.

Under the current law in these jurisdictions, unpaid vendors may have title retention devices, but their efficacy is open to some doubt, especially against good faith purchasers, and the enforcement powers available under them arise under older laws and are limited and less efficient. The Model Law would give unpaid vendors certainty of position and modern, reliable enforcement powers, but without any burdens. They would not have to register or even notify currently registered chargeholders. Since unpaid vendors receive all the advantages of the Model Law system without any of its burdens, it will be difficult for a nation which enacts this law to take any further steps to actually incorporate them into the system. Unpaid vendors would resist any additional burdens if they already have all the advantages of the law. It would be preferable to drop both of those concepts from the Model Law until the Central and Eastern European nations have more experience with effective registered secured transactions in movables.

It is clear that reform of secured transactions law in Central and Eastern European nations will not be accomplished in a single step. As a first step, the Central and Eastern European nations have not and probably will not enact the entire Model Law provisions. The EBRD may not even expect them to do so. They do need, however, to enact a registered charge system which will give them experience with a secured transactions system which is more effective. Hungary and Poland are attempting to take that path, adopting a registered charge system, but omitting the unpaid vendors who will continue to have whatever security is available under the prior law, but will not have the benefits of the new legislation such as certainty of priority, protection from good faith purchasers, modern enforcement provisions and control of resale of the collateral. More experience with more effective secured transaction systems could then lead to subsequent enactment of a more comprehensive secured financing system which would cover all secured creditors. Until then, it is preferable to leave unpaid vendors outside the system, rather than to include

them in a manner which subverts the registration system.

The actions of Hungary and Poland to omit unregistered unpaid vendors from the system may be preferable. That approach denies unpaid vendors who do not register any of the benefits of the new law, forcing them to choose. They may either rely on title retention and eschew the new law, or eschew their title retention rights and register under the new law to obtain its benefits. If the secured transactions law in these nations develops further in the future, it would be more feasible to persuade unpaid vendors to bear the burdens of registration in order to obtain the advantages of certainty of protection against third parties and modern enforcement techniques, which do not enforce charges only through courts and bailiffs.

This author believes that the most worthwhile result which could come from this Conference would be for the EBRD to revise its Model Law. The revisions would be based upon the comments and suggestions presented in the papers written for this Conference and the discussions that ensued during it. During the Conference, the General Counsel of the EBRD indicated a willingness to consider such a course of action. The EBRD could then provide a Revised Model Law which would build on its current impressive strengths, but amend the weak points identified. Those weak points will create disfunctionalities in practice. The issuance of an EBRD Revised Model Law on Secured Transactions would prove that it is in fact not engraved in stone, but is a living document which adjusts to economic realities.
