DEVELOPMENT OF STANDARDS FOR SECURITY INTERESTS

I. VALUE OF SECURITY INTERESTS

In developing standards for the legal framework of security interests, it is important to recognize that security interests serve discernable economic goals. Security interests reduce credit risk by increasing then creditor’s likelihood to be repaid, not only when payment is due, but also in the event of a default by its debtor. This increased likelihood of repayment produces wider economic benefits. First, the availability of credit is enhanced; borrowers obtain credit in cases where they would have otherwise failed absent a security interest. Second, credit is also made available on better terms involving, for instance, lower interest rates and longer maturities. The relative cost of secured credit under that of unsecured credit reflects the commercial recognition of the advantages of secured credit in connection with the recovery of the debt.

The efficiency of the legal framework for secured credit is a critical factor in the strengthening of financial systems. In the face of financial sector crises, an effective legal framework of security interests enables banks and other credit institutions to mitigate the deterioration of their claims, it also facilitates corporate restructuring by providing tools to support interim financing. In the longer term, an effective framework for security interests fosters economic growth. Specifically, it supports access to affordable credit, thereby facilitating the acquisition of goods. Further, it increases the capacity of enterprises to finance expansion fueled by the supply of credit. Also, an effective framework for security interests can support the development of a sound banking system and promotion of capital markets founded on the efficient allocation of credit and effective and predictable mechanisms for realizing credit claims.

This paper identifies the key issues that should be addressed in designing an orderly and effective legal framework for security interests. It highlights the implications of various limitations, arising from legal traditions or policy choices, that are placed on the rights of debtors and creditors in relation to security interests. The intention of this paper, is that its exposition would inform the development of international standards on security interests.

II. PERVERSIVE ISSUES

Recognizing the value of secured credit leads one to the task of attempting to develop standards for an effective system of security interests to guide the design of the law. Two pervasive issues present themselves in an analysis of the law of security interests. First, the design of the law must address the competing interests between secured creditors and other creditors. Second, the design of the law must address the extent to which the freedom of parties in their contractual arrangements is respected.

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1 This article was initiated by Pascale De Boeck. It was completed by Thomas Laryea, Counsel, IMF Legal Department.
Tension between secured creditors and other creditors.

The favoring of secured creditors, however appropriate, necessarily disadvantages unsecured creditors. The difference in the relative legal position of secured and unsecured creditors should not be so wide as to negate the value of unsecured credit. The provision of unsecured credit generally requires a better risk assessment analysis from credit providers. The comprehensive favoring of secured credit risks an over-reliance on the value of collateral as the basis for loan decisions, causing lenders potentially to neglect performing adequate credit risk assessment. Further, although certain borrowers may not have assets to offer as collateral, the strength of their business operations may place them in a position to service their debts in a timely manner. In a system where secured credit predominates, prospective borrowers may be denied economic opportunities as a result of not being able to obtain unsecured credit.

Most, if not all, legal systems recognize the existence of statutory or other non-consensual mechanisms\(^2\) that provide their holders with a preferential treatment vis-à-vis other creditors. These statutory and other non-consensual mechanisms take various forms, such as privileges, preferences, statutory liens and judicial liens. In many cases, the rights entailed in these mechanisms may prevail over security interests, and thereby interfere with the effectiveness of contractual security interests. Greater the incidence of preferences given to creditors with non-consensual mechanisms, the less predictable would be the functioning and the enforcement of secured credit.

Tension between freedom of contract and statutory and/or judicial constraints.

The extent to which the parties’ contractual freedom should be endorsed or contained by the legal environment is another pervasive issue. The issue of party autonomy is relevant to the scope and terms of allowable security interests and the manner of their enforcement. Recognition of the economic benefits derived from security interests argues in favor of giving broad license to the parties’ capacity to devise security interests. Nevertheless, some “regulation” of security interests that qualifies the parties’ contractual freedoms is justifiable and inevitable in order to establish order in the legal environment.

### III. GENERAL PRINCIPLES

The design of an efficient legal framework of security interests should be guided by a number of general principles.

Establish simple rules for creation of security interests

The creation of security interests in a cost effective manner requires keeping formalities to a minimum. Furthermore, uniformity in the formalities for creating security interests simplifies the task of economic actors in comprehending and navigating through the requirements. Accordingly, uniformity in

\(^2\) For the purpose of this paper, statutory and other non-consensual mechanisms will be referred to as “non-consensual” mechanisms.
formalities across the types of security interests tends to reduce the aggregate costs of establishing security interests.

- **Validate non-possessory security interests in movable assets**

One of the main problems of many legal systems is the unwarranted limitation on the types of security interests that can be created. Commonly, security interests could be taken only in the form of: (i) non-possessory security interests over immovables, and (ii) possessory security interests over movables. The limitation on the creation of non-possessory security interests over movable assets is particularly problematic in modern commercial contexts where businesses need to retain movable assets to maximize their operations. An efficient framework should allow for the creation of a non-possessory security interest in movable assets.

- **Establish simple and transparent perfection rules**

The ability to enforce the security interest against third parties—an issue governed by rules of perfection—is central to the value of security interests. Simple and transparent perfection rules are therefore crucial. Complex and burdensome perfection rules work against the efficient use of security interests.

- **Establish clear and predictable priority rules**

The issue of priorities between various security interest devices and between various types of creditors is extremely complex, largely due to the myriad of possible competing interests. Whatever priority rules a legal framework establishes, they ought to be clear, predictable and transparent. They need to allow creditors to assess their position before creating a security interest and to enforce their rights in case of default in a timely, predictable and cost-efficient manner.

- **Facilitate the enforcement of creditor rights**

Enforcement is a critical factor in the law and functioning of secured credit. A security interest is of little value to a creditor unless the creditor is able to enforce it in a predictable, efficient and timely manner vis-à-vis the debtor and third parties. An effective framework needs to allow quick and predictable enforcement both within and outside insolvency proceedings.

- **Encourage responsible behavior through a transparent legal environment**

The framework should be transparent in terms of substantive and institutional rules. All interested parties should thereby be able to assess their respective legal positions and the consequences of their conduct.

### IV. Creation of Security Interests

It is in the nature of a consensual security interest that its creation is dependant on an agreement between the debtor and creditor (or their associates). Additional formal requirements are commonly imposed. These include a requirement of written documentation, a public or notarized deed, registration or
delivery of possession of the encumbered assets. Burdensome formalities will either stifle use of security interests or create incentives for circumvention of the required formalities, thereby reducing the transparency and predictability of the legal framework.

As a general rule, the legal framework should not categorically distinguish between characteristics of debtors. However, it is recognized that the policy of protecting economically “weaker” debtors against over-indebtedness often leads to special rules with respect to consumer debtors. Such rules include protection from: (i) encumbering assets deemed essential to their subsistence (e.g., future income, pensions, household items), (ii) creating non-possessory security interests over after-acquired goods (including universality of assets), and/or (iii) securing future debt obligations. Also, in some jurisdictions, a policy of protecting parties may extend to certain non-consumer debtors (e.g., farmers) whose maintenance is perceived to serve important economic or social goals. These exceptional limitations should be narrowly tailored only so far as to protect those interests deemed essential.

Limitations on creditors with respect to the creation of security interests tend to relate to foreign creditors or to non-financial institutions. The policy considerations for such limitations would need to be measured against their adverse effect in hindering access to credit. In order to foster international credit and investment, legal frameworks should not discriminate against foreign creditors (possibly except to exclude foreign nationals from acquiring interests in national land or buildings of a sensitive nature). With regard to the distinction between financial and non-financial creditors, a limitation on particular security interests to categories of financial creditors such as banks that are subject to relevant regulatory supervision may be warranted in order to protect debtors from unscrupulous creditors. However, the effects of such limitations should not spill over to curtailing other avenues of credit such as suppliers credit.

Traditionally, security interests were often limited to the following two types: non-possessory security interests over immovables and possessory security interests over movables. This exclusion of the creation of non-possessory security interests over movable assets particularly affects financing from foreign creditors. Taking possession of movables may be less practicable for a prospective foreign financier and the costs of effecting the often burdensome formalities associated with taking security interests over immovables in a foreign jurisdiction may be prohibitive. Consequently, jurisdictions that do not provide for non-possessory security interests are vulnerable to being less attractive to foreign investment relative to jurisdictions that gave effect to non-possessory security interests.

Debtors should be allowed to utilize the full value of their assets as collateral to the maximum extent possible. The value of the collateral is a function of the value of the rights that the debtor has over the assets, rather than the value of the assets themselves. Within this understanding, an appropriate legal framework should allow for a wide array of “rights over assets” to be used as collateral. There should be as few restrictions as possible on the types of assets (be they movable or immovable) that may be encumbered. In particular, restrictions on allowing future (after-acquired) assets to be used as collateral, as are in place in many jurisdictions, are problematic. 3

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3 This issue is closely linked to the implementation of the principle of specificity (principally associated with the Civil Law tradition), pursuant to which security interests may only be created over assets, or (continued)
Limiting the creation of security interests over identified existing assets curtails the use of commercially valuable assets as collateral. In particular, future account receivables may be the main available valuable assets for a newly established small or medium enterprise. If the framework prohibits or unduly limits the creation of security interests over such future assets, the only recourse (if any at all) for such enterprises to generate the necessary cash flow to begin operating would be to obtain unsecured credit with less favorable financial terms. Thus, the exclusion of future assets from the class of potential collateral is highly problematic from a commercial perspective.

A specific and precise identification of assets is often technically and practically difficult. Further, in so far as one of the purposes of the identification is to form the basis for providing third parties notice that the assets have been encumbered, the important factor is that the identification be sufficient to give meaningful notice. From this perspective, the requirement for specific and precise identification of assets is unduly restrictive.

The framework should also allow for a broad range of debt obligations, both present and future, to be secured. Within this broad range, the framework should avoid different treatment depending on the incidents of the obligations to be secured. However, narrow exceptions for categories, such as consumer debts, may be justified.

Accommodating the demands of a modern internationally competitive economy has led to the creation of non-possessory security interests over movables through multiple special legislation or ad hoc judicial decisions allowing the use of various “quasi-security interests” (e.g., outright retention of title or fiduciary transfer of ownership or possession retention techniques) in order to overcome the rigidity of the formal regime for security interests. Many jurisdictions have thus responded to the need for expansion in security interest instruments in a non-systematic fashion, resulting in patchwork legal frameworks entailing security interests with distinct formalities for creation and perfection, priority rules, and enforcement procedures. Such patchwork regimes suffer from complexity, lack of transparency and unpredictability. Expansion of the scope of security interests, in particular, provision groups of assets, that are specifically identified. Held to its extreme, the principle of specificity would prevent the creation of security interests over future assets or over a universality of assets.

4 Another consequence of an inflexible regime of non-possessory security interests over movable assets is the increased use of personal guarantees. Where a legal framework does not provide for the use of non-possessory security interests over movables, and there is no available immovable property to be encumbered and when there is no general support for unsecured credit, the tendency is to require personal guarantees from third parties. This creates a problem for small and medium-size enterprises, which may not have the necessary family or business connections to secure a personal guarantee. This is also problematic for corporations in general because, in many cases, personal guarantees will be required from major shareholders, thereby circumventing the shareholders’ limited liability in corporate insolvency.
for non-possessory security interests over movables, should be achieved in a systematic manner with a view to maintaining coherence of the security interests legal framework.

Also experience teaches that, when a system is overly rigid in terms of limiting non-possessory security interests over movables or by imposing too strict and burdensome formalities for the creation of security interests, parties tend to design financial transactions to circumvent the limitations imposed by the law. These transactions can take various forms, but often involve outright retention of title or fiduciary transfer of ownership or right of physical retention. Because, by nature, title retention mechanisms used as security are generally not deemed a “security interest” per se (at least in those jurisdictions following the *numerus clausus* approach), the rules governing them tend to fall outside the framework applicable to security interests.

Unless the *functional* approach is followed and titled-based mechanisms are treated as security interests, title retention mechanisms are typically not subject to any formalities or publicity requirements. This absence of publicity contributes to legal uncertainty since other creditors lack the ability to investigate whether the goods in possession of their debtors in reality belong to someone else. Title retention mechanisms can affect insolvency proceedings as well since goods are not part of a debtor’s estate and the title-holder is not thwarted by the claims of other creditors. Thus, even though the purpose of the transaction is the same as that of taking a security interest (i.e., to enhance the likelihood that the creditor will be paid by preference vis-à-vis other creditors), the protection granted to retainers of title might be too high: it grants more powers to the holder of the title than is needed economically to protect its claims and prevents access the debtor’s residual value in assets that could otherwise be charged to second creditors.

This increased use of ownership as security has forced many jurisdictions to examine the interaction between the use of ownership and the law on contract (sales’ contracts in particular), on the one hand, and the rules applicable to security interests, on the other. The approaches taken differ. Some have decided to treat legal ownership as the equivalent of security and to subject mechanisms of legal ownership to the security interests framework. Others (mainly of civil law tradition) have regulated aspects. For instance, some countries permit the use of ownership as security only in narrow circumstances, while others have forbidden it altogether; some others are subjecting such mechanisms to rules similar to those applicable to security interests, in particular in terms of publicity and bankruptcy proceedings. The emerging tendency is to “downgrade” the effects of ownership used as security to those of security interests in terms of priorities both in the general enforcement context and within insolvency proceedings. Therefore, the problem should be addressed in a systematic fashion through legislative action in the context of a comprehensive reform of the framework governing secured transactions.

**V. Perfection**

Although the subject of perfection is an analytically separate concept from the creation of a security interest, in some instances security interests are deemed perfected at the time of creation (at least for certain purposes). Perfection is best conceived as a threshold issue to priorities. Through perfection, the security interest (or functionally related right) establishes its place in the priority queue. Given the
importance of perfection, most systems provide for an objective indication of the event of perfection. Public registration commonly serves this purpose. Public registration systems also address other concerns, such as curtailing the presentation of false wealth by debtors. Possessory security interests are typically exempted from registration as a requirement of perfection. In their case, attainment and maintenance of possession by the holder of the security interest is deemed to adequately address the need to make third parties aware of the existence of the security interest and thus, inter alia, avoid the appearance of false wealth.

In addition to exhibiting the existence of a security interest over encumbered assets, should registration also serve the purpose of providing evidence of the grantor’s legal interests in the assets? Use of registration systems also to evidence title, often compromises the efficiency of the registration system by requiring additional resources to maintain the system to search and certify the title. Such additional formalities thus entail further costs and delay.

Should the registration mechanisms be extended to non-consensual mechanisms? Registration mitigates the problem of non-transparency in relation to these mechanisms that arise by operation of law. Some modern systems require registration of non-consensual mechanisms, at least to the extent they take priority over rights of secured creditors. Again, however, care should be taken to ensure that the registration system is not so overburdened that its efficient operation is undermined.

VI. PRIORITIES

Priorities concern the relative hierarchy among security interests (and functionally related legal mechanisms). This is a complex issue because of the myriad of interests or rights that may coexist. However, in any system, simplicity and transparency should be prime objectives. Any legal framework will need to address two main types of concern: (i) the relationship between conflicting contractual security interests created over the same assets; and (ii) the relationship between different types of consensual and non-consensual interests that purport to grant special rights (in rem or in personam) in relation to enforcement of an obligation.

- Priorities between security interests

Simplification of the priority rules with respect to various types of security interests is highly desirable. The problem is even more acute when the existing framework allows for the creation of many different types of security interests as a result of various special laws.

To what extent should priority rules be security interest specific (irrespective of the date of perfection)? A policy in this direction can often be motivated by the desire to protect certain types of creditors (e.g., creditors in possession of the encumbered goods or holders of a security interest over a specified asset versus holders of a security interest over a universality of assets (e.g., *fonds de commerce*)). This approach, however, presents a significant disadvantage: the greater the number of possible security interests, the higher the probability of conflicts. This problem is compounded when the various special laws fail to address the priority rules between the various security interests. In those cases, it is generally left to the judiciary to resolve any conflicts among holders of various security interests, which could lead to unpredictable and sometimes inconsistent results. It leads to further legal uncertainty because
creditors cannot be assured that subsequent security interests with higher ranking will not be granted. Consequently, the level of creditor protection is in large part weakened. This vulnerability could result in an increased use of other mechanisms, such as negative pledge clauses\(^5\).

The commonly favored approach is to simplify the priority rules by adopting the general principle of fist in time, first in right for all types of security interests, regardless of the assets being encumbered, whereby priority will be determined on the basis of the date at which the security interest was created. When coupled with a general publicity/registration requirement, this principle is relatively simple to implement. If exceptions to this principle are to be introduced, they should be limited to those compelled by overriding social or commercial policies. Other than the concern to protect super preferred beneficiaries of privileges or preferences, the main exceptions to the general principle of first in time, first in right relate to (i) purchase (or loan) money security interests (which evidences the economic policy choice of facilitating the extension of credit for transactions in goods); and (ii) the treatment of the bona fide purchaser (motivated by the consideration that transfers of goods in the ordinary course of business should be facilitated to encourage the expansion of market activities).\(^6\)

- **Priorities between contractual security interests and other mechanisms**

Although the substantial economic benefits resulting from secured credit could warrant a system whereby the parties would be free to create security interests affording secured creditors a priority ranking over any other non-secured creditors, the need to safeguard competing interests often justifies limiting such freedom. One of the main purposes of any general framework is to establish rules governing the conflicts created by the existence of non-consensual mechanisms.

Like security interests, non-consensual mechanisms are intended to provide their beneficiaries with a preferential treatment vis-à-vis other creditors. In some cases, they will prevail over consensual security interests, even those created at an earlier date. This situation compromises the legal certainty and predictability with respect to the protection of secured credit.

As long as a legal system continues to recognize the existence of numerous non-consensual mechanisms, the development and efficiency of secured credit will be hampered by the resulting unpredictability in the priorities among creditors. The preferable approach in dealing with this issue is to

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\(^5\) An interesting question in the context of negative pledge clauses relates to the possibility of automatically establishing a security interest in the event a security interest is created in favor of another creditor. Most negative pledge clauses merely provide for a breach of a covenant, in the event the borrower grants a security interest to another creditor. Nevertheless, a minority of these clauses purports to grant automatically to the existing lender an equal interest in a collateral pledged to another. This type of negative pledge clause is often found in some development banks’ loan documentations (e.g., World Bank). The effectiveness of such automatic grants, however, is suspect.

\(^6\) Note, however, that the protection afforded to the *bona fide purchaser* is not always treated as an exception to the rules of priority but rather as an exception to the general principle of *droit de suite*. 
eliminate the non-consensual mechanisms. Exceptionally, a case could be made for retaining in a confined fashion, only those non-consensual mechanisms necessary to protect interests deemed essential within the social or economic context in any particular country (e.g., employees’ wage or tax preferences). In addition, legislators should consciously decide not to introduce new forms of overriding non-consensual rights. Where certain non-consensual mechanisms are retained, the transparency and predictability of priorities between secured creditors and creditors preferred by non-consensual mechanisms could be enhanced by imposing a requirement that non-consensual mechanisms be made public, for instance through registration in a relevant registry.

VII. ENFORCEMENT

The procedures for the enforcement of security interests need to be addressed coherently with the substantive aspects of the legal framework for security interests. As noted above, the main function of secured credit is to reduce credit risk by increasing a secured creditor’s likelihood to be repaid not only when payment is due, but also in the event of a default by its debtor. This function is critically realized by providing secured creditors with enhanced enforcement mechanisms.

The operation of enforcement mechanisms for security interests takes place at two levels. The first level is through reducing the risks of enforcement of the underlying obligation against debtors, or at least by reducing the burden (such as costs and delay) of enforcement mechanisms in the event of default. When a borrower grants a security interest over its assets to a creditor, awareness that in the event of default the encumbered asset could be forfeited serves as an incentive for debtors to service their debts in a timely manner and thus reduces the risk of incidents of default. In addition, the granting of security interests can limit debtors’ ability to engage in further borrowing, at least to the extent the borrowing is not supported by available assets of the debtor. Limitation of a debtor’s capacity to borrow may be seen by creditors as tempering the debtor’s ability to engage in risky or unsustainable businesses transactions, thereby further reducing the risk of default on the original borrowing. Further, in case of default, enforcement of security interests is generally afforded preferential protection, through accelerated enforcement procedures.

The second level in which the function of security interests is achieved through enforcement is in mitigating the risks of enforcement in relation to competing creditors. An important underlying assumption for the need of a security interest is that, if a debtor defaults vis-à-vis one creditor, it will likely default vis-à-vis others as well. The granting of a security interest to one creditor enhances that creditor’s likelihood of recovery vis-à-vis other creditors, be they secured or unsecured.

● Enforcement vis-à-vis debtors:

A fundamental question in this context is the extent to which creditors will be able to use self-help remedies. This question arises at each step of the enforcement proceedings--from recognition of default, through the sale of the charged assets, and distribution of the sale proceeds. In this regard, the legal framework will have to balance two often conflicting interests: (i) protection of debtors against abuse of rights on the part of the creditors; and (ii) avoidance of excessive state and/or judicial involvement.
One of the preliminary questions that arises is whether creditors would be required to obtain a court judgment on the merits of their credit claims before they can enforce the security interests? Imposing such a requirement introduces a significant hurdle in the proceedings towards realizing the security interest. Recognizing the problems with this approach, many jurisdictions allow secured creditors to move directly to the execution of their security interests. If a judgment on the merits is required, safeguards should be afforded to secured creditors to limit the extent of the added delay and costs. Such safeguards include the use of summary procedures based on the particular evidence or the nature of the claim (e.g. where embodied in an executory title).

The design of the legal framework would also need to address the extent to which secured creditors are required to obtain an execution order from a court giving the authority to the secured creditors to seize and sell the encumbered assets or whether the secured creditors are allowed to proceed on their own without pre-authorization from, and/or supervision of, the courts. If an execution order from a court is required, the proceeding leading to it should be expedited and should only permit the admission of limited, well-defined, defenses, and should require only minimum formalities (such as the presentation of evidence attesting the existence of the security interest and of the default). The less efficient the judicial system (e.g., due to case backlogs, burdensome formalities, high costs or even corruption), the more compelling is the justification for allowing “self-help” remedies. However, the greatest difficulty with self-remedies is that they can unduly expose debtors to abusive creditors. To address this concern, the exercise of self-help remedies should be subject to protections for the debtors, such as requirements of advance notice, enforcement waiting periods, a right for debtors to cure defaults, and a requirement for the creditor to use commercially acceptable methods. In relation to these circumscribed protections, the debtors should be entitled to bring the propriety of the enforcement action before the court. Conversely, due to the common requirement that self-help remedies be implemented without breach of the peace, creditors will need the intervention of a court where a debtor refuses peaceably to relinquish possession of the encumbered assets.

One salient point to be made about sales procedures is that speed in realizing the value of the collateral is key. Appropriate speed can often be achieved through private sales, with the protection of the debtor deferred to ex-post compensatory damages for undervalue sales. Alternatively, if the sales procedure is subjected to judicial supervision, the applicable rules should be transparent and judicial discretion in interpretation should be restrained.

- Enforcement vis-à-vis other creditors

The procedural framework will need to define the extent to which the individual action of a secured creditor would affect other secured creditors. The preferred approach is that there should not be a requirement to bring into the enforcement proceeding all creditors having a security interest over the assets being seized and sold. However, other interested parties should have a right to intervene to ensure adequate protection of their interests.

In the insolvency context, the imposition of a “stay” on enforcement proceedings by secured creditors is a central inter-creditor issue. Such a stay risks undermining the value of the security interest at a time when it is most needed. However, the justification for imposing such a stay includes the preservation of inter-creditor equity, in particular in preventing the precipitous dismembering of the debtor’s productive
assets that potentially could provide for rehabilitation of the debtor’s business to service claims of secured, as well as unsecured, creditors. Where such a stay is imposed, secured creditors should be compensated for delay in realizing the value of their collateral. The costs of this compensation should be borne by the debtor’s estate, the reduction in which is effectively borne by the unsecured creditors.

VIII. CONCLUSION

This paper has sought to identify some of the key issues that arise in the design and implementation of an effective and orderly framework for security interests. The approaches adopted across countries on security interests are diverse. While many of the differences are attributable to divergent legal traditions, others result from different policy choices. This paper has sought to examine the design of the law from the perspective of these policy choices. From this analytical vantage one can then begin to articulate international standards for the law and practice of security interests.