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# Harmonizing the Law Governing Secured Credit: The Next Frontier

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# Harmonizing the Law Governing Secured Credit: The Next Frontier

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SUMMARY



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## I. INTRODUCTION: THE RELEVANCE OF SECURED CREDIT

It is certainly an honor for this paper to be included among those prepared for this august symposium, but I feel a duty to explain the presence of this article. What, after all, does secured credit have to do with international insolvency law?

The answer, both legally and economically, is "quite a bit." From a legal perspective, the interactions between the secured credit and insolvency systems are obvious. In the United States, for example, bankruptcy law refers to other bodies of law, including secured credit law, in the course of determining the rights of parties asserting claims in bankruptcy.[1] In addition, rights created under the aegis of secured credit law are sometimes vulnerable in bankruptcy; for this reason, bankruptcy law is often considered the "acid test" of any security interest. Yet the economic links between the systems are even closer than the legal links.

### *A. The Need for Credit Enhancement*

The economic links between insolvency and secured transactions are simple, flowing from a desire to facilitate mutually profitable credit transactions. In virtually all extensions of credit, there is a fundamental economic reason—generation of profits—to seek or extend credit. To the borrower, a potential extension of credit will be seen as profitable if the borrower anticipates a greater return on the loaned funds than it will pay in interest. Obviously, the interest rate to be charged in the transaction plays the major role in determining whether the transaction will be seen as profitable. For the creditor, a transaction may generate profits in two different ways. The profits flowing to the seller that are generated by an extension of credit may be direct, derived from interest charges in excess of the creditor's time value of the money, or indirect, such as when the credit finances profitable sales (that might not otherwise have occurred) of the creditor's products or services to buyers. Obviously, many transactions generate profits for creditors both indirectly and directly—enabling a profitable sale that may not otherwise have taken place *and* making a separate profit from the interest charged to the customer.

In any case, individual extensions of credit are profitable for creditors only when the debtors' obligations are fulfilled, and an aggregate of credit extensions is profitable only if the profits from the successful transactions[2] are greater than the losses from those in which the debtor does not fully repay the credit. While in some cases a debtor's failure to fulfill his or her obligations is due to dishonesty or unwillingness to pay, much more often the failure springs directly from inability to perform. Inability to fulfill one's financial obligations, of course, is part of the classic definition of insolvency.[3] Thus, the risk of debtor insolvency is a major (perhaps *the* major) determinant of whether a credit transaction will be seen as profitable for the creditor.

Given the major impact on the creditor's profit or loss associated with a debtor's insolvency, it is not surprising that if a creditor believes that the risk of nonpayment associated with a particular proposed extension of credit is too high, that extension of credit will likely not take place. This is the case because nonpayment would not only make that transaction unprofitable, but would also more than offset gains from many other

1. *See, e.g.*, 11 U.S.C. §§ 544, 547 (1994).
2. In other words, those transactions in which the borrower fulfills its obligation.
3. *See, e.g.*, U.C.C. § 1-201(23) (1995); *see also* 11 U.S.C. § 101(32) (1994).

transactions in which the debtors fully pay their debts.[4] Similarly, a creditor considering engaging in a particular class of credit extensions will not do so if the risk associated with individual extensions within that class exceeds a certain threshold. Even if the chance that any one debtor will default is relatively low, a small number of projected defaults will yield a negative expected value for the entire class. It might seem that this problem could be ameliorated for the creditor by simply raising the interest rate so that the profits from the successful transactions are high enough to outweigh the losses from the unsuccessful transactions. There are limits to this strategy, though, springing from the basic principle, described above, that a transaction must be profitable for *both sides* in order to proceed. Raising the interest rate, it must be remembered, decreases the likelihood that a transaction will be profitable for the borrower. If the transaction is not seen as profitable by the borrower, it will not take place. Thus, when the insolvency risk is high, it will often be the case that the transaction, viewed *ex ante*, can be profitable for the creditor or for the debtor, but not both.

Decisions not to extend credit are obviously unfortunate for the debtors who are deprived of credit. They are also, however, a source of disappointment for prospective creditors, since foregoing an extension of credit is foregoing a potentially profit-making activity. Thus, both prospective debtors and prospective creditors have incentives to seek ways to structure transactions so that they can be profitable for both parties.

Credit structures that reduce risk and enable a mutually profitable transaction are sometimes called "credit enhancement" mechanisms. Credit enhancement, generally speaking, is the art of structuring a transaction, through economic agreements and legal mechanisms, so that the transaction is seen by both the creditor and the debtor as prospectively profitable. In other words, the goal of credit enhancement is to minimize the creditor's risk of loss due to nonperformance while nonetheless allowing the transaction to be profitable for the debtor.

### *B. Security Interests as Credit Enhancement Devices*

Credit enhancement devices are mechanisms that work to lower the creditor's expected loss due to debtor nonperformance (thereby allowing the transaction to be profitable to the creditor) while allowing the transaction to remain inexpensive enough to be profitable to the debtor. These devices work by applying one or both of the following two simple ideas: (1) making more assets reachable by the creditor to satisfy the claim and (2) increasing the creditor's priority with respect to assets available to it. The first principle is usually accomplished by arranging for a surety, guarantor, or other secondary obligor[5] to

4. Indeed, the loss associated with one defaulting debtor is typically several times greater than the profit generated by a fully performing debtor. Take, for example, a one year $10,000 loan with an annual interest rate of 8% when the creditor's cost of funds is 4.5% per year. The expected profit from this loan is $350. (This can be calculated as follows: Assuming, for simplicity of illustration, that the creditor has no costs (other than its cost of funds) associated with the loan and that the loan is payable in a single payment at the end of one year, the loan would generate $800 in interest (8% of $10,000), but the creditor's cost of funds would be $450 (4.5% of $10,000). The difference, then, between the interest charges and the cost of funds is $350.) Yet, let us assume that the debtor defaults and, after an additional year of collection efforts, $3000 is recovered from the debtor. The creditor's loss on the transaction would be $7920.25. (The creditor in this case has invested a total of $10,920.25 ($10,000 plus two years' interest at 4.5% compounded annually) and received only $3000, leaving a loss of $7920.25.) Obviously, a single default eliminates the profits generated by many fully performing extensions of credit. *See generally* Neil B. Cohen, *Credit Enhancement in Domestic Transactions: Conceptualizing the Devices and Reinventing the Law*, 22 BROOK. J. INT'L L. 21 (1996).

5. The term "secondary obligor" is the generic term used in modern analyses to describe parties such as guarantors that agree to be liable with respect to an obligation that is primarily the responsibility of another. *See* RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 1(1)(a) (1996).

agree to liability with respect to the debtor's obligation. The second principle is fulfilled by the use of collateral—the granting to the creditor of a "security interest" in specified assets of the debtor. A security interest, of course, gives the secured creditor higher priority in reaching those assets to satisfy the debt than would be the case if the creditor simply were entitled to share the debtor's assets with all of the debtor's creditors. With this "first shot" at the assets of the debtor it becomes possible for the debt to be paid in full, even if the debtor becomes insolvent. The grant of a security interest decreases the creditor's risk of loss and, accordingly, allows the creditor to enter into the credit transaction at an interest rate low enough for the transaction to be profitable to the debtor. Thus, by reducing the expected cost of insolvency risk, the security interest facilitates the transaction.

## II. THE COSTS OF DISHARMONY

### A. *The Extent of Disharmony*

The differences in insolvency law (both substantive and procedural) among nations create a serious problem in international credit transactions. In the context of a particular failed transaction, the differences among insolvency regimes create one more battlefield to be survived in the eventual allocation of the debtor's assets. In the context of transaction planning (and pricing), though, these differences create uncertainty for the prospective creditor. Because uncertainty makes a transaction less valuable in a world of risk aversion, these differences result in higher interest rates or foregone transactions.

A similar phenomenon exists with respect to credit enhancement mechanisms such as security interests that, when effective, ameliorate the effects of debtor insolvency. The differences between secured credit regimes, in terms of both substantive principles and their procedural effectuation, create uncertainty and transaction costs that lower the expected value of a transaction to the creditor. Once again, these differences likely result in higher interest rates and, in some cases, foregone transactions. Indeed, the problem may even be worse, because secured credit law is designed to operate largely without court supervision.

The differences between secured credit regimes in different nations are quite significant. Regimes differ, for example, as to whether they provide unified treatment for virtually all security interests in one system (as is the case with Article 9 of the Uniform Commercial Code in the United States)[6] or separate regimes for particular types of collateral and particular types of transactions.[7]

Substantively, regimes differ as to the types of property in which a security interest may be granted[8] and the creditors authorized to receive security interests.[9] They also differ

6. U.C.C. § 9-102 (1995).

7. In Germany, for example, different statutes or rules govern the pledge (*see* §§ 1205–96 Bürgerliches Gesetzbuch [BGB] [Civil Code] (F.R.G.)), the seller's reservation of title (*see* § 455 BGB), the assignment of claims (such as accounts receivable), and security (*see* Jens Hausmann, *The Value of Public-Notice Filing Under Uniform Commercial Code Article 9: A Comparison with the German Legal System of Securities in Personal Property*, 25 GA. J. INT'L & COMP. L. 427, 462–65 (1996)).

8. *Compare, e.g.*, the United States in which a security interest governed by Uniform Commercial Code Article 9 can be granted in almost every type of personal property or fixture (*see* U.C.C. §§ 9-102, 9-104 (1995)), *with* Bolivia, where the "civil pledge" may be used only for goods used in hotels, industry, agriculture, and ranching (*see* OFFICE OF THE CHIEF ECONOMIST, LATIN AMERICA AND CARIBBEAN REGION, HOW LEGAL RESTRICTIONS ON COLLATERAL LIMIT ACCESS TO CREDIT IN BOLIVIA 18–19 (World Bank Report No. 13873-BO, 1994)) [hereinafter World Bank Report].

9. For example, in Mexico, a *hipoteca industria* (industrial mortgage) may only be taken by a Mexican-incorporated credit institution (such as a bank). *See* "Ley de Instituciones de Crédito," art. 67, D.O., 18 de julio de 1990.

as to the ability of a debtor to grant a security interest in after-acquired or subsequently-created property and whether one contract or conveyance can grant an interest in a mass of individual items of collateral or, rather, individual conveyances are required.[10] Most important, they differ greatly with respect to the rules concerning priority of the secured party as against other claimants of the collateral. Some priority contests are resolved by the application of simple first-in-time, first-in-right rules,[11] while others are resolved through order of registration, or publicity, of the security interest.[12] Finally, the secured credit regimes differ as to whether transactions that are security interests in substance but not form, such as conditional sales, are governed by the rules for security interests.[13]

### *B. The Effects of Disharmony*

Not surprisingly, the existence of different legal regimes that may govern an international secured transaction can place many burdens on such transactions. Some of those burdens merely add transaction costs to the extension of secured credit, while others may result in restructuring a transaction or even foregoing it completely.

The first burden is quite simple. Ascertaining and complying with an unfamiliar rule of law adds to the costs associated with closing a transaction, even if the governing law turns out to work quite well for the particular extension of credit. These additional costs may include increased attorneys' fees as well as other internal costs of time and effort.

Sometimes, though, matters will be more difficult. It may not be clear which state's law will govern a particular secured transaction or whether one state will govern one aspect of the transaction while the law of a different state will govern a different aspect. In some secured transactions, such as a security interest in accounts, there can be a third party (such as the account debtor) who is from still another state and whose law might govern all or part of the transaction. In any event, the possibility that there will be a claimant to the collateral who is from a different nation than the debtor or the creditor must be considered. Thus, not only may it not be clear which state's law will govern, but it may also not be obvious which states even have an interest in the transaction. Uncertainty about which law governs has an impact on the value of transactions.

In some cases, the differences in governing law may have a more profound effect. A transaction that can be accomplished easily under one legal regime may be difficult, uncertain, or unduly expensive under another regime. For example, in the United States it is quite simple for a debtor to grant an enforceable security interest in all of its accounts—both those now existing and those that may come into existence in the future—in one transaction.[14] In many other countries, though, such a transaction would have to be structured quite differently, in some because a security interest cannot be granted in property not yet in existence, while in others because a security interest in individual accounts cannot be conveyed in one omnibus security agreement.

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10. *See, e.g.*, Código Civil para el Distrito Federal [C.C.D.F.] art. 2895 (1986) (Mex.). *See also* John E. Rogers & Carlos de la Garza-Santos, *General Goods: A Case Involving Security Interests in Inventory and Accounts in the United States, Canada, and Mexico*, 5 U.S.-MEXICO L.J. 3, 8–14 (1997) (describing the system of security interests in inventory and accounts in Mexico).

11. For a German example, *see* Judgment of June 9, 1960, BGHZ 32, 367, 370.

12. For a United States Example, *see* U.C.C. § 9-312 (1995).

13. *Compare* U.C.C. § 9-102(1) (1995) (Article 9 governs transactions within its scope regardless of form), *and* § 9-102(2) (explicitly covering conditional sales), *with* § 455 BGB (Germany's separate treatment of seller's reservation of title, a synonym for conditional sale).

14. *See* U.C.C. § 9-204(1) (1995).

Finally, if the collateral is "mobile goods," it may be impossible to predict where the goods might be at any particular time and, accordingly, to predict which country's laws might govern.[15] Once again, this uncertainty can result in foregone, constrained, or less profitable transactions.

## III. PROSPECTS FOR HARMONIZATION

Given the costs of disharmony in the various systems governing secured credit worldwide, we must give serious thought to the prospect of harmonizing some of the differences. Such harmonization could take the form of special rules for international transactions or new substantive rules adopted for both internal and external purposes.

### *A. The 1977 UNCITRAL Study*

Almost thirty years ago, the United Nations Commission on International Trade Law (UNCITRAL) retained Professor Ulrich Drobnig of the Max-Planck-Institut für Ausländisches und Internationales Privatrecht[16] to "make a study of the law of security interests in principal legal systems."[17] One function of the study was to assess the need and, perhaps, prospects for accomplishing harmonization in this area of law.

The study, published in 1977, comprehensively examined the laws of nineteen nations, noting the similarities and differences in their treatment of the basic legal issues of secured credit.[18] Not surprisingly, the differences were great. More important for our purposes today, the Drobnig Report also contained assessments to "help to confront the necessity or desirability of framing rules in this field at the international level, especially for the international movement of goods subject to security interests."[19]

As part of these assessments, Professor Drobnig catalogued prior attempts to achieve some degree of international uniformity with respect to security interests. These attempts included:

(1) A uniform conditional sales act enacted by three Scandinavian countries (Norway, Sweden, and Denmark) during 1915–1917.

(2) UNIDROIT draft provisions of 1939 and 1951 concerning the impact of reservation of title in the sale of certain goods.

(3) Provisions regarding the effect in bankruptcy of reservation of title in the sale of goods in the draft EEC Bankruptcy Convention of 1970.

(4) Model reservation of title clauses contained in several "General Conditions" elaborated by the United Nations Economic Commission for Europe.[20]

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15. *See* U.C.C. § 9-103, cmt. 5, para. (b) (1995).

16. The Max-Planck-Institute for Foreign Private and Private International Law.

17. *See Report of the Commission on International Trade Law on the Work of its Third Session*, [1971] 1 Y.B. U.N. Comm'n on Int'l Trade L. 129, 145, U.N. Doc. A/CN.9/SER.A/1970.

18. *See Report of the Secretary-General: Study on Security Interests*, [1977] VIII Y.B. Comm'n Int'l Trade L. 171, U.N. Doc. A/CN.9/SER.A/1977 (presenting a study by Professor Ulrich Drobnig) [hereinafter *Drobnig Report*].

19. *See id.* at 173.

20. *See id.* at 209.

These attempts were all ineffective in achieving uniformity in the law governing security interests.

Professor Drobnig also analyzed at some length two recent (at the time of his study) proposals for the harmonization of secured credit law that had been submitted to the Council of Europe. The first such proposal was made by UNIDROIT in 1968; the other was submitted by the Service de recherches juridiques comparatives of the CNRS of Paris in 1972.[21] Together, these proposals put forth a range of possible unification schemes, from the "maximum" solution of creating a uniform security interest for international cases to the much narrower suggestion for a uniform document accompanying motor vehicles on which security interests could be entered.[22] In addition, Professor Drobnig noted the existence of a proposal to the European Community for establishing a central register for security interests.[23]

Noting that none of these efforts had succeeded or appeared likely to have significant influence, Professor Drobnig was, to say the least, not optimistic about the likelihood of framing international rules governing security interests. With respect to a uniform law convention, he concluded:

> It would seem that international legislation in the form of a convention providing uniform rules of substantive and conflicts law is not appropriate in this case. As against international sales or international transportation or the international circulation of negotiable instruments, transnational incidence of security interests is as yet relatively moderate. It would probably be difficult to obtain sufficient government support for an international conference dealing with the relatively technical topic of security interests; and even if the text of an international instrument could be agreed upon, national parliaments would probably be slow and perhaps even reluctant to ratify such a text.[24]

With respect to the advisability of developing recommendations to nations for the adoption of rules that would promote uniformity, Professor Drobnig was dismissive: "Mere recommendations, even if emanating from an international organization of the highest repute, will not command sufficient moral or other support for adoption by any sizable number of states."[25]

Only with respect to the possibility of developing a model law in this area was Professor Drobnig's view less bleak. Even there, however, his relative optimism was tempered with doubt: "Perhaps moral persuasion or intellectual insight into the virtues of the model rules will move some States to adopt them. Others may need persuasion by more effective means such as insistence on the part of international financing institutions."[26]

### *B. Is 1997 Different?*

There is reason to believe that the pessimism of Professor Drobnig in 1977, however strongly justified at the time, should not govern decisions as to whether and how to seek or achieve harmonization in 1997. After all, much has changed in the twenty years since the Drobnig study. For example:

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21. *See id.* at 210–11.
22. *See id.* at 211–12.
23. *See id.* at 212.
24. *Id.* at 218.
25. *Id.*
26. *Id.*

(1) Practical barriers to international commerce (arising from communications and travel barriers, for example) have lessened dramatically. Accordingly, today there is a significantly greater demand for international commercial transactions of all kinds, including secured credit, than was the case twenty years ago.

(2) Several nations have joined the United States in enacting secured credit laws reflecting the concepts and policy choices on which Article 9 of the Uniform Commercial Code is based.[27]

(3) The fall of command economies following the collapse of most communist regimes has resulted in opportunities for the wholesale rewriting of the commercial laws of many countries in order to make market economies workable.

(4) Organizations outside the United States, such as the European Bank for Reconstruction and Development (EBRD), have drafted and proposed for adoption model acts governing secured transactions.[28] The EBRD Model Act is particularly significant because it deviates from many traditional European norms and, instead, is compatible with the structure of the secured transactions system created by U.C.C. Article 9.

(5) The World Bank and other organizations have actively pushed for modernization of the secured credit laws of many nations.[29]

(6) More recently, work has begun on two conventions concerning international secured credit. UNIDROIT is preparing a convention on security interests in mobile goods,[30] and UNCITRAL is preparing a convention on assignment of accounts receivable.[31]

Accordingly, I would respectfully suggest that in the twenty years since the UNCITRAL report, the international secured transactions landscape has changed dramatically, requiring a rethinking of that study's pessimism. Particularly within the last decade, initiatives for the reform of both international and domestic law governing secured transactions have mushroomed. While many of these initiatives are still in progress and uncertain of success, modernization and harmonization are no longer far-fetched dreams.

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27. For example, see the enactment in most anglophone Canadian provinces of Personal Property Security Acts based on similar concepts to those in U.C.C. Article 9. *See, e.g.*, The Personal Property Security Act, 1967, ch. 73, 1967 S.O. 305 (Ont.); *see also* Jacob S. Ziegel, *The New Provincial Chattel Security Regimes*, 70 CAN. BAR REV. 681 (1991) (discussing provincial property security legislation generally).

28. *See* EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, MODEL LAW ON SECURED TRANSACTIONS (1994).

29. *See, e.g.*, World Bank Report, *supra* note 8.

30. *See International Interests in Mobile Equipment*, <http://www.agora.stm.it/unidroit/english/news/news-97-2.htm> (reporting on the progress of the efforts to draft Uniform Rules on International Interests in Mobile Equipment).

31. *See* Working Group on Int'l Contract Principles, UNCITRAL, *Revised Articles on the Draft Convention on Assignment in Receivables Financing (Apr. 23, 1997)*, U.N. Doc. A/CN.9/WG.II/WP.93, <http://www.un.or.at/uncitral/> [hereinafter UNCITRAL Receivables Project]. The most recent draft of this convention is available from a number of sources on the Internet. On the American Bar Association site, <http://www.abanet.org/>, the United States delegation to the Working Group drafting the Convention (of which the author of this article is a member) posts from time to time other documents of use in tracking the progress of this convention, including reports of the discussions at working group meetings and drafts annotated with the comments of the U.S. delegation as to the importance of various issues.

The following is a description of some of the current initiatives that are changing the face of secured credit law around the world. There are certainly others, as the list changes almost daily, but this sampling illustrates the pace of reform.

1. Initiatives by International Organizations

*(a) UNIDROIT*

The International Institute for the Unification of Private Law (UNIDROIT) has, over the years, developed several conventions in the commercial law area. Two recent initiatives concern the law of secured credit. Each deals with an important subset of the commercial finance world in which international transactions place great stress on the system. The first initiative, already completed, concerns factoring, while the second concerns interests in mobile goods.

(i) Factoring

First, UNIDROIT addressed many of the difficulties attendant in international factoring. Factoring is a common method of commercial finance in which a merchant who sells goods or services on credit can transform its rights to receive money from its customers in the future to cash in the present by selling those rights to a financier, or "factor," who will undertake to collect from the customers. While factoring, at least in form, involves a sale of an asset (the receivable owed by the customer) rather than a credit transaction, factoring is so closely associated with secured credit, both historically[32] and functionally,[33] that it is often governed by secured credit laws.[34]

When a merchant in one country sells goods on credit to a buyer in another country, a complex factoring "chain" may result. Take the case of a manufacturer of clothing in South Korea who sells some overcoats to a wholesaler in California on open account. The Korean seller now has an asset (the account owed by the California wholesaler) that it would like to convert to cash. The seller probably has financing contacts and expertise in South Korea, but not in California, and therefore seeks out a factor located in South Korea to whom to sell the account. A typical South Korean factor would be willing to purchase the account but, because the South Korean factor is likely to be limited by cost and unfamiliarity in its ability to enforce the claim against the California wholesaler if the wholesaler does not pay voluntarily, the factor would likely only purchase the account at a steep discount. This discount would be significantly less, however, if the South Korean factor could sell *its* interest in the account to a California factor, who could much more easily enforce it if necessary. Through informal contacts and organizations such as Factors Chain International, it is often possible for factors in the account creditor's country to identify factors in the debtor's country to arrange such inter-factor transfers. The result, in many international credit transactions, is a series of transfers of the account receivable with international dimensions. The initial transfer (in the example above, from the South

32. *See generally* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 5.1 (1965) (introducing "factors" generally and factor's liens specifically).

33. Once one gets beyond the simplest transactions, it is often difficult to distinguish a "sale" of a receivable from a loan secured by it. *See* U.C.C. § 9-102, cmt. 2 (1995).

34. *See, e.g., id. See also* UNCITRAL Receivables Project, *supra* note 31.

Korean manufacturer to the South Korean factor) is a domestic transfer of an international claim, while the second transfer (South Korean factor to California factor) is an international assignment. Are these assignments enforceable against other claimants of the receivable, such as the bankruptcy trustee? Must the account debtor pay the ultimate transferee (the California factor), or may it insist on paying only the party with whom it dealt? The laws of the world's nations differ significantly with respect to such questions.

To answer these questions and others, in 1988 UNIDROIT promulgated a Convention on International Factoring.[35] While this Convention is limited in scope and has few signatories to date, it is nonetheless a landmark, demonstrating that it is possible to reach an international consensus on difficult legal questions governing international secured finance.

(ii) Mobile Goods

Another matter on the UNIDROIT agenda is a convention concerning security interests in mobile goods.[36] Under most legal regimes, a security interest in goods is governed by the law of the jurisdiction in which the goods are located.[37] This causes problems occasionally when the goods are moved to a different jurisdiction, but these problems are for the most part workable. What if, however, the goods are of the sort that, by their nature, move from jurisdiction to jurisdiction? Two good examples of such goods are railroad cars and airplanes. The normal rule—that location of the goods is paramount in determining the governing law—would lead to chaos, as creditors would have to adjust their status daily. Accordingly, many secured credit systems have special rules to determine the governing law for mobile goods. Of course, as is not surprising in the international arena, these rules differ significantly from nation to nation. The current UNIDROIT effort is an attempt at an international convention in this area.

*(b) UNCITRAL*

The United Nations Commission on International Trade Law (UNCITRAL) has also produced several conventions and model laws in the commercial area. Since 1995, its major ongoing project has been the development of a convention that would govern international accounts receivable financing, a subject which in the United States is within the scope of U.C.C. Article 9.[38] This project is in part concerned with transactions that would also be within the scope of the UNIDROIT Factoring Convention, but goes much further. It would govern virtually any international assignment of a receivable and any assignment (domestic or international) of an international receivable (that is, a receivable for which the debtor and creditor are in different nations).[39] Since there are at least three parties involved in a receivables financing transaction—the account debtor, the account

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35. Diplomatic Conference for the Adoption of the Draft UNIDROIT Conventions on International Factoring and International Financial Leasing: Final Act and Text of Two Conventions, May 28, 1988, 27 I.L.M. 922.

36. *See International Interests in Mobil Equipment*, *supra* note 30.

37. Interestingly enough, the United States, which has followed this rule, may be about to move away from it in part. The most recent drafts of Revised Article 9 provide that perfection or non-perfection of a security interest in goods is governed by the jurisdiction in which the debtor is located, rather than the jurisdiction in which the goods are located. *See, e.g.*, Nat'l Conference of Comm'rs on Uniform State Laws, *January 1998 Draft* <http://www.law.upenn.edu/library/ulc/ucc9/ucc9198.htm>.

38. *See* U.C.C. § 9-102(2) (1995).

39. *See* UNCITRAL Receivables Project, *supra* note 31, art. 1.

creditor/assignor/debtor,[40] and the assignee/creditor/secured party[41]—there are myriad problems currently facing such transactions. Can the accounts be assigned (either absolutely or as security) without the consent of the account debtor? Can accounts be assigned without notice to the account debtor? May a bulk of accounts be assigned in a single contract, or must individual assignments be executed? May one contract be used to assign not only currently existing accounts, but also accounts that will not come into existence until sometime in the future? How does a secured party ensure that it will have priority with respect to the account over competing claimants from the secured party's country? What of priorities over claimants from other countries? Will the interest in the account survive the bankruptcy of the assignor/debtor? The UNCITRAL Working Group addressing these issues has met three times and has tentatively resolved many of these issues.[42] The remaining issue that has garnered the most attention, though, may well be the most important: Will perfection and priority of interests in receivables be determined by public notice filing (as is the case in the United States, Canada, and some other nations), or by a different method in which information about security interests is less available to the public and potential lenders?

It should also be noted that both the UNIDROIT and UNCITRAL initiatives deal with a specific type of secured transaction rather than with secured transactions generally. This probably increases the likelihood that the rules that emerge from these initiatives will gain widespread ratification or enactment, because adoption of those rules will not require nations to reconceptualize the entire field of secured credit. To the extent, however, that adoption of these rules in countries without modern secured transactions laws will provide an opening into the legal cultures of those countries, they might provide the precursor to more general reform in the future.

### 2. Foreign Law Initiatives

There are currently efforts to reform domestic secured transactions law in many nations throughout the world. The total number of such initiatives is difficult to ascertain, however, because there is no central clearinghouse for this information. Current initiatives include, but are by no means limited to, initiatives in former Soviet republics, Soviet-dominated states, and other developing economies reforming under the World Bank.

#### *(a) Initiatives in Former Soviet Republics and Soviet-Dominated States*

##### (i) European Bank for Reconstruction and Development

In 1994, the European Bank for Reconstruction and Development (EBRD) released the final draft of its Model Law on Secured Financing.[43] The Model Law was drafted to serve as the basis for the enactment of modern secured transactions laws in the nations of

40. U.C.C. Article 9 refers to this party as the "debtor." *See* U.C.C. § 9-105(1)(d) (1995).

41. U.C.C. Article 9 refers to this party as the "secured party," even if the transaction is an outright sale of the account rather than a "true" secured transaction. *See* U.C.C. § 9-105(1)(m) (1995).

42. *See Explanatory note by the UNCITRAL secretariat, in* UNCITRAL MODEL LAW ON INTERNATIONAL CREDIT TRANSFERS at 14–24, U.N. Sales No. E.95.V.17 (1994).

43. EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, MODEL LAW ON SECURED TRANSACTIONS, *supra* note 28.

Central and Eastern Europe.[44] While the Model Law is not ideal from an American perspective, it nonetheless may provide an effective catalyst to aid the nations for whom it was developed in moving toward a domestic secured financing regime that could enhance the availability of credit to their residents, both internally and from other nations.

(ii) CEELI

The American Bar Association, through its Central and Eastern European Law Initiatives (CEELI) Project, has been providing assistance to former Soviet republics and nations formerly in the Soviet sphere in the development of their domestic law.[45] The assistance includes educational efforts in particular substantive areas of the law and assistance in the drafting of legal codes. In many cases, CEELI assistance has been in the area of secured transactions.[46]

(iii) The IRIS Project

The University of Maryland is a sponsor of the Institutional Reform and the Informal Sector (IRIS) Project.[47] This project has provided both substantive and technical input to nations upgrading their secured transactions systems, particularly in the area of filing and registration systems.[48]

(iv) The Commercial Law Project for Ukraine

The Commercial Law Project for Ukraine is an independent project, financed in part with United States government grants, to aid the Ukrainian government in developing a comprehensive body of business law for that nation as it makes the transition to a market economy. One focus of the project has been the development of laws that govern security interests.

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44. *See id.* at v.

45. *See, e.g.*, Janet Key, *Old Countries, New Rights*, 80 A.B.A. J. 68, 68–69 (1994); Spencer Weber Waller, *Neo-Realism and the International Harmonization of Law: Lessons from Antitrust*, 42 U. KAN. L. REV. 557, 561, 569 (1994). *See also* Central and East European Law Initiative, American Bar Association, *American Bar Association Central and East European Law Initiative* (visited Oct. 10, 1997), <http://www.abanet.org/ceeli/home.html>.

46. *See* Key, *supra* note 45, at 68–69. *See also* Central and East European Law Initiative, American Bar Association, *Commercial Law* (visited Oct. 10, 1997) <http://www.abanet.org/ceeli/commercial.html>; Central and East European Law Initiative, American Bar Association, *CEELI's Activities in Latvia* (visited Oct. 10, 1997) <http://www.abanet.org/ceeli/latvia.html> (providing examples of CEELI assistance).

47. *See* William E. Kovacic, *The Competition Policy Entrepreneur and Law Reform in Formerly Communist and Socialist Countries*, 11 AM. U. J. INT'L L. & POL'Y 437, 446 (1996) (discussing IRIS assistance provided to the Mongolians in drafting antitrust law). *See also IRIS: History and Goals* (visited Oct. 10, 1997) <http://www.inform.umd.edu/EdRes/Colleges/BSOS/Depts/IRIS/present.html>.

48. *See* Kovacic, *supra* note 47, at 446, 460 (detailing the author's experiences helping draft a Mongolian antimonopoly law). *See also IRIS Field Programs* (visited Oct. 10, 1997) <http://www.inform.umd.edu/EdRes/Colleges/BSOS/Depts/IRIS/field.html>; *Preface* (visited Oct. 10, 1997) <http://www.inform.umd.edu/EdRes/Colleges/BSOS/Depts/IRIS/collapref.html> (providing examples of IRIS assistance).

### (b) *Other Developing Economies (World Bank Projects)*

The World Bank has recently linked many of its lending operations to reform of secured transactions laws in the debtor nations. Nations in which projects to reform secured transactions law financed by the World Bank are underway or are planned include Argentina, Bolivia, Brazil, Honduras, Peru, El Salvador, and Uruguay. The World Bank is also working jointly with the Inter-American Development Bank in Mexico and with the EBRD in Bulgaria.[49]

### (c) *NAFTA Countries*

The National Law Center for Inter-American Free Trade, located at the University of Arizona, has been quite active in encouraging the development of modern secured transactions law throughout the three-nation NAFTA complex.[50] Its primary impact, however, is in Mexico.[51]

### (d) *Developed Countries*

Many developed nations around the world, from Israel to New Zealand, are considering modernization of their secured transactions laws.[52] These efforts are at various stages and, of course, have differing prospects of success.

Perhaps the most important ongoing developments are the international law-making efforts of UNIDROIT and UNCITRAL. After all, the mere fact that a large number of nations have gotten together in these two efforts suggests a degree of consensus, rarely achieved in the past, that there is a problem that should be dealt with.

Of the two projects, the UNCITRAL receivables project, if successful, has the greater potential for transforming the international credit marketplace. Receivables financing is simply bigger business than the financing of mobile goods. While much progress has been made to date on the UNCITRAL project, there are important issues not yet resolved within this effort that threaten its ultimate success. Substantial agreement has been reached on the formalities necessary to transfer an interest in receivables and the rights of the transferee as against the account debtor. However, no consensus has been reached on the topic of priorities. Some nations, such as the United States, have advocated a priority system based on notice filing of the transferee's interest, while other nations have advocated a first-in-time, first-in-right rule based on the creation of the transferee's interest. In addition, no consensus has been struck concerning the scope of the Convention's rules. While it is agreed that they will apply to both assignments of international receivables[53] and international assignments of receivables,[54] it is not yet settled whether the Convention

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49. *See generally* John W. Head, *Evolution of the Governing Law for Loan Agreements of the World Bank and Other Multilateral Development Banks*, 90 AM. J. INT'L L. 214 (1996).

50. *See* TODD C. NELSON & RONALD C.C. CUMING, HARMONIZATION OF THE SECURED FINANCING LAWS OF THE NAFTA PARTNERS: FOCUS ON MEXICO 4 (1995).

51. *See id.* at 1.

52. *See, e.g.*, John Regis Coogan, et. al., *Central European Law*, 31 INT'L LAW. 495, 495 (1997).

53. An "international receivable" is a receivable for which the account debtor and account creditor are located in different nations. *See* UNCITRAL Receivables Financing, *supra* note 31, art. 3.

54. An "international assignment" of receivables is one for which the assignee and the account creditor/assignor are located in different nations. *See id.*

applies if only some of the parties to the assignment are located in nations that are "contracting states."[55] Some countries would prefer that a rule that required all three principal parties (account debtor, account creditor/assignor, and assignee) be located in contracting states for the convention's rules to apply. Others would require only the assignor to be in a contracting state, or only the assignor and assignee.

One of the often-ignored challenges associated with the UNCITRAL project is that it might create an unstable equilibrium. The rules governing transactions within the scope of the Convention will necessarily cause tension when they affect transactions outside the scope of the Convention. For example, assuming *arguendo* that the Convention adopts a first-in-time priority system based on notice filing for international transactions governed by the Convention, there will be significant tensions when the Convention rules are applied to a transaction in a nation with priority rules for domestic transactions based solely on the date of the assignment of the receivables (with no filing required).

To illustrate this point, imagine an account creditor in Atlantis, a nation whose domestic priority rules are based on time of assignment without any requirement of filing or registration. On July 1, the account creditor assigns some domestic accounts (*i.e.* accounts for which the account debtor is located in Atlantis) to Assignee #1 who is also located in Atlantis. On August 1, the account creditor assigns those same accounts to Assignee #2 who is located in the United States; assume further that Assignee #2 complies with the notice filing requirements of the Convention. This second assignment is international and thereby governed by the convention's rules. Under those rules, Assignee #2 would have priority against competing claimants.[56] Under the time of assignment rule that governs domestic assignments, however, Assignee #1 would have priority over competing claimants. As between Assignee #1 and Assignee #2, who should have priority?

If Assignee #1 has priority, the convention's rules will be of little utility because an assignee with priority under those rules might still lose to a domestic assignee under the different priority rules governing domestic transactions. If, on the other hand, Assignee #2 has priority, then presumably Assignee #1 could have protected its interests by filing in the international system. Yet, if this is the case, well advised creditors in Assignee #1's place will have a strong incentive to make an international filing. If so, the convention rule, applicable by its terms only to international transactions, will subtly change ways of doing business domestically. Thus, whatever equilibrium of credit practices is initially created by the Convention will inexorably evolve into a system in which the rules governing international transactions determine much domestic conduct.

### C. *The ALI International Secured Transactions Project*

In May 1997, the American Law Institute (ALI) officially commenced the International Secured Transactions Project. The Project has as its stated goal "to promote and assist the development of effective and efficient legal regimes for secured transactions in the contexts of international law, United States domestic law, and the domestic law of other nations."[57] Those goals are stated in the somewhat non-specific language in which institutions such as the ALI often articulate their objectives. A closer look is required to get a good sense of the project, both functionally and operationally.

55. "Contracting states" are nations that have signed and ratified the Convention.

56. *See* UNCITRAL Receivables Financing, *supra* note 31, art. 23(4).

57. *See* Neil B. Cohen, The International Secured Transactions Project: A Proposal and Outline 3 (1997) (copy on file with the *Texas International Law Journal*) [hereinafter International Secured Transactions Project].

The proposal for the International Secured Transactions Project identifies two functions for it. The first is "participation in the United States component of international lawmaking."[58] While the contours of this involvement remain to be developed, the ALI anticipates cooperative involvement with the Office of Private International Law of the State Department's Office of Legal Adviser in the process by which the United States negotiates and ratifies international conventions related to international secured transactions.[59] Noting that the development of international commercial law is not only critically important in its own right and has a significant impact on domestic law and commerce generally, the Project's proposal points out that such international law will have its greatest impact in areas that are now governed domestically by the U.C.C.[60] Thus, as international transactions make up an increasing portion of the economy, the law governing those transactions will increasingly displace the U.C.C. if the two do not develop harmoniously. The U.C.C., of course, is a joint product of the ALI and the National Conference of Commissioners on Uniform State Laws (NCCUSL). By participating in the negotiation and ratification processes, the ALI will also be continuing its long-term investment in developing American commercial law.

The second function identified for the International Secured Transactions Project is the facilitation of the international development of secured transaction regimes.[61] This development may have three aspects. First, the Project hopes to play a helpful role in developing domestic law governing secured transactions in other nations.[62] As World Bank studies have demonstrated, the absence of efficient legal regimes governing secured transactions significantly diminishes the economic output of many nations.[63] Realization of the economic effect of secured transactions law has led a number of countries to consider establishing or modernizing their legal systems in this regard. The International Secured Transactions Project will try to facilitate this legal development by functioning as a resource center for nations embarking on efforts to formulate modern secured transactions law.[64] In this role, the Project can provide expertise and consultative services, as well as model legislation (and articulate the legal and economic theory supporting it) for such lawmaking efforts.

Second, the Project will set out to be a significant force in developing the common consensus necessary to accomplish broad-based international secured transactions law reforms.[65] The current UNCITRAL and UNIDROIT efforts to develop international rules in the area of secured transactions are confined to particular business contexts. While those contexts (mobile goods and receivables financing) are important, even if both efforts are successful the law governing those transactions will fall short of a broad and integrated international secured transactions system. Yet breadth and integration are often seen as two of the reasons that U.C.C. Article 9 has been such a resounding success. However, the UNCITRAL and UNIDROIT efforts can, if handled properly, be useful precursors to such broad-based law making. The Project might well play a role in building a consensus for general legal rules governing international secured transactions from the successes of more particularized endeavors.

Third, while U.C.C. Article 9 has served the United States's internal commercial interests well, it is likely that the domestic legal system of which Article 9 is a part might,

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58. *Id.* at 4.
59. *See id.* at 6.
60. *See id.* at 4–5.
61. *See id.*
62. *See id.* at 4.
63. *See, e.g.*, World Bank Report, *supra* note 8.
64. *See* International Secured Transactions Project, *supra* note 57, at 5.
65. *See id.*

from time to time, need augmentation in order to appropriately facilitate and govern international secured transactions. Efforts in that regard are already being undertaken within the Article 9 revision process and are likely to be considered in the U.C.C. Article 1 revision process, as well.[66] Nonetheless, both of those projects are of finite duration, culminating in the promulgation of revised drafts of those articles. Yet, the need for accommodation of international transactions will continue indefinitely and might involve the development of legal rules outside the U.C.C. context. Thus, the International Secured Transactions Project may also serve the role of sounding the alarm when there is a need for domestic law to adjust in order to accommodate international commerce, as well as taking the lead in developing needed legislation.

## IV. CONCLUSION

The events of the last decade have given us an opportunity to harmonize the law of secured credit to an extent not imaginable only twenty years ago. Harmonization efforts, if successful, can lower the cost of international credit transactions, making more credit available at a lower cost. The potential benefit of harmonization is so great that it has generated multiple harmonization efforts, yet only the passage of time will determine which efforts, if any, succeed. The increasing globalization of the credit economy suggests, however, that the prospects are significantly greater than in the past.

66. *See Uniform Law Commissioners Drafts* <http://www.law.upenn.edu/library/ulc/ulc.htm> (containing drafts and Reporter's Notes for proposed revised U.C.C. §§ 1-302, 9-307 (Sept. 1997 draft)).