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# Legal Infrastructure for Promoting SME Finance: a regional survey of issues



## *Executive Summary*

- In general, security enforcement regimes in most APEC jurisdictions are intended to encourage provision of credit to commercial borrowers by recognising and protecting the expectations of senior-secured lenders and providing legal certainty in the event of borrower insolvency.
- However, a number of important gaps remain. Absence of a clear legal framework to enforce rights of secured lenders is an impediment to credit availability, disproportionately affecting SME's and other businesses that have historically had difficulty accessing bank credit.
- An APEC initiative to improve and harmonize standards for perfection and enforcement of security interests in collateral, as part of a system for developing a robust commercial finance market, would promote innovative financial products, enhance overall liquidity for the SME sector, and advance the goal of financial sector inclusion and sustainable growth.
- In addition to facilitating financing for SMEs, a harmonized approach would promote regional investment and trade in financial services in the APEC region.



## ABAC 2009 Report to Economic Leaders

- (R) Strengthening and Deepening the Region's Capital Markets
  - 2. Improving Regulatory Frameworks
    - (c) Building Financial System Infrastructure to Facilitate SME Finance

The development of financial system infrastructure as well as appropriate supporting regulatory and legal frameworks, will be vital to facilitating the financing of enterprises, particularly SMEs, and eventually to restoring confidence and growth. Key areas that should be given attention are promoting commercial lending through an enhanced secured lending framework; promoting improved risk management through modernized credit information; and improving the regulatory process, transparency and predictability of the judicial system.

Secured lending requires legal and judicial infrastructure to ensure predictability. Asset-based lending and secured financing remain in many cases at less than their full potential to provide needed corporate liquidity, particularly for SMEs.

### *Recommendation*

Undertake initiatives to promote a more predictable legal architecture for secured lending, including an exclusively available system for registering and perfecting security interests in both movables and receivables as collateral, efficient judicial procedures for enforcement of security interests, and clear regulations around asset-based lending requirements to further enable both lenders and borrowers to assess risk and enhance sound credit and lending activities.



## Some Issues in Secured Lending Legal Infrastructure

- Absence of Exclusive Security Interest Registry
  - “Hidden Lien” Problem
- Voidable Conversion/Preference
- Unclear Perfection Rules for Certain Types of Collateral
  - Movables
  - Receivables
  - Goodwill
- Absence of Blocked Account Security Precedence
- Untested Debtor-in-Possession (“DIP”) Process
- Treatment of Floating Charges or Absence of such Concepts
- Lack of Broad Licensing Authority for Commercial Lending



## Northeast Asia Overview

1. Dual Transfer Perfection Methods for Receivables and Movable Assets —Hidden Prior Transfers/Liens
  - Current dual system
    - Civil Code: delivery in the case of movable assets and notice to/acceptance by debtor with a certified date in the case of receivables
    - Law Regarding Special Cases to the Civil Code Regarding Perfection of Transfer of Receivables and Movable Assets (“Special Law”) : registration
      - priority decided chronologically
  - Issue
    - one cannot check the priority of claim merely by checking the registration records. Under such circumstance, lenders may hesitate to take receivables or movable assets as collateral in the fear of potentially preceding transfer/pledge.
  - Desirable solution
    - Consolidating into a single perfection system would solve this issue.
    - Looking into potential amendments to the section on receivables under the Civil Code through study groups and this unified perfection system should be explored in their discussion.



## Northeast Asia Overview (2)

- 2.No Specified Claw Back Period for Voidable Actions/Preferences in Bankruptcy Proceedings
  - Addition of a specified claw back period could enhance financings to struggling companies.
3. No Security in Goodwill
  - There is no concept of security in goodwill.
4. Security in Bank Account Used in the Market but no Court Precedent for Validation
  - It is not uncommon to pledge the bank account as collateral (precisely rights to request the bank to repay the money deposited in the bank account); however, due to the lack of court precedent, it is not 100% certain whether such pledge is valid.
  - Many parties in the finance world are waiting for a court precedent on this issue.
5. No Super Priority Claims for DIP Lenders
  - No system to give strong protection to DIP lenders, such as super priority or priming lien in US. It is not entirely clear how the claims held by DIP lenders would be treated in terms of priority.
  - Introduction of super priority claims and priming lien for DIP lenders could facilitate DIP finance.
6. Broad concept of fiduciary duty which prohibits almost all upstream guarantee or security in leveraged buyout transactions
7. Ability of Court to Confirm Plan that Binds Dissenting Creditors in Corp Rehab Proceeding



## *China - Overview*

1. Unclear registration system for recording priority of lenders; and consequent lack of clarity in courts' approach in determining priority of competing security interest.
2. No centralized registration system for the pledge of movable assets (i.e. difficult to identify the true owner and the encumbrance status of movable assets).
3. Lack of registration authority for certain kinds of interests.
4. Lack of precedence of enforcement of registered floating charges
5. PBOC Credit Bureau's database only covers a small part of SMEs (i.e. hard to ascertain the borrower / guarantor's credit)
6. PBOC Credit Bureau's database is not open to non-CBRC regulated finance entities.
7. SAFE approval / registration required for international lending and difficult to obtain such approval if the borrower is a domestic entity.
8. Practical obstacles in enforcing a court judgment / arbitration award.



## *SE Asia Overview*

1. Fraudulent Preference (6 months for both HK and Singapore) & Avoidance of Floating Charge (12 mths for HK, 6 months for Singapore)
2. Future Fixed Charge Ranks Ahead of Earlier Floating Charge
3. Automatic Stay in Liquidation Procedures
4. Whitewash Needed for Upstream Guarantee and Security
5. No duty to search public register prior to financing and subsequent secured creditors are not deemed to have notice of the terms of prior registered charges.



## Australia - Overview

### Australia (Current):

1. More than 70 Commonwealth, State and Territory Acts regulate personal property securities with some major inconsistencies.
2. The law and practice concerning a particular personal property security vary depending on:
  - the legal form of the grantor (for example, company, individual or other entity)
  - the State or Territory in which the personal property is located
  - the legal form of the personal property security (for example, fixed and floating charges, chattel mortgages, finance leases, commercial consignments including retention of title arrangements, and pawns), and
  - the nature of the personal property (for example, motor vehicles, investment instruments or livestock).



## Australia - Overview

### Australia (New System):

3. On 2 July 2009 the Council of Australian Governments (COAG) decided that PPS Reform should be implemented in May 2011. In doing so, COAG acknowledged the importance of allowing an adequate transition time for businesses and consumers to accommodate this and other changes, including the global financial crisis.
4. In April 2007, COAG agreed in principle that a national PPS system be implemented by Commonwealth legislation, supported by referral of powers from the States.
5. The Personal Property Securities Act 2009 was passed in November 2009. The Act will commence in May 2011 (but the PPS register will be available from May 2010 to allow for familiarization with the new regime).
6. The PPS Register created under the Act will replace most of the 70 current acts regulating security interests, the existing register of company charges maintained by the Australian Securities and Investments Commission, the register of co-operative charges established under the uniform Co-operatives legislation, the REVS registers maintained by a number of States and Territories for motor vehicles, and a number of instruments, bills of sale and security interests in goods registers maintained by the States and Territories.
7. The Act will regulate security interests in all tangible and intangible goods except for interests in land which remain subject to the State based land registries.



## *New Zealand - Overview*

### **1. Publicly available register (“PPSR”) for registration of all security over “personal property” since 2002.**

“Personal Property” includes all types of collateral (including leases of collateral) other than large ships and land. PPSR determines priority and perfection of security interests in collateral. Market practice for financiers to separately agree priority limits over “fixed and floating” charges. Romalpa clause alone not effective against 3<sup>rd</sup> parties must also register ROT arrangements on PPSR. NZ laws adopted from Canada and form the framework for proposed Australian reforms.

### **2. RISKS**

Failure to register on PPSR prohibits ability to enforce security over collateral.

Under NZ law must re register security interests on PPSR every 5 years or security will automatically lapse.

On-leasing to 3<sup>rd</sup> parties remains a risk if robust registration procedures not in place.

Sale of collateral in the “ordinary course of business” extinguishes security interest automatically.

### **3. BENEFITS**

One register creates greater transparency and confidence.

Improved risk management via accessible & real time security register.



## *Comparative View - India*

1. India has a legal framework regulating creation and perfection of security; however, enforcement of security is an issue. Litigation is too time-consuming, affecting lenders' ability to rely on judicial recovery and making them less likely to lend to SMEs.
2. SARFAESI Act provides fast track enforcement; however, SARFAESI protection is available only if a loan is an “NPA” (which requires a payment default to exist for at least 90 days + 60 days notice under SARFAESI thereafter) and it is available to only specific lenders. There is no SARFAESI protection for NBFCs.
3. No uniform system to monitor borrower credit history.
4. SMEs may have various forms, such as corporate, sole proprietorship, Hindu United Family/Family Business, partnership, Association of Persons, trusts, co-operative societies, societies etc. The Indian Companies Act, 1956 requires only companies to submit a record of security created on their assets. No other legal entity is required to mandatorily register security interests, making SME security verification difficult.
5. Winding up and consequent distribution of assets to satisfy lender dues is effectively available only against companies. For other legal structures, the governing law may effectively negate the ability of a lender to wind up a borrower (such as co-operative societies, HUFs, ) and in some structures personal bankruptcy proceedings need to be initiated rather than winding up proceedings.
6. Self-executing treaties (e.g. Cape Town Convention) not valid until national legislation passed, even if ratified by GOI.



## Proposal for APEC SME Financing Initiative

- Survey of Key Enablers of Financing Availability
- Model Elements of “APEC Code” of Security Interest Creation, Perfection and Enforcement
  - Clear Perfection Rules
  - Broad Coverage of Collateral Types
  - Exclusivity (Eliminate “Hidden Liens”)
  - Provisions for Debtor-in-Possession (“DIP”) Financing
- Model Treatment of Floating Charges/AR Financing
- Public/Private Dialogue to Validate Improvements
- APEC “Checklist” for Statutory/Regulatory Implementation
- Promote Broad Licensing Authority for Commercial Finance
  - NBFC Charters, etc.