

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

Document: AGFSCB 33-050
Draft: **FIRST**
Source: APCC/GE Capital
Date: 9 July 2013
Meeting: Kyoto, Japan

Third Meeting 2013

10 July 2013

7:30 AM – 9:30 AM

Gyoun Room, Kyoto Hotel Okura

Kyoto, Japan

Meeting Paper 5-B

Elements of Model Code of Security Interest Creation, Perfection & Enforcement

APCC/GE Capital

<i>PURPOSE</i>	For consideration.
<i>ISSUE</i>	Elements of Model Code of Security Interest Creation, Perfection & Enforcement
<i>BACKGROUND</i>	In 2012, the Advisory Group and ABAC recommended the development of an APEC Model Code of Security Interest Creation, Perfection and Enforcement.
<i>PROPOSAL</i>	Recommend the endorsement by APEC Finance Ministers of proposed elements of the model code as contained in this document.
<i>DECISION POINT</i>	Agree to recommend.

INTRODUCTION

This document contains elements for a Model Code to enhance the legal architecture for security interest creation, perfection and enforcement for secured lending, including Asset Based Lending (“ABL”) which utilizes account receivable and movable assets.

For many mid-market companies, access to ABL is an important component of liquidity for working capital and growth. Even big corporates use ABL for working capital when they are in financial trouble and when traditional financial statement lending is not sufficient.

However, in many economies in Asia, gaps in legal regimes for secured lending, especially ABL, discourage lenders from providing new credit to such borrowers. Promoting an enhanced legal environment will grant more assurance to the ABL lenders, which in turn will lead to more liquidity to such borrowers. Thus, it is in the interests of both potential lenders and borrowers of ABL that development of ABL markets enhances the liquidity of potential borrowers and business opportunities of the potential lenders.

We would hereby like to raise a few fundamental elements of Model Code of security interest creation, perfection and enforcement so that the Model Code to be made in the future will function to enhance security of lenders and accommodate funding needs of potential borrowers of ABL.

General Characteristics as collateral

1. The Model Code should define the scope of asset types. The scope of asset types should include, but not limited to, the following:
 - (1) Receivable, including account receivable, installment receivable, loan receivable, credit card receivable and other types of contractual obligation of third parties
 - (2) Inventory, including retail, wholesale and manufacturers
 - (3) Machinery & equipment

It would be better for the scope to cover many types of assets, so long as this does not conflict with the scope defined in local law. We excluded intellectual properties from the scope since security interests on intellectual properties highly depend on local law.

The Model Code should cover existing assets and future assets, which the borrower will acquire in the future. Providing for a security interest in after-acquired collateral will reduce risks for lenders and thus result in more liquidity for the borrowers. This is similar concept of “After-acquired collateral” under UCC. Please see **Uniform**

Commercial Code § 9-204. After-acquired Property; Future Advances (P6).

2. A secured party should not receive from the disposition more proceeds of collateral than the claim. Proceeds received in excess of the claim should be returned to the borrower. This general characteristic is also mentioned in UNCITRAL Legislative Guide on Secured Transactions. Please see **UNCITRAL Legislative Guide on Secured Transactions: Terminology and Recommendations**, *Distribution of proceeds of disposition of an encumbered asset* (P7).
3. When a secured party sells/transfers/assigns their interests in loans to a third party, the security interests associated with the loan should be transferred to the buyer/transferees/assignees of the loans.

Enforceable Floating Charge/Process of enforcement

1. When ABL goes into Event of Default, the lenders of ABL may want to liquidate inventory collateral in order to pay down ABL. However, since the quality and quantity of inventories change very rapidly due to the frequent purchasing and selling by the borrowers, if the lenders cannot enforce security interests in the inventory, they may face a significant drop in the value of the inventory. Similarly, if the lender cannot enforce security interests in the receivable, borrowers of ABL may continue to spend the cash, paid to them in the form of receivables, for their working capital purpose, which may cause drop of value of collateralized receivable. Therefore, without the assurance that they can enforce security interests in a timely manner, it can be difficult for the lenders to provide loans, depending upon the value of collateral.
2. To ensure smooth enforcement, it is required that a clear process of enforcement is defined under the Model Code, otherwise the process depends on security agreement between secured party and borrower. Bearing in mind the changing quality of collateral during course of enforcement, this process should be completed within a reasonable time period to minimize the loss of value.
3. A secured lender may want to acquire collateral using their total or partial secured claim instead of cash at the auction. The law should provide a rule with regard to this type of bid (“Credit Bid”). This is mentioned to UNICITRAL Legislative Guide on Secured Transactions. Please see **UNCITRAL Legislative Guide on Secured Transactions: Terminology and Recommendations**, *Acquisition of an encumbered asset in satisfaction of the secured obligation* (P7).

Perfection of Security Interests/Priority

1. Perfection of security interests¹ of collateral is very important for ABL lenders. Without perfection, a third party creditor of the same borrower may claim that they also have the right to receive a part of proceeds from the assets when collateral is liquidated, and the original ABL lender may lose priority claim against the proceeds. A claim based on the value of security interests without perfection will not be admitted as a secured claim by the bankruptcy court when ABL borrower files for bankruptcy protection. This leads to an unsecured claim status and usually results in significant portion of loss.
2. Methods of perfection vary depending on laws in the countries and multiple methods of perfection often cause confusion in the priority of collateral. For example, when two creditors perfect their security interests through the same method, the one who perfected their security interest first will have priority over the other. However, when two creditors perfect their security interests through different methods, which creditor will have priority? Thus it is important to establish a single provision defining the priorities among conflicting security interests in the Model Code. The Model Code should provide that security interests perfected by registration should have priority to security interests perfected by other methods regardless of order of perfection. Exceptions to this rule, such as the retention of title & tax lien, etc., should be narrow and clearly defined under Model Code. This concept is written in UNCITRAL Legislative Guide on Secured Transactions. Please see **UNCITRAL Legislative Guide on Secured Transactions: Terminology and Recommendations** *Priority of preferential claims* (P8).
3. If junior security interests are admitted under Model Code, junior lenders may extend credit based on the value exceeding the amount which first lien holder can lend and result in more funding than without concept of junior lien.

Transparency of Security Interests

1. Security interests should be transparent; any third party that should desire should be granted access to records identifying the existence of security interests in the assets easily and timely without significant costs. A centralized registration system would be effective to achieve such goal. Under the Japanese Civil Code, there are methods to perfect receivable and movable assets in a form other than registration. Liens perfected through such methods are not publicly notified. If different parties are to perfect their security interests over the same collateral, priority among the conflicted security

¹ Security interest that are made effective against third party

interests are determined by the date of perfection, in other words, security interest holder with earlier perfection will have priority. Therefore, it is impossible to prove that there are no prior hidden liens to the registered lien, which may have priority over registered security interests. To avoid such a nontransparent situation, it is recommended that although exceptions may exist, basically registered security interests should have priority over the lien perfected by other methods regardless date of perfection and exception and limitation of the exception should be clearly mentioned in the law.

2. There are two types of functions of registration, one is public notification and the other is identification of assets subject to lien. UCC filing system in the US places priority on public availability of record of existing lien. Usually filing documents do not tell details of assets (characteristics, quantity, location, etc.) subject to lien; the details are described in pledge agreement between borrower and lender of ABL. On the other hand, filing documents, which identifies assets subject to lien, is very important in Japan. Effectiveness of perfection may be affected by the description of assets subject to lien in filing documents.
3. Ease of search and registration can be achieved if registration places priority on public notification, like UCC, rather than identification of assets subject to lien. Anybody will be able to register security interests and see whether security interests have been recorded or not through the centralized registration system. It is preferable that researching existing lien, registering security interests, and deregistering the security interests can be done electronically with reasonable costs and quickly. Practically even before finalizing security agreement, it is preferable that registration can be done. Good example is UCC search in US.

As for sufficiency of information under UCC filing, please see **Uniform Commercial Code § 9-502. CONTENTS OF FINANCING STATEMENT; RECORD OF MORTGAGE AS FINANCING STATEMENT; TIME OF FILING FINANCING STATEMENT.** (a) [Sufficiency of financing statement.] and **§ 9-504. INDICATION OF COLLATERAL.** (2) (P7)

As for registration before completion of security agreement, please see **Uniform Commercial Code § 9-502. CONTENTS OF FINANCING STATEMENT; RECORD OF MORTGAGE AS FINANCING STATEMENT; TIME OF FILING FINANCING STATEMENT.** (d) [Filing before security agreement or attachment.] (P8)

Assignability of Account Receivable

1. The Model Code should provide that lien on receivables can be created and perfected regardless of non-assignment clause. In Japan, lien on receivables is placed through assignment of receivable from the assignor, ABL borrower, to the assignee, ABL lender. If the receivable is subject to non-assignment clause, which is usually put in sales/supply/service contracts between ABL borrower and their customers, creation of lien is invalid under Civil Code. Therefore, receivable with good quality cannot be utilized as collateral of secured lending. Currently we are in discussion to change Civil Code and one of the agendas is treatment of lien on receivables subject to non-assignment clause.
2. Even if assignment and/or perfection of account receivable with non-assignment clause is legally effective, creditors who want to lend money backed by collateral of account receivable may be concerned that by the assignment of an account receivable with non-assignment clause, borrower will breach non-assignment clause of their sales/service contracts with their clients and that may result in compliance issue, i.e. forcing borrower to breach the provision of contracts by taking security of account receivable. The Model Code should provide protection for the assignor of the account receivable against potential claim/liability arising from breaching the non-assignment clause and the counter party of sales/service contracts cannot terminate the contracts solely because of the breach. Legislative Guide on Secured Transactions by UNCITRAL also pointed the same point. Please see **UNCITRAL Legislative Guide on Secured Transactions: Terminology and Recommendations** *Effectiveness of an assignment of a receivable made despite an anti-assignment clause.* (P9)

Consistency with Insolvency Law

1. Some countries in Asia adopt a bankruptcy law for reorganization/rehabilitation of the borrowers. In such countries, borrowers in financially difficult situations may file for bankruptcy to protect themselves. Conflict arises between protection of borrower under insolvency law and protection of secured party under security law. Borrower wants to avoid liquidation of assets to keep operation while secured lenders want to be paid before value of assets is eroded.
2. While the borrowers must use proceeds from account receivable and sales of inventory to survive under bankruptcy, the account receivable and the inventory are pledged to ABL lender and ABL lender should be entitled to receive those proceeds. If ABL lender allows the borrower to use those proceeds and borrower does not allow ABL

lender to take collateral of after-acquired assets, including account receivable and inventory, value of collateral will decrease as time goes by, on the other hand, if ABL lender does not allow borrower to use those proceeds, borrower will run out of cash in the meantime. That means there is a conflict between security law and insolvency law. Therefore, it will be preferable to discuss the treatment of pre-petition security interests on account receivable and inventory that are essential assets for the borrower to keep operation under bankruptcy so that the secured lender's position will not be impaired under bankruptcy and so that the borrower can survive under bankruptcy.

As for protection from diminution of the value of collateral, please see **UNCITRAL Legislative Guide on Insolvency Law: Terminology and Recommendations** *Protection from diminution of the value of encumbered assets* (P10).

As for use and disposal of assets/cash, please see **UNCITRAL Legislative Guide on Insolvency Law: Terminology and Recommendations** *Power to use and dispose of assets of the estate, Use of cash proceeds* (P10 & 11).

Criminal charge

The introduction of a criminal charge on obstruction of enforcement of security interests is very important to secure recovery from collateral disposition. Without a criminal charge, illegal interruption will make enforcement difficult or take unnecessary period of time, and this may cause a decrease in recovery of claim.

Criminal charge on fraudulent transfer of assets or fraudulent accounting is also important to decrease the risks of those illegal conducts, which jeopardize ABL lender's position. Fraudulent transactions and/or fraudulent accounting bring risks which ABL lender do not assume when they analyze credit. If the borrower commits those types of conducts, they cause a significant negative impact on credit and security of ABL.

Appendix

Uniform Commercial Code

§ 9-204. After-acquired Property; Future Advances

(a) [After-acquired collateral.]

Except as otherwise provided in subsection (b), a security agreement may create or provide for a security interest in after-acquired collateral.

(b) [When after-acquired property clause not effective.]

A security interest does not attach under a term constituting an after-acquired property clause to:

- (1) consumer goods, other than an accession when given as additional security, unless the debtor acquires rights in them within 10 days after the secured party gives value; or
- (2) a commercial tort claim.

(c) [Future advances and other value.]

A security agreement may provide that collateral secures, or that accounts, chattel paper, payment intangibles, or promissory notes are sold in connection with, future advances or other value, whether or not the advances or value are given pursuant to commitment.

UNCITRAL

Legislative Guide on Secured Transactions: Terminology and Recommendations

Distribution of proceeds of disposition of an encumbered asset

152. The law should provide that, in the case of extrajudicial disposition of an encumbered asset, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. Except as provided in recommendation 153, enforcing secured creditor must pay surplus remaining to any subordinate competing claimant that, prior to any distribution surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of the amount of that claim. The balance remaining, if any, must be returned to the grantor.

UNCITRAL

Legislative Guide on Secured Transactions: Terminology and Recommendations

Acquisition of an encumbered asset in satisfaction of the secured obligation

156. The law should provide that, after default, the secured creditor may propose in writing to acquire one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

UNCITRAL

Legislative Guide on Secured Transactions: Terminology and Recommendations

Priority of preferential claims

83. The law should limit, both in type and amount, preferential claims arising by operation of law that have priority as against security rights and, to the extent preferential claims exist, they should be described in the law in a clear and specific way.

Uniform Commercial Code

§ 9-523. INFORMATION FROM FILING OFFICE; SALE OR LICENSE OF RECORDS.

(f) [Public availability of records.]

At least weekly, the [insert appropriate official or governmental agency] [filing office] shall offer to sell or license to the public on a nonexclusive basis, in bulk, copies of all records filed in it under this part, in every medium from time to time available to the filing office.

Uniform Commercial Code

§ 9-502. CONTENTS OF FINANCING STATEMENT; RECORD OF MORTGAGE AS FINANCING STATEMENT; TIME OF FILING FINANCING STATEMENT.

(a) [Sufficiency of financing statement.]

Subject to subsection (b), a financing statement is sufficient only if it:

- (1) provides the name of the debtor;
- (2) provides the name of the secured party or a representative of the secured party;
and
- (3) indicates the collateral covered by the financing statement.

(b) [Real-property-related financing statements.]

Except as otherwise provided in Section 9-501(b), to be sufficient, a financing statement that covers as-extracted collateral or timber to be cut, or which is filed as a fixture filing and covers goods that are or are to become fixtures, must satisfy subsection (a) and also:

- (1) indicate that it covers this type of collateral;
- (2) indicate that it is to be filed [for record] in the real property records;
- (3) provide a description of the real property to which the collateral is related
[sufficient to give constructive notice of a mortgage under the law of this State if

the description were contained in a record of the mortgage of the real property];
and

(4) if the debtor does not have an interest of record in the real property, provide the name of a record owner.

(c) [Record of mortgage as financing statement.]

A record of a mortgage is effective, from the date of recording, as a financing statement filed as a fixture filing or as a financing statement covering as-extracted collateral or timber to be cut only if:

- (1) the record indicates the goods or accounts that it covers;
- (2) the goods are or are to become fixtures related to the real property described in the record or the collateral is related to the real property described in the record and is as-extracted collateral or timber to be cut;
- (3) the record satisfies the requirements for a financing statement in this section other than an indication that it is to be filed in the real property records; and
- (4) the record is [duly] recorded.

(d) [Filing before security agreement or attachment.]

A financing statement may be filed before a security agreement is made or a security interest otherwise attaches.

Uniform Commercial Code

§ 9-504. INDICATION OF COLLATERAL.

A financing statement sufficiently indicates the collateral that it covers if the financing statement provides:

- (1) a description of the collateral pursuant to Section 9-108; or
- (2) an indication that the financing statement covers all assets or all personal property.

UNCITRAL

Legislative Guide on Secured Transactions: Terminology and Recommendations

Effectiveness of an assignment of a receivable made despite an anti-assignment clause

24. The law should provide that:

- (a) An assignment of a receivable is effective as between the assignor and the assignee and as against the debtor of the receivable notwithstanding an agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables;

- (b) Nothing in this recommendation affects any obligation or liability of the assignor for breach of the agreement mentioned in subparagraph (a) of this recommendation, but the other party to such an agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;
- (c) This recommendation applies only to assignments of receivables:
 - (i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;
 - (ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;
 - (iii) Representing the payment obligation for a credit card transaction; or
 - (iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

UNCITRAL

Legislative Guide on Secured Transactions: Terminology and Recommendations

Protection from diminution of the value of encumbered assets

50. The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest. The Court may grant appropriate measures of protection that may include:

- (a) Cash payment by the estate;
- (b) Provision of additional security interests; or
- (c) Such other means as court determines.

UNCITRAL

Legislative Guide on Secured Transactions: Terminology and Recommendations

Power to use and dispose of assets of the estate

52. The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Use of cash proceeds

59. The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

- (a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or
- (b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.