CORE PRINCIPLES FOR A REGIME OF SECURITY ON PROPERTY

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INTRODUCTION

The overall objective of a legal regime of secured transactions is to promote the availability of low-cost credit in order to facilitate the successful operation and expansion of domestic businesses and improve their ability to compete domestically and in the global marketplace.

To this end, a legal regime must be designed in a manner that is effective, efficient and responsive, and that is sufficiently harmonized with secured lending regimes in other States so that commerce between and among them may be promoted.

The seven principles that follow attempt to signal the key structural and policy goals that should be pursued in the elaboration of such a legal regime.

PRINCIPLE ONE: COHERENCE WITH PUBLIC POLICY AND LEGAL TRADITION

A regime of security on property is an adjunct to the regime of debtor-creditor relationships and should reflect a balance between the legitimate public policy goals of States as these are reflected in their regulation of basic concepts of status, property and obligations, and the principle of freedom of contract.

Corollaries:

1. **No impressment of physical persons.** A regime of security on property implies the affectation of property to ensuring the enforcement of obligations. It should not tolerate either direct enforcement against people -- whether through slavery, debtor's prison, the impressment of future and unearned wages -- or indirect enforcement against persons through legislative provisions making the failure to pay a debt a criminal offence.

2. **Promotion of freedom of contract where possible.** A regime of freedom of contract, like a regime of private property, is a political choice that States make in order to achieve various distributional goals. Consequently, while freedom of contract should underpin this sub-set of the law of security on property, it must be

well integrated into the overall logic of debtor-creditor relationships adopted by particular States.

3. **Regulating wealth redistribution.** A regime of security on property is necessarily wealth redistributing. Consequently, States should be entitled to establish the conditions under which different forms of wealth transfers as between classes of creditors (for example, secured, privileged, and unsecured) should be permitted.

4. **Not a stand-alone field of legal regulation.** The foundational logic of a regime of security on property should be consistent with other basic principles of debtor-creditor law in a given jurisdiction -- notions of status, property, contract, civil liability, civil procedure, exemptions from seizure, execution of judgements and execution priorities.

5. **Integration with insolvency and bankruptcy regulation.** A regime of security on property should be cast so that it can be efficiently integrated into cognate legal regimes such as banking, negotiable instruments, interest regulation and especially, insolvency and bankruptcy regulation.

PRINCIPLE TWO: EFFICIENCY THROUGH COMPREHENSIVENESS

To the extent possible, a regime of security on property should be comprehensive as to all the elements of the security nexus -- debtors, creditors, obligations, collateral -- and no central part of the regime should be relegated to external sources or extraneous legislation.

Corollaries:

1. **Avoiding uncertainties and unfair inequality of access.** One of the most striking features of modern law is its potential universality. With the advent of a credit and consumer economy, the range of secured debtors expands enormously. With the development of pension funds, mutual funds and other capital pools, it is no longer the case that banks, insurance companies, trust companies and brokerages have a *de facto* monopoly on large financing transactions.

   Hence, the regime should be comprehensive in order: (1) to minimize regulatory uncertainties or unfair inequality of access to the regime; (2) to avoid creating inadvertent gaps; (3) to ensure the best integration possible of competing regulatory regimes; (4) to promote competition on the cost of credit among purveyors of credit to businesses; and (5) to prevent debtors and creditors from artificially manipulating their status, the character of their obligation or the legal nature of their assets so as to either (a) escape, or (b) fall under, the regulatory

regime.

2. **Seeking universality of coverage of classes of debtors and creditors.** Parties should generally not be required to engage in a preliminary analysis of their legal status in order to determine how the regime applies to them. The basic principles of the regime should embrace both consumer and commercial debtors and creditors. They should embrace both corporate and non-corporate debtors and creditors. They should embrace both private and public bodies. They should embrace both domestic and foreign-based debtors and creditors.

3. **Seeking comprehensive coverage of types of secured obligations.** The regime should embrace security meant to guarantee the performance of all types of credit obligations -- whether these are obligations to do, not to do, or to give. It should embrace both balance of purchase (vendor) credit obligations and general financing (lender) credit obligations. It should embrace security arising both in respect of consensual and non-consensual credit obligations. It should embrace all forms of credit obligations, whether these are initially cast in terms of monetary obligations or whether they are only reducible to a monetary obligations at the time enforcement is sought.

4 **Integrating the treatment of diverse types of collateral.** As the range of debtors and secured obligations expands, so too does the leverage of collateral. The regime should seek to expand the range of assets over which security can be granted. It embrace security on both moveables and, to the extent moveables are affixed to immoveables or immoveables are potentially severable into moveables, should also regulate the security effects of such changes of characterization. The regime should embrace security on both corporeals and incorporeals. It should embrace both present and future property. It should embrace both individual assets and universalities. It should embrace the regime of intellectual property.

PRINCIPLE THREE: EFFICIENCY THROUGH FUNCTIONAL ANALYSIS

In principle, the same regime of capacity to grant security, eligible collateral, pre-default rights and obligations, secured creditors' recourses, and general theory of publicity of secured rights should apply regardless of the origin or form of the security right.

Corollaries:

1. **Overcoming acrobatic techniques to retain or transfer of title.** Creditors who seek to use conditional rights of property and other devices to such as trusts, leases and consignments to achieve a security right should be subject to the same regime.

2. **Overcoming legislative subversion of the regime.** Except where a compelling

public policy rationale can be advanced for differential treatment, the mechanisms of non-consensual security regimes should track those of consensual security.

3. **Preventing strategic choice of publicity regimes.** While publicity may be achieved in diverse ways -- for example, possession or registration -- and while the registries may be designed to be searchable in different ways -- for example, by identifying the collateral or identifying the debtor -- the *inter partes* and third party effects of publicity should be the same regardless of mechanics of the publicity regime.

PRINCIPLE FOUR: EFFICIENCY BY PROMOTING PARTY AUTONOMY

The logic of the regime should be as a simple as possible and the legislature should decide questions having to do with definition and distribution of entitlements in the regime from an "ideal-type" perspective that maximizes the efficiency potentialities of a consensual regime of security on property and that permits enterprises to deploy assets to greatest advantage in the ongoing operation of their businesses.

Corollaries:

1. **Avoiding technical barriers to contractual freedom.** Once the scope of credit transactions appropriate for private determination is settled, the regime should be designed to facilitate parties' legitimate desires. Non-substantive (that is, not reflecting a legitimate public policy goal) and technical barriers to contractual freedom should be eliminated. Technical barriers should not be used as an alternative to direct legislative regulation where this is deemed necessary.

2. **Facilitating the achievement of the parties' business purposes.** The regime should take notice of the intentions, interests and behaviour of ideal creditors and debtors so as to best instantiate the concept of a security right. The regime should as closely as possible resemble the regime of rights and obligations that the parties would themselves choose to achieve their purposes.

3. **Liberating collateral for its most effective deployment by a business.** The regime should permit debtors to grant security over business assets without unduly limiting the use of these assets for legitimate business purposes and, in particular, should facilitate the granting and taking of non-possessory security.

PRINCIPLE FIVE: EFFICIENCY THROUGH INTELLIGIBLE RULES

Public order or imperative rules should only be deployed to establish the rules of the game

that parties are permitted to play, and these as well as all other rules should be drafted in language that is clear, comprehensive and accessible.

Corollaries:

1. **Achieving transparency through linguistic elegance.** All rules of the regime should be drafted in a manner that is intelligible to non-lawyers.

2. **Avoiding the overuse of imperative or public order rules.** Imperative rules should strive to create the possibility of choice for parties, and should limit or prohibit choices only for reasons of unfairness or perverse distribution of burdens upon the parties to the transaction or to third parties. Except in cases where the default regime closely models the choices parties would themselves make and can facilitate contractual ordering, suppletive rules should be avoided.

3. **Avoiding superficial non-substantive distinctions.** The regime should avoid making superficial distinctions of form where there are essential identities of substance. Legislative texts should state clearly the policy choices being made and should anticipate and regulate primary litigation points.

4. **Avoiding legal fictions, neologisms and expressions of presumed intent.** Legal fictions should be avoided or purged. Neologistic expressions should not be used to redescribe relatively well-understood legal institutions. The regime should not mandate an implied intent either by creditors or debtors.

5. **Avoiding deemed valuations.** The regime should not presume outcomes -- for example, what is a commercially reasonable price upon realization -- that can actually by determined by the operation of market principles.

PRINCIPLE SIX: EFFICIENCY THROUGH INTERNAL COHERENCE

The rights created should reflect the legitimate interests and expectations of debtors, creditors and third persons, given the underlying logic of a regime of security on property.

Corollaries:

1. **Structuring incentives to encourage performance by debtors.** The regime should presume that most secured obligations will be performed as agreed and should structure incentives to encourage performance by debtors. It should offer debtors a just allocation of rights that will avoid precipitous creditor action, and opportunistic realization. It should give debtors a fair opportunity to redeem the security. It should give debtors acting in good faith and not abusing the right, a reasonable opportunity to reinstate the credit obligation -- for example, by paying missed instalments and avoiding the application of acceleration clauses -- prior to

realization once they are in default. It should ensure that debtors are not burdened with penalty clauses or other charges unrelated to the creditor's actual expectations on the secured obligation. It should give debtors the right to recover any surplus once the property has been sold and the debt paid.

2. **Structuring incentives to encourage responsible behaviour be creditors.** The rights awarded to creditors should structure incentives to encourage cooperation in the event of debtor distress, and should neither encourage nor allow precipitous creditor realization or interference with legitimate work-outs by third parties. The regime should offer creditors the opportunity to obtain a fair recourse that will persuade debtors that there is little to be gained from breaching the secured obligation. The regime should seek to achieve low transaction costs in creating, monitoring and enforcing security. The regime should allow creditors to determine accurately the debtor's equity in collateral, and should give them an indefeasible right as against debtors, third parties, and subject to overriding *ex ante* public policy determinations, even ordinary-courses-of-business good faith transferees of secured collateral and the trustee in bankruptcy. It should give creditors transactional finality when taking or realizing upon a security. It should not charge creditors with *ex post facto* obligations -- environmental, labour, tax, presumed realization valuation -- that could not be not foreseeable at the time of a good faith realization. It should give creditors a deficiency claim in the event the proceeds of realization are insufficient.

3. **Designing the regime to discourage illegitimate third-party interference.** The regime should offer third persons a structure of rights that does not impose hidden charges, *ex post facto* priorities, and excessive realization penalties. It should work to maximize realization values. It should protect third party improvers by giving them a fair compensation for their efforts. It should give third parties an opportunity to redeem the prior security, and to reinstate the security by taking over the debtor's outstanding obligations.

PRINCIPLE SEVEN: EFFICIENCY BY MAXIMIZING REALIZATION VALUE

The allocation of pre- and post- default rights and obligations should encourage responsible behaviour by the debtor, or by any other person having custody or control of the secured collateral and should seek to maximize the realization value of the secured collateral.

Corollaries:

1. **Maintaining pre-default value of secured collateral.** The pre-default regime should structure incentives so that the value of the collateral is maintained. It should discourage waste of the secured assets. It should provide incentives for the improvement of the collateral consistent with the terms of the security agreement. It should encourage the use and exploitation of the secured collateral

as a revenue generator for the debtor.

2. **Avoiding inefficient formalism in post-default enforcement.** The post-default enforcement regime should encourage responsible behaviour in the realization process by avoiding excessive state formalism in seizure and sale. Responsibility for execution of a task should generally be in the hands of the person who has the primary responsibility for seeing it completed. Liability should follow responsibility and should not be delegable. Realization rights given to creditors should be limited by general norms of commercial reasonableness and good faith so that they cannot be used to achieve other creditor objectives extraneous to the security nexus. Legitimate interests should be protected by giving third parties adequate notice of default, and rights to ensure timely reinstatement or efficient enforcement.

3. **Providing incentives for debtors, creditors and third parties to maximize realization value.** The realization regime should seek to maximize in fact the realization values of the secured asset. The realizing creditor should carry the risk of deficiency attributable to improvident or commercially unreasonable enforcement and realization proceedings it carries out. Other parties with a strong interest in the outcome should be encouraged to intervene in ways that lead to the highest realization value for the collateral. Non-regular market transactions, such as a judicial sale, should be avoided except as a last recourse.