

UNIDROIT 1992  
Study LXXII - Doc. 4  
Original: English

U n i d r o i t

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW  
=====

RESTRICTED EXPLORATORY WORKING GROUP TO EXAMINE  
THE FEASIBILITY OF DRAWING UP UNIFORM RULES ON CERTAIN  
INTERNATIONAL ASPECTS OF SECURITY INTERESTS IN MOBILE EQUIPMENT

Basic issues identified in responses to the Questionnaire  
on an international regulation of aspects of security interests  
in mobile equipment

by

Professor Ronald C.C. CUMING  
(University of Saskatchewan)

Rome, February 1992

## BASIC ISSUES IDENTIFIED IN RESPONSES TO THE QUESTIONNAIRE

by Professor Ronald C.C. Cuming  
(University of Saskatchewan)

The Unidroit Secretariat has provided an excellent summary and analysis of the replies to the Questionnaire on an International Regulation of Aspects of Security Interests in Mobile Equipment (Doc. 3).

In Appendix A to the study entitled *International Regulation of Aspects of Security Interests in Mobile Equipment* I set out "tentative conclusions" relating to the issues raised in the Study. These conclusions were formulated at the start of the Study and were very tentative only. It was noted in the preamble that each conclusion would be assessed in the light of the empirical evidence and expert advice obtained in the course of carrying out the Study. As it turned out, some of the "tentative conclusions" were not supported in the Study.

In the following paragraphs, I have set out my analysis of the replies to the Questionnaire (the empirical evidence) that focus on these conclusions in an attempt to identify what appear to be the basic issues involved.

### I. THE NEED FOR A CONVENTION (OR RULES)

My tentative conclusion that there is a need for a Convention dealing with international aspects of security interests in mobile equipment was based on several assumptions which were very substantially supported by the respondents to the Questionnaire.

1. High-cost mobile equipment which is collateral under secured financing agreements is frequently used in a State other than the one in which it is acquired or in which the owner of the equipment has its principal place of business.

A large percentage of the business corporation respondents reported that this occurs frequently or occasionally (Doc. 3, p. 4, para. 6). For a brief discussion of the types of movables to which a Convention (or rules) might apply, see *infra* heading II.

2. Because of the large capital expenditure needed to acquire this type of equipment, the purchase of it is frequently financed. In other situations security interests are taken in the equipment by financiers who provide general financing for the business activities of the owners of the equipment.

The great bulk of the replies received indicate that secured financing of mobile equipment that is occasionally or regularly taken across national borders is significant and comes in the form of both sales financing (loans to purchase the equipment) and loans secured with interests in the equipment (Doc. 3, p. 5, paras. 6 and 8).

The replies also indicate that the largest number of transactions of this kind involve domestic buyers that use the equipment principally within the State where the equipment is bought but occasionally use it in another State (Doc. 3, p. 5, para. 8). However, several banks and legal advisers to banks indicated that they (or their clients) lend to domestic and foreign borrowers and/or buyers carrying on business in more than one State and take security interests in movables to secure short-term or long-term credit. Industrial organisations focussed on secured financing of buyers of equipment that is taken across national frontiers. Airline owners and financiers (including lease financing organisations) reported the use of secured financing of both domestic and foreign purchasers of aircraft.

The responses indicate that any Convention (or rules) should address both types of secured financing: secured sales financing of mobile equipment and general business financing where mobile equipment is taken as collateral.

3. The existence of an international Convention (or rules) under which Contracting States undertake to recognise the validity and enforceability of security interests in equipment brought within their territories should have an important, positive effect on the availability of credit to buyers and owners of equipment.

This assumption is supported by the widely held view of the respondents that the lack of an international system of law in this area is a negative factor in decisions of lenders to sell, or of creditors to take security interests in equipment of the kind generally moved from one State to another (Doc. 3, p. 7, para. 11).

## II. THE TYPES OF MOVABLES TO WHICH THE CONVENTION (OR RULES) WOULD APPLY

The proposed Convention (or rules) would apply to security interests in "mobile equipment" only. This term is used to describe the use to which the goods are being put by the debtor; it is not a generic description of a type of goods. The definition would exclude most automobiles and small trucks (lorries), since they are most often held by debtors as consumer goods and not as equipment. All automobiles and small trucks (lorries) should be excluded from the Convention (or rules) since any attempt to draw a distinction between vehicles held as consumer goods and vehicles held as equipment would be unworkable in an international context.

A wide variety of different types of equipment were identified by respondents as the subject-matter of security interests taken by them.

These include trucks, automobiles, railway rolling stock, construction equipment, earth moving equipment, industrial machinery, oil drilling equipment, agricultural equipment, ships, vessels and floating equipment, aircraft, containers, computer equipment, graphic arts equipment, telecommunication equipment, recreation vehicles and trailers. Some respondents were content to refer to "all capital goods" (Doc. 3, p. 4, para. 7).

In response to the question as to what types of movables should be within the scope of a Convention (or rules), many of the respondents indicated an eagerness to have included the complete range of kinds indicated above.

It is relevant to note that aircraft were not in the list of movables on this part of the Questionnaire. However, a few respondents suggested that they be included. Svenska Finans International raised concerns with respect to recognition of security interests in aircraft engines. Inclusion of security interests in aircraft and aircraft engines would raise the issue of overlap or conflict with the *Geneva Convention on the International Recognition of Rights in Aircraft, 1948* (see Doc. 1, pp. 16-17). It may be necessary to assess the relevance of this Convention given its age and the fact that a significant number of States are not Parties to it. A few respondents suggested exclusion of ships and vessels on the basis that they are subject to existing Conventions or established international practices (see Doc. 1, pp. 17-19). In particular, the response from Danmarks Rederiforening noted that the 1926 and 1967 Conventions on liens and ship mortgages have been under review by IMO and UNCTAD and a new Convention has been prepared and will be submitted to a diplomatic Conference in the near future.

Professor Allan of Australia suggested that items for which there is already an internationally recognised register should not be subject to the Convention (or rules). He points to aircraft and ships as examples. It is important to draw a distinction between excluding types of equipment because they are now subject to some form of domestic or international registration, and recognising in a Convention (or rules) the existence of such registries as an aspect of an international priority system. The important issue is not the existence of a registry system, but rather the existence of an associated set of priority rules that is workable in an international context.

The Questionnaire was perhaps deficient in that it failed to address the possible need to draw a distinction between consumer goods and commercial equipment. Most respondents did not focus on this aspect of the Study. However, Professor Vagts of Harvard Law School points to the difficulties in attempting to "cut a definitional line between some kinds of vehicles that are subject to registration requirements and other registrable vehicles."

Clearly the application of any proposed Convention (or rules) to consumer goods or small-value goods often purchased as consumer goods will be a threshold question. While the ideal would be to have a Convention (or rules) that applies to all types of movables of significant commercial value that are transported across national boundaries, I continue to believe that such a Convention (or rules) would be unworkable or would be unacceptable to a large number of States. While Professor Vagts is correct in pointing to the difficulties in drawing distinctions between types of goods that are subject to an international regime and those that are not, it is my view that this must be done. There are too many public policy and logistical difficulties associated with attempting to create an international regime that has very broad application (see Doc. 1, pp. 30-33).

### III. THE TYPES OF "SECURITY INTERESTS" TO WHICH THE CONVENTION (OR RULES) WOULD APPLY

The proposed Convention (or rules) would apply to "security interests" in mobile equipment. This term would be defined generically so as to encompass any type of non-possessory interest in equipment created by contract that has been taken or retained to secure performance of an obligation owed by the debtor or third party to the secured party. It would include, *inter alia*, a contractual transfer of title or contractual charge or hypothec in favour of the secured party, a contractual reservation of title or ownership by a seller, a hire-purchase contract, a lease of equipment which, under the applicable law, is characterised as a security agreement and a contractual privilege in favour of an unpaid vendor. The term would not include liens, charges, general privileges or other interests that arise by operation of law in favour of repairers, government agencies or creditors.

The above-noted proposition was addressed in two separate questions in the Questionnaire.

There was very substantial support for the suggestion that the scope of a Convention (or rules) would be set by reference to a generic definition of "security interest" (Doc. 3, p. 10, para. 15). This definition would encompass all financing devices whether or not technically they are conceptualised as such under the law of the State where they are created or enforced. In particular, this would entail recognition that title retention agreements between sellers and buyers are "security agreements" that create "security interests" and that, for the purpose of the system, the seller is not the "owner of the equipment" but a secured party.

The responses to the question dealing with the application of the Convention (or rules) to non-consensual security interests (liens, charges and general privileges arising by operation of law) reflect the complexity of the issues involved (Doc. 3, p. 9, para. 14). Most respondents wanted

the Convention (or rules) to apply to both consensual and non-consensual security interests. This is an expected response from business organisations that would like to have available a system which encompasses all the various types of interests that threaten the enforceability of a consensual security interest. Recognising the immense difficulty, perhaps impossibility, of devising a workable, all-inclusive system, a significant number of respondents recommended that the project be confined to contractually created security interests. The respondents from the Paris Institute of Comparative Law, Professors Audit and Tallon, pointed out that, whilst it is unrealistic to ignore non-consensual interests, it is equally unrealistic to think that they can all be brought under the regime. They suggested inclusion of privileges given by law to creditors (Doc. 3, p. 9, para. 14). A roughly similar approach is contained in the suggestion of Svenska Finans International that the Convention (or rules) encompass asset-specific liens. It went further, however, to propose that non-asset-specific liens be limited to a percentage of the value of the asset to which they attach.

It is most unlikely that a Convention (or rules) can be drafted so as to encompass all consensual and non-consensual security interests in movables. My original view was that an international regime should address only consensual interests. This was based largely on the Canadian experience. However, this may be too narrow a view. It may be necessary to include in a Convention (or rules) certain widely-recognised types of non-consensual, asset-specific interests that have the same function as a consensual security interest.

A possible deficiency in the Questionnaire was its failure to address directly the issue as to whether leases of equipment should be brought within the scope of at least the registration and priority structures of a Convention (or rules). However, several respondents identifying themselves as lessors, and at least two identifying themselves as lessees, appear to have answered the Questionnaire on the assumption that a Convention (or rules) would apply to leasing contracts.

It will be an important question of scope as to whether or not leases should be brought into the system. Experience in North America indicates the futility of attempting to distinguish between "true leases" and "security leases" without clear statutory guidance (or rules). Further, so far as priorities are concerned, this distinction may not be relevant.

#### IV. THE LAW APPLICABLE TO "VALIDITY" OR "EFFICACY" OF A SECURITY INTEREST IN MOBILE EQUIPMENT

Under the proposed Convention (or rules) a State would be obliged to recognise the validity of a security interest constituted under the law of the debtor's principal place of business. This would be so even though the equipment is located in such a State or some other State at the time the security agreement is executed.

Recognition entails acceptance of any restrictions or limitations on the type of property that may be taken as collateral or on the type of debtor that may incur secured obligations. It would also entail recognition of restrictions on financiers if they are located in the State where the debtor has its principal place of business.

The responses to the question as to what law governs the "validity" of a security interest indicate an unusually wide range of views. However, the differences may be in part at least a product of the generality of the question and the lack of a clear appreciation of what is involved in the term "validity". This ambiguity is noted by Professors Audit and Tallon of the Paris Institute of Comparative Law. They suggest that a distinction be drawn between "validity" and "efficacy" of a security interest. Two Italian practitioners suggested that the secured party's law should apply to "formation of the security interest" but that the debtor's law should apply to "the execution of the security interest and the relevant system of priorities."

The term "validity" was used in the Study to refer to the question as to whether or not a security interest has been created. Since the debtor's principal place of business is being put forward as a substitute for the *lex situs*, it follows that validity addresses the issue as to whether or not the proprietary interest (security interest) has vested in the secured party. However, it was not intended to refer to all issues of contract formation, although it was intended to address issues of capacity of debtors to grant and of creditors to take security interests to the extent that the applicable law restricts types of persons from giving security interests in their property or limits the types of collateral in which certain types of credit grantors can take security interests. It was not intended to address priorities or enforcement of *inter partes* rights (see Doc. 3, p. 11). While the existence of such rights depends upon the existence of a security interest in the equipment, the rules for the enforcement of such rights are quite separate and could be (but need not be) subject to different legal regimes. "Validity" would not encompass *inter partes* issues (e.g. warranties) arising out of the sale of goods aspects of a secured instalment sales contract.

Rather than focussing on a particular label that is not easy to define with precision and which loses meaning in translation, perhaps it would be better to focus on the problems that the proposed Convention (or rules) would be designed to address. As noted in the Study (Doc. 1, pp. 7-9) the perceived difficulty with existing conflict of laws rules of non-North American States is that, under the *lex situs* (*lex rei sitae*) rule, a security interest created under the law of one State may not be recognised as "valid" in another State when the collateral subject to the security interest is moved into that State and priority or enforcement issues arise in that State. What is needed is an international regime under which a secured party that takes a security interest in mobile equipment has some assurance that, should issues of validity or enforcement arise in

another State, its security interest will be recognised as having a status not unlike that which it has under the law of the State governing its creation. In other words, the municipal law of the forum would not be used as a mould within which the security interest must fit if it is to be recognised and enforced in the forum. It was suggested in the Study that such a regime would require the courts of participating States to look to the law of the debtor's principal place of business to determine whether or not a security interest had been created. Not only would this remove most of the uncertainty associated with the *lex situs* rule, but in addition it would facilitate the suggestions contained in the Study dealing with public disclosure of security interests (Doc. 1, pp. 32-33; Appendix A, p.v).

As to the suggestion that the *lex situs* rule be retained in a Convention, I noted with particular interest the comments of Professor Ole Lando of the Copenhagen School of Economics and Business Administration in his article "The Application by Danish Courts of Foreign Rules on Non-Possessory Security Interests" appended to his response. Professor Lando is a supporter of the *lex situs* rule for validity and priority. However, he suggests that when goods are unexpectedly taken to another State, "the holder of the security interest should be protected under the law of the original *situs* of the goods against creditors of the possessor." When dealing with situations in which the secured party knows or could expect that the goods would be removed to another State he concludes: "However, by an international Convention...it could be laid down within what time-limit the security interests should be registered, which security interests in the country of the original *situs* correspond to which security interests in the country of the new *situs*, and what is to be done in countries which either do not recognise non-possessory chattel mortgages or do not recognise such an interest in the goods in question" (p. 12). Professor Lando is prescribing a very difficult, if not impossible, job for the drafters of such a Convention. For example, what is to be done in countries which do not recognise non-possessory security interests in movables?

My admittedly unscientific survey of the replies has led me to believe that an overwhelming number of banks and secured lenders prefer application of the law of the debtor's principal place of business to issues of validity or efficacy.

As Professor Drobnič and Air New Zealand pointed out in their replies, where the collateral is of a type for which there is an internationally recognised national ownership registry, validity or efficacy should be governed by the *lex libri*, the place of registration.

#### V. THE LAW APPLICABLE TO PRIORITY COMPETITIONS BETWEEN SECURED PARTIES, OTHER SECURED PARTIES, EXECUTION CREDITORS AND BUYERS

The priority status of a security interest in mobile equipment (and in certain types of proceeds) in relation to other interests in the

equipment (or proceeds) would be set by substantive rules of the proposed Convention and not by reference to the law of the principal place of business of the debtor.

A Contracting State would not be required to recognise such a priority structure if the secured party has not complied with the applicable public notice requirements of the State where the debtor has its principal place of business or if the secured party has not complied with the public notice requirements of the law of the recognising State.

The replies indicated a significant division of opinion as to sources of priority rules. The majority supported the above-noted proposition that the Convention (or rules) deal with priorities through a set of substantive priority rules. A minority chose the applicable law (principal place of business of the debtor or the *lex situs*) as the source of such rules. A variant on this latter position was support for the *lex libri* in cases where an internationally recognised registration system exists.

There are several obvious advantages to having a set of priority rules prescribed by an international regime. This approach facilitates the development of a truly international system for security interests in movable equipment. It removes the reticence and uncertainty that would otherwise prevail when the courts of one State are forced to apply the law of another State to priority disputes. It permits the recognition of new approaches to secured financing that might be unrecognised or underdeveloped under the municipal laws of many States (e.g. securing future advances, purchase money security interests and security interests in proceeds).

If the law of the principal place of business of the debtor is the source of priority rules (as is the case under North American regimes), some States may take the position that these rules may not provide sufficient protection to persons who acquire interests in equipment when it is located in those States. For example, they may insist on foreign security interests being registered in their registries and that the rule *possession vaut titre* be retained for certain types of buyers.

In Appendix A, I suggested, without qualification, that priority disputes involving "good faith buyers" be excluded from a Convention (or rules) (p.v). However, in the Study I recanted and noted some of the complications that would be associated with doing so (Doc. 1, pp. 31-33). The important question that must be addressed in this context is whether or not protection of good faith buyers through, for example, the retention of the *possession vaut titre* rule is so politically important to States that any attempt in a Convention (or rules) to address the position of good faith buyers would be met by significant opposition. The argument against leaving the matter to municipal law is that, at least conceptually, a large hole is left in the priority structure of the Convention (or rules) with the attendant potential for the type of problems described in the Study

(Doc. 1, pp. 31-32). The suggestion to leave the matter to municipal law was based on the assumption (generally supported by experience in Canada) that fraudulent sales of mobile equipment are not a matter of primary concern to financiers.

#### VI. POST-DEFAULT REMEDIES OF SECURED PARTIES

A Party to the proposed Convention (or rules) would agree to recognise the enforceability of a security interest in mobile equipment as provided in the law of the debtor's principal place of business subject to two qualifications: (i) recognition need not extend to remedies other than seizure and sale of the equipment; and (ii) all procedural matters associated with seizure and sale would be governed by the law of the State in which the equipment is seized. The Convention (or rules) would contain a non-exhaustive list of matters that are to be treated as procedural.

Replies dealing with the source of law applicable to the enforcement of security interests did not indicate overwhelming support for any one of the possibilities suggested. A majority supported the formulation of a set of substantive rules to be included in a Convention (or rules). A significant number of respondents wanted the matter to be left to the applicable law as suggested above.

There was some support for an alternative not suggested in the Questionnaire. This is to allow the parties to the security agreement to choose the applicable law. This is generally the approach embodied in the Canadian Personal Property Security Acts. However, party autonomy in this context should perhaps be subject to the qualification that the law chosen should have some relation to the contract. The latter qualification may be necessary to ensure that debtors are not subjected to regimes that are attractive to secured parties only because they provide minimal protection of the debtors' interests. If this approach is adopted, it would be necessary to address the question as to whether a distinction should be drawn between substantive rules (governed by the law chosen by the parties) and procedural rules (governed by the law of the forum).

#### VII. BANKRUPTCY

The proposed Convention (or rules) would not deal in any way with the priority position of the holder of a security interest in mobile equipment in relation to the debtor's trustee in bankruptcy.

There was minority support for a total "hands-off" approach. However, a much larger group of respondents suggested that the Convention (or rules) should seek to ensure that all transactions that are defined under the Convention (or rules) as creating security interests are treated in bankruptcy proceedings as security agreements. This group shares the conclusion set out in the Study that, while bankruptcy law cannot be ignored, it is completely unrealistic to attempt to influence national

bankruptcy law in any significant way through a Convention (or rules) dealing with the international recognition of security interests in mobile equipment.

Of course, the various issues associated with security interests in mobile equipment of a bankrupt are far too complex to attempt to address in a questionnaire. The subtleties of interaction between the law of the debtor's principal place of business and the *lex fori* set out in the Study (Doc. 1, pp. 34-36) were not canvassed in the Questionnaire. However, what is clear is that there is considerable support for a minimalist, but not a hands-off, approach.