

# A Paradigm Shift in a Modern Law on Secured Transactions

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## I. Introduction

Recently how to modernize and improve secured transactions law has been actively under discussion all over the world. It is because, since the late 1980s, international banks have been so careful of their capital adequacy ratios, formulated by the Bank for International Settlements (BIS), that they usually extend loans to creditworthy borrowers. If additional valuable assets secure commercial borrowings, debtor companies are willing to borrow more on improved terms. On the other hand, transition economies in the Central and Eastern Europe, and East Asia have been eager to adopt modern secured credit laws to induce foreign investors. Alleviated credit risk by means of new types of security would boost up cross-border trades internationally thereby promoting new commercial activities, and accordingly resolve the increasing inequalities in the access of capital between the parties in developed countries and developing countries.

International financial institutions are forerunners in preparing secured credit laws. The European Bank for Reconstruction and Development (EBRD) made the Model Law on Secured Transactions<sup>1)</sup> in 1994 and vigorously advised the adoption thereof to Russia and other former socialist countries.<sup>2)</sup> The institution's character that the EBRD devotes its efforts to the development of private sectors in the

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1) <<http://www.ebrd.com/english/trans/sectrans/modellaw/modlaw0a.htm>> [Feb. 7, 2003]

2) Sato Yasunobu, Akahane Takashi and Dogauchi Hiroto, "The Introduction and Explanation of the EBRD's Model Law on Secured Transactions (I)", NBL No.695 (Aug. 15, 2000), pp.73-75; Frederique Dahan and Gerard McCormack, "Secured Transactions in Countries in Transition (The Case of Poland): From Model to Assessment", [1999] *European Business Law Review*, p.85.

transition economies in Europe by providing loans, investments and technical assistance to private companies without guarantee or backup of the government of debtors is reflected on the EBRD model law. It means that the EBRD should secure its own claims and enforce its security rights by itself.

The International Institute for the Unification of Private Law (UNIDROIT), which had adopted two conventions on international financial lease and factoring in the late 1980s, concluded the Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment in November 2001. Following suit of the UNIDROIT convention, the United Nations Committee on International Trade Law (UNCITRAL) established the Convention on Assignment in Receivables in International Trade in December 2001.<sup>3)</sup> It is noteworthy that the UNCITRAL Working Group VI started to work out the model legislative provisions of secured transactions law in 2002.<sup>4)</sup>

Also the European Union made a draft Directive on Delays of Payment with respect to retention of title in 1998 and 1999. The World Bank and the Asian Development Bank are willing to provide financial and technical assistance to developing countries for the proper legislation of secured transactions law. The Organization of American States (OAS), influenced by the secured transactions law of the United States and Canada, embarked on drafting a unified model law on secured transactions.<sup>5)</sup>

This article delves into the worldwide momentum and key principles of such discussions on secured transactions law in the international context. Now that the

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3) Originally in 1999, the convention was named as the Convention on Assignment in Receivables Financing. After UNCITRAL requested comments of the member states and international institutions, the final one with detailed commentary (UNCITRAL A/CN.9/489) was renamed as the "Convention on Assignment in Receivables in International Trade" and adopted by the General Assembly in December 2001.

4) UNCITRAL, Report of Working Group VI (Security Interests) on the work of its first session (New York, 20-24 May 2002), A/CN.9.512. UNCITRAL is currently working out either the legislative guide or the model legislative provisions rather than a model law, more rigid one. The writer participated in the "Working Group VI (Security Interests)" meeting held in Vienna during December 16-20, 2002. The participants concluded a considerable drafting work should be done to produce a more harmonized but definitive legislative guide on the subject matter. The working papers for discussion are available at the "Working Groups" section of the UNCITRAL website, <<http://www.uncitral.org/en-index.htm>>.

5) UNCITRAL, *SECURITY INTERESTS: Current activities and possible future work*, A/CN.9/475, 27 April 2000, p.9. <<http://www.uncitral.org/en-index.htm>> [Feb. 7, 2003]

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Korean government is moving to make a long-cherished amendment to the Civil Code, it would be necessary to devise how to improve the legal regime on secured transactions, and how to adopt the key principles into Korean circumstances.

## **II. A Paradigm Shift in Modern Secured Transactions Law**

Traditionally a security right shall mean the right *in rem* over a specific property so as to recover creditor's claims, and should notify the public of its existence and priority. Accordingly a general mortgage could not be created over whole properties of the debtor. There is an exception of the fiduciary transfer of movables on a limited basis. Several privileged claims are established by special laws without any notification. The fiduciary transfer of movables takes place in a manner of creating a security right without any explicit notice.

In the 1990s, we witnessed a paradigm shift in collateralization.<sup>6)</sup> For instance, asset-backed securitization (ABS) is widely felt to function as collateral. In other words, when an originator transfers a pool of assets to a special purpose vehicle (SPV), investors of the bonds or investment certificates issued by the SPV could be satisfied by cash flows and total values of the separated, or bankruptcy-remote, assets. In the United States, it is generally called "structured financing". The object covers any asset that could generate comparatively stable cash flows in nature, for example, commercial buildings, personal properties, account receivables, trade receivables, and so on. Thus financial institutions and business entities are able to securitize their assets including distressed loan portfolios and real estate backlogs at a competitive cost.

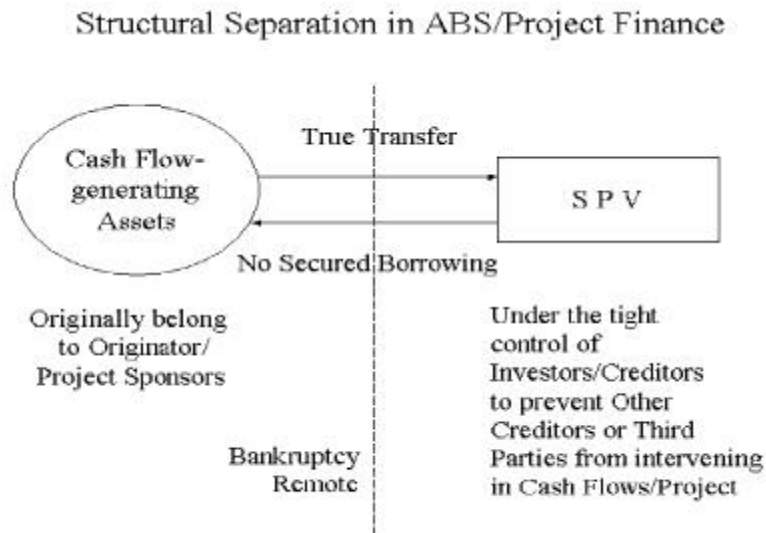
The similar structure is being applied to project finance in which a project company, i.e., SPV, is established for the purpose of off-balance sheet financing. Revenue-generating assets of the project will be set aside for the repayment to project financiers. Project financiers shall maintain security rights over the assets related with the project, not because they want to dispose of such assets, but because they should prevent third parties from intervening in the project as

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6) Professor Uchida Takashi at Tokyo University asserted that the paradigm of the secured credit law of Japan has been changed from that predicted by the late Professor Wagazuma Sakae in his lecture in July 2002, "Paradigm of the Secured Credit Law", *Jurisprudence Classroom* published in November 2002, pp.7-20.

security holders.

<Figure 1>



In the meantime, the EBRD set out the core principles for a secured transactions law when its secured transactions project was completed in 1994 as follows:<sup>7)</sup>

*a. Reduce risk of credit*

Security should reduce the risk of giving credit leading to an increased availability of credit on improved terms.

*b. Simple and non-possessory*

The law should enable the quick, cheap and simple creation of a proprietary security right without depriving the person giving the security of the use of his assets.

*c. Claim satisfied out of charged assets*

If the secured debt is not paid, the holder of security should be able to have the charged assets realized and to have the proceeds applied towards satisfaction of his claim prior to other creditors.

*d. Prompt enforcement at market value*

Enforcement procedures should enable prompt realization at market value of the assets given as security.

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7) John Simpson and Joachim Menze, "Ten years of secured transactions reform", *Law in transition*, Autumn 2000, p.26. The same contents may be found at  
<[http://www.ebrd.com/english/region/legtran/secured\\_trans\\_core.htm](http://www.ebrd.com/english/region/legtran/secured_trans_core.htm)>.

*e. Effective in insolvency*

The security right should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.

*f. Low cost*

The cost of taking, maintaining and enforcing security should be low.

*g. All types of assets/debts/persons*

Security should be available:

- over all types of assets;
- to secure all types of debts; and
- between all types of persons.

*h. Publicity*

There should be an effective means of publicizing the existence of security rights.

*i. Priority*

The law should establish rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security.

*j. Commercial flexibility*

As far as possible, the parties should be able to adapt security to the needs of their particular transaction.

The common thing that may be derived from the above principles is three-fold:

- First, security is open to every kind of assets - from real assets to movables and account receivables;<sup>8)</sup>
- Second, security is not specialized on a certain type of assets, but is extended to security-like transactions or schemes; and
- Therefore one of the most important factors is the electronic registration, almost without exception, in creating the security right in modern times.

For instance, the newly amended Article 9 (Secured Transactions) of the Uniform Commercial Code (UCC) of the United States purports to include the electronic registration. Poland, Hungary, Canada and Japan have followed the

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8) When personal properties or receivables are granted as security, they are usually possessed and used by the debtor. In order to create such non-possessory security rights, a public notice filing system or perfection against third parties are required.

precedent of the EBRD model law and Article 9 of UCC.

The above core principles might be compared with the conventional ones, and explained in <Table 1>.

<Table 1>  
Paradigm Shift in Collateralization

	Conventional Paradigm	Modern Paradigm
Nature	o To respect an individual security right	o To acknowledge a specific scheme like ABS as well as the individual security right
Principles	<ul style="list-style-type: none"> <li>- A security right is created against a specific and present asset of the security grantor.</li> <li>- Publicity should show the existence and priority of a security right.</li> <li>- The encumbered assets should have some value to satisfy security holder's claim.</li> </ul>	<ul style="list-style-type: none"> <li>- ABS or structured financing is generally regarded as security.</li> <li>- Publicity could be attained by advanced information technologies like electronic registration, which is highly effective, convenient and economical.</li> <li>- Creditors prefer cash flows to the exchange value of the assets.</li> </ul>

### III. New Standards of the Secured Transactions Law

In view of the key principles mentioned above, Korean legal regime on secured transactions seems to meet the standards in general (*See* Items a, c, d, e and i below), but lacks some other factors (*See* also Items b, f, g, h and j below).<sup>9)</sup>

- a. The Civil Code provides for various security rights such as lien, pledge and mortgage, thus reducing the risk of giving credit.
- b. In Korea, the non-possessory security right is confined to mortgage over real estate, ships or vehicles subject to registration. So the creation of a security right other than mortgage means depriving the security grantor of the use of his assets. Otherwise, the debtor may resort to the fiduciary transfer of title

9) Whon-Il Park, "The Implication of the New UCC Art.9 toward the Secured Transactions Law of Korea", *Kyung Hee Law Journal*, December 2002, pp.51-54.

or the security under the provisional registration.

- c. In case of default, the security holder may apply for the foreclosure or make the encumbered asset realized, and recover his claims from the proceeds prior to other creditors.
- d. The newly amended Civil Enforcement Act (effective July 1, 2002) ensures prompt realization through court-presided auction at market value of the assets provided as security.
- e. In case of insolvency of the debtor, the security right remains effective and enforceable in Korea. Thus the holder of lien, pledge or mortgage may invoke the right of separation even though the insolvency administrator puts the charged assets into the bankruptcy estate. The security right is given preferential treatment to other claims in the corporate reorganization procedure.
- f. In general, taking and maintaining lien and pledge cost almost nothing because they are possessory in nature. However, mortgage costs considerably much with respect to registration and maintenance thereof. In addition, private disposal of security is not allowed in Korea, where the court-arranged public auction comes first.
- g. In Korea, the debtor or the third party may give security. But the security is limited to the following:
  - the asset related to the cause of lien;
  - only movables, receivables or other claims in case of pledge; or
  - real estate and expensive mobile equipment (i.e., ships, vehicles, aircrafts, etc.) which are eligible for registration.
- h. Publicity is achieved by means of possession of the lien/pledge holders, and public registration or filing in case of mortgage. In Korea, the non-possessory security right cannot be created against personal properties because of the lack of proper publicity. The fiduciary transfer of title is only one exception for movables.
- i. Priority is governed by the time of registration, or transfer of title between the competing claimants. In case of lien and pledge, the fact of possession determines the priority.
- j. The creation, maintenance and enforcement of a security right may be adapted to the needs of particular transactions between the parties. But there is only one article in the Civil Code concerning *Keun* mortgage, the favorite one for

Korean creditor banks, which might give rise to plenty of disputes and troubles.

In short, the current regime on secured transactions rules out the non-possessory security right against movables. The creation of such security right is not allowed without any legislative background in Korea. So far asset based financing like lease<sup>10)</sup> or ABS scheme<sup>11)</sup> has been regarded as functionally giving security.

The situation in Japan is strikingly similar to that in Korea. In January 2003, the Working Group to Study Corporate Legislation (Security Right Regime) of Japan published the final report on "New Financing Schemes based upon Cash Flow rather than Real Estate Mortgage".<sup>12)</sup> According to this report, the Working Group enumerates, as new financing schemes for Japanese corporations, i) inventory or receivable-backed financing focused on the origin of cash flow, ii) structured financing through securitization of income-generating assets, and iii) project financing based upon cash flow from a specific project. It is also making following suggestions to change practices and law:

- To grant as security collective corporate properties or inventory confined to specific type, location or volume of assets with appropriate perfection like registration or filing;
- To allow unspecified future receivables to be transferred as security to the creditors by means of registration or advertisement on newspaper; and
- To allow the transfer-prohibited stocks of a project company through a series of approvals of the board of directors and the general meeting of stockholders of the company in order to transfer its management to a third party in project financing.

So the necessity for new standards of security rights can be pointed out as follows:<sup>13)</sup>

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10) When a lessee could not pay rental, the lessor has the right to recover the leased property and dispose of the property.

11) See the Act on Asset-backed Securitization (the "ABC Act").

12) This report is available at the homepage of the Ministry of Economy and Industry of Japan, <<http://www.meti.go.jp/feedback/index.html>>.

13) Park, *op.cit.*, pp.54-58.



First, security should enhance the financial ratios of both creditors and debtors alike. When creating an additional security right, a creditor should be able to reduce credit risk and debtor may improve financial terms without considerable cost.

Second, a corporate debtor should be able to make most of the value of its assets regardless of their types and nature. There has been a limited use as security of such assets as machinery and equipment, half products or inventory. Only the methods like adding to the list of existing factory mortgage<sup>14)</sup> or making the fiduciary transfer of title of inventories<sup>15)</sup> are available. If a corporate might utilize asset-based financing or comprehensive collateralization of its whole assets, there will be increasing availability of funds for business activities. One breakthrough for finance has been announced internationally for mobile equipment like aircrafts, rolling stocks and space property.

Third, non-possessory security rights have to be introduced for such valuable assets as personal properties, receivables and claims which the security grantor continues to hold and use. It is proved highly useful in the former socialist countries where the land and other fixtures belong to the exclusive ownership of the state.<sup>16)</sup> But the non-possessory security right requires a public notice filing system<sup>17)</sup> or perfection to prevent double transfer of the same object. At present, thanks to the advancement of information industries, the electronic registration/filing system is eligible as a convenient and cheap instrument for publicity.

Fourth, the security rights should be compatible with the existing corporate

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14) Article 7 of the Factory Mortgage Act.

15) It is possible for a steel maker to create a security right over raw materials for a certain period of time under an agreement of the fiduciary transfer of collective inventory on condition that the scope of type and quantity of the inventory is designated and that the location of warehouses is specified. Supreme Court Judgment on October 25, 1988 85Nu941, Supreme Court Judgment on December 27, 1988 87Nu1043.

16) In a survey by the EBRD, 22 of the 26 transition economies in Europe have enacted security laws permitting non-possessory security over movable assets. Simpson and Menze, *op.cit.*, p.21; The Czech Republic still resort to the conventional fiduciary transfer of title of movables. Tom Oliver Schorling, "Secured transactions in the Czech Republic - a case of pre-reform", *Law in transaction*, EBRD, Autumn 2000, pp.66-69; In East Asia, Indonesia, Thailand and Vietnam were quick to introduce such non-possessory security rights after the financial crisis in 1997.

17) The UNIDROIT Convention on International Interests in Mobile Equipment requires the establishment of the International Registry and the International Registrar who keeps it, of which Canada took absolute advantage.

insolvency laws. Security rights should be ultimately enforced against debtor's property except when the commencement of the insolvency proceeding trigger or invoke the stay of the actions against the debtor. Secured creditors would not want to see the insolvency administrator restrict the enforcement of security rights nor the diminution of the value of security.

Fifth, new regime on secured transactions should be indifferent of the nationality of the concerned parties and applied to cross-border transactions. The first example might be the UNCITRAL Convention on Assignment in Receivables in International Trade.<sup>18)</sup>

In conclusion, there is an increasing need for non-possessory security rights over movables and the assignment of receivables financing, which could modify the rigidity of the current regime on secured transactions in Korea. By doing so, this type of new security would increase the availability of credit and improve the terms of the credit. Furthermore it could resolve the bottleneck of funding faced by small and medium-sized enterprises (SMEs), and accelerate the economic growth of the nation.

On the probable occasion of the unification of the Korean Peninsula in the future, it will be useful for enhanced availability of funds to North Korea. There have been plenty of precedents of transition economies in the Central and Eastern Europe and East Asia. The publicity of these security rights will be obtained conveniently at comparatively low cost by means of electronic registration/filing on the Internet and telecommunications network.

#### **IV. Electronic Registration Procedures and Effects**

The non-possessory security right takes place when the filing system notifies the public of the existence of the security interest on the charged asset and enables the security grantor to continue to possess the security. Such types of the security right can be found in many countries.

For instance, since 1974 Canada had computerized the filing system over personal properties and receivables under the Personal Property Security Act prior to the United States. The system is called as "ACOL" (Atlantic Canada On Line)

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18) See the Preamble and Article 28 of the UNCITRAL document A/RES/56/81.

in the Atlantic Provinces.<sup>19)</sup> Poland introduced the American system on secured transactions with the financial assistance of the World Bank in June 1995, while Hungary empowered the Hungarian Chamber of Notaries to carry out the function of registering charges in 1996 based upon the legal technical advice of the EBRD.

Japan shows a good example in the Far East. When Japan implemented the ABS scheme through a special purpose company in 1998, it provided for the registration of designated monetary claims both on the Internet and off-line.<sup>20)</sup>

In Korea, the electronic registration would take place in the following manner:

- First, the registry shall be established by the name of debtors or security grantors. One can investigate the registry to ascertain whether the debtor has granted security over the personal property for finance or assigned the receivables to the third party.
- Second, one may apply for the incorporation of the following records of "security registration" into the commercial registry<sup>21)</sup>:
  - i. the name, address and ID number of security grantor, debtor (other than the security grantor), secured creditor;
  - ii. the maximum amount of the secured claims, and accompanying costs;
  - iii. the encumbered property or claims; and
  - iv. other necessary information within the scope of registration record limit.

If the foregoing takes place in Korea, we can expect a revolutionary increase of availability of funds for SMEs and individuals alike. If so, banks are willing to extend loans to small businesses upon the assignment to the banks of monetary claims or promissory notes payable to SME suppliers.<sup>22)</sup>

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19) Canadian jurisdictions have been divided into Quebec, where French law is still influential, and other Anglo-Saxon Provinces, where the Personal Property Security Act governs secured transactions. Ikeda Masao, *The Developments of Legal Theory on the Assignment of Receivables*, Koubundou Publishing Co., 2001, pp.207, 219.

20) Under the Japanese "Act Concerning the Exceptional Cases of the Civil Law for the Perfection of Assignment of Receivables", a debtor company may transfer the account receivables to the bank by electronically filing a relevant registry with the competent registrar. It means the bank would extend a loan to the debtor company upon the perfection of secured transactions.

21) At present in Korea, there exists electronic commercial register books for companies. The amendment to the existing laws and regulations is required for the filing of non-possessory security rights. Then the registrar should establish a new commercial registry for individuals, which does not exist right now. It has a striking resemblance in the registration of transfer of assets which, in usual ABS transactions, should be done at the Financial Supervisory Service under Article 6 of the ABS Act.

22) At present in Korea a large number of promissory notes payable to SME suppliers have been

Also, as mentioned before, such non-possessory security rights would be indispensable in North Korea,<sup>23)</sup> where only the state owns the land and valuable means of production, and debtors should continue to possess the security after they create a security interest for creditors. And an electronic registration system could notify the existence of the security rights with a nominal cost. It would constitute preparatory legal infrastructure for a Unified Korea in the future.<sup>24)</sup>

Key words: Secured Transactions, Electronic Registration, BIS, UNCITRAL

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replaced by suppliers' monetary claims assigned electronically to the banks. So small businesses take advantage of short-term loans from their banks the next day rather than two or three month-long waiting for not 100% probable payment of those promissory notes.

- 23) In view of the experiences of other transition economies, North Korea has nothing but to usher in foreign investors to develop its poor economy. It is necessary for this last communist country of the world to reshape such infrastructure to accommodate foreign capital as corporation law, secured credit law, insolvency law, etc. South Korea has to find opportunities to participate in these projects, and suggest to the North Korean counterparts a modernized regime on secured transactions as well as technical and financial assistance. If North Korea adopts quite different legal systems, not to mention of security rights, there would be tremendous troubles and confusion in trading between the parties from the South and the North. Harmonization and unification of legal systems will be of the utmost importance between the two Koreas.
- 24) Dong-Ho Cho, *The First Anniversary of the North-South Summit Meeting: the Valuation of Economic Cooperation between the North and the South and its Prospects*, Policy Research Series 2001-03, Korea Development Institute, 2001, p.86.

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