SECURED CREDIT IN COMMERCIAL INSOLVENCIES
A COMPARATIVE ANALYSIS

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I. Introduction

There is a concern in many countries that unsecured creditors occupy an unduly unfavourable position in commercial bankruptcies and, correspondingly, that preferred and secured creditors enjoy rights and privileges that can not easily be justified. We therefore initiated a *series of national studies* for six major industrial countries in various parts of the world: *Australia, England, France, Germany, Japan,* and the *United States of America.* Each of these studies investigates the status in bankruptcy of secured and unsecured creditors under the present law, and also proposals for reform.

This summary attempts to draw the comparative conclusions that emerge from the various national reports. At the outset we should establish a number of points or disclaimers:

1. The national studies are limited to the secured financing of *commercial enterprises.*

2. Since the studies concentrate on the position of the *secured creditor in insolvency,* it was impossible to deal with the full range of problems either of secured credit or of insolvency. The borderlines vis-à-vis these two general fields are, of course, not easy to draw and have, in fact, not been drawn uniformly in all the national reports.

3. We have also limited the scope of the studies with respect to the *collateral* over which security may be taken. We have concentrated on securities over corporeal movables as the central theme, because dissatisfaction about the theoretical approaches used, and the practical results archieved, in this area are of the greatest concern and have been given prominence in each national manuscript. Some attention has also been paid to accounts receivables as being a novel and important form of financing technique and therefore of collateral.

4. These problems and their solutions, present and proposed, are examined for *six countries,* three Civil and three Common Law systems. More important than this very general and, in this field, rather irrelevant division, the six countries display different attitudes to the problems of secured credit, based on diverse economic and social environments. The nature of the economic base, of business practice, of commercial morality, and of the social ethos clearly varies from country to country. It is precisely these factors which affect in each country the determination of desirable objectives for both security law and bankruptcy law. The six national reports are therefore capable of standing on their own and, by consequence, are published here *seriatim.*

5. In this paper, the editors offer a *comparative analysis,* identifying and analysing the major problems raised in the national studies, and evaluating the actual and proposed solutions. Our assessments of the existing legal systems and of proposals for reform are based upon criteria that we have had to establish ourselves[1]. In this respect, as in any comparative evaluation, a subjective element has inevitably affected our study.

6. Because of this subjective element, and certainly also due to our experience in different systems of law, this summary does *not necessarily* speak with *one voice.* Nor have we thought it necessary that any solutions propounded should be common solutions acceptable in all systems.

II. The Relation of Security and Bankruptcy

1. The Role of Security in Commercial Financing

a) Equality of Creditors and Security

The basis of insolvency procedures in all legal systems is the equality of creditors. However, this principle, is subject to, if not riddled by, exceptions. Everywhere certain classes of creditors are placed in various ranks or orders of priority, based either on the preferential status of certain types of claims or on security interests held by them in collateral. A comparison of

[1] See *infra,* II 1 e and f, and II 2.

the dividends received by preferred and secured creditors, on the one hand, and unsecured creditors on the other[2] suggests that the principle of equality has been substantially replaced by one of inequality.

Equality of creditors has been reduced to a secondary function: it merely ensures that the claims of all creditors in the same rank are satisfied *pro rata*. However, even as an intra-group principle, equality has little relevance to secured creditors. Each of them must often stand on his own feet because his success often depends on the celerity with which he can appropriate the collateral to the satisfaction of his claim.

b) Contract and Security

The preferential status of the secured creditor provokes the question in all legal systems why an agreement between a debtor and a particular creditor appropriating particular assets of the debtor (or, in the case of a floating charge, all the assets or a class of the assets of the debtor enterprise) to the satisfaction of a particular claim in priority over other claims should bind third parties, be they creditors or purchasers.

Here, the American report presents the view of *Grant Gilmore* that secured credit involves a proprietary theory operating in a contractual system and that the history of secured credit displays a tension between the law of contract and the law of property[3]. Whether or not one accepts Professor *Gilmore*'s rationalization, the purpose and effect of a security interest is to support a personal right or claim by conferring on the creditor a proprietary right which he can exercise in certain circumstances against the property of the debtor and in priority over certain other classes of claimants. It is precisely in the case of insolvency that the emphasis moves from the creditor's personal right or claim to his supporting proprietary right. Only the existence of this proprietary right makes the *inter partes* priority agreement binding upon third parties.

c) Creation of Real Rights

How do proprietary rights of security arise? In the Common Law, traditionally some overt act or element of publicity has marked the transition of a contractual right into a real right: delivery, whether actual, constructive or symbolic, representing a transfer of *dominium* over a *res;* or the solemn, formal, and often public execution or recording of documents. In modern societies, real rights are created by transferring possession of the collateral to the creditor or by registration or filing or by the giving of notice. These various methods of giving publicity may be conceptualised as "perfection" of a security interest[4], although this is still not a term of art.

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[2] See *Hiscock/Sono, sub* III 5 and Chart E, and *Drobnig, sub* II 3.

[3] See *Ayer, sub* III 2.

[4] See *Ayer, sub* II 4; *Goode, sub* II 2 i, and *Allan/Hiscock, sub* II, *in fine*.

The modern theory of the Common Law can be expressed shortly: an agreement for security between creditor and debtor has only *internal* effect, *i.e., inter partes.* For the security to be effective against third parties, perfection is needed. That is the general theory. The national reports from England and Australia in particular reveal instances of unperfected or quasi-securities[5] that are capable of having real effect generally or in liquidation.

The position is not very different in the Civil Law. As in the Common Law, the agreement to create a security interest has effect only between the parties; and, even more definitely, it is only the security interest which as a real right binds third parties. However, the true peculiarity of most Civil Law systems is that the parties are not allowed to create *any* kind of real right which their fancy may imagine and which they might deem appropriate for their purpose. Rather, the law of most countries offers to the parties only a limited number of well-defined real rights from which they may choose *(numerus clausus).*

The function of this limitation is twofold: as only a limited choice of real rights is available, third parties and the public in general have to cope only with a restricted range of well-defined types of real rights; this increases legal security and facilitates commercial intercourse. On the other hand, if the parties comply with the legal requirements for the creation of any particular type of security, they can be certain that their real right will have effect *erga omnes,* subject only to the appropriate legal limitations. Apart from this restriction to the statutory forms of real rights, the general requirements established by the Civil Law countries for the creation of security interests do not differ substantially from those of the Common Law. Delivery or registration are the most prominent methods, although they are less generally adopted than in the Common Law.

d) The Status of Security Laws

The American law of personal property security has benefited from the thorough overhaul effected by art. 9 of the Uniform Commercial Code (UCC) adopted in almost all States of the Union. America thus presents a functional, modern regulation of security over movables with a high degree of technical sophistication. In other countries, the security laws have not been consolidated and are therefore complex and confused. There are different forms of security that can be created over various categories of collateral; there are irrational divergencies as to the formalities for the creation and perfection of security interests; the priority rules and the pro-

[5] See *Goode, sub* II 2 b, and *Allan/Hiscock, sub* V. – Examples are *contractual arrangements* such as conditional sale or hire-purchase, based on reservation of ownership, which serve the function of security.

visions for enforcement differ. In all these countries, a coherent theory presenting a rational scheme reflecting modern needs and practices is lacking.

In the Common Law, the lack of a consistent theory and the absence of a *numerus clausus* has encouraged parties to invent new quasi-security rights[6]. In the Civil Law, the *numerus clausus* has, in France[7], prevented from introducing new security interests. In Germany and Japan, however, this principle has proved to be somewhat flexible by allowing, through customary law, the introduction of a few new security interests[8]. These makeshifts import a considerable degree of inconsistency and confusion into the existing systems of security law.

e) The Proprietary Nature of Security and the New Purposes of Insolvency Proceedings

In all countries secured credit, due to its proprietary nature, constitutes an exception to the principle of equality of creditors in insolvency[9]. It will be necessary to examine how far this exception remains justified where the financing of business has itself become so complex a matter, involving the interdependency of so many classes of creditors[10].

Moreover, increasingly the insolvency process is being directed towards the rehabilitation and reorganization of the debtor enterprise wherever this is feasible, and the public interest is seen to require that businesses should be saved from liquidation, if possible[11]. If the proprietary rights of the secured creditor enable him, by withdrawing collateral from the enterprise, to frustrate the prospects of rehabilitation and the continuation (or even eventual sale) of the business as a going concern, then these rights may be not only inimical to the bankruptcy process but also to the public interest. The question and consequences of restricting the proprietary effects of secured credit will therefore have to be faced.

f) The Scope of Reform

Given the preferred position of secured creditors and the weaknesses of their unsecured brethren, and also the confused state of security law in most countries, a reconsideration (if not reform) of security law seems imperative. But can one restrict a reappraisal of security interests to their status in the debtor's insolvency?

On the other hand, some revision of bankruptcy laws, involving also modifications of the rights of secured creditors in particular instances, is

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[6] See *supra*, note 5.
[7] See *Cabrillac* no. 9.
[8] See *Hiscock/Sono*, *sub* II 8, and *Drobnig*, *sub* I 3.
[9] See *supra*, a.
[10] See *Goode*, *sub* I and IV 6.
[11] See *infra*, 2.

feasible without a general review of security laws. However, we recognize that the reform of bankruptcy laws can be tackled more effectively against a background of modern functional security laws[12].

2. *The New Purposes of Insolvency Proceedings*

In all countries examined in this study, the purposes of insolvency proceedings have shifted in recent years. In the past, legal intervention has been virtually limited to securing the orderly distribution of the assets of the insolvent debtor among his creditors. Increasingly today, however, emphasis is placed upon the discharge of the debtor from the burden of his accumulated debts and on his financial rehabilitation. But this shift has not proceeded evenly. In some countries, bankruptcy is still "creditor-oriented" whilst in others today it is "debtor-oriented".

At one extreme stand the systems in Germany and France where the primary function of the law on the insolvency of a debtor is to secure the *liquidation and distribution* of his assets among his creditors in a prescribed order[13]. But the laws of both countries also provide for a second type of procedure aiming at the discharge of the debtor from some of his liabilities, or at least extending the time for their satisfaction – composition[14]. Dissenting unsecured creditors are bound by such arrangements which must be consented to by a majority of the creditors and require, in addition, approval of the court. In reality, however, in both countries compositions play a very minor and ever dwindling role in insolvency proceedings[15]. The elaboration of procedures for the rehabilitation of debtor-enterprises is one of the major objectives of the current efforts for an insolvency reform.

At the other extreme, in the United States of America the bankruptcy process is primarily a *debtor's remedy*[16]. It is seen as a means by which a debtor can relieve himself of an intolerable burden of debt and make a fresh start. It could be suggested that the extent to which this is available to individual debtors creates too much opportunity for cynical abuse, and

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[12] The compatibility of security and bankruptcy laws has an additional, *jurisdictional aspect* in the United States and Australia. In both countries, bankruptcy law is a federal matter while security is a matter of state law. The federal law of bankruptcy depends, for the scope of its effectiveness, on state security law as its basis. Experience proves that in these countries it is impracticable to restrict a reform of security law to insolvency proceedings. This is illustrated by the United States where the Bankruptcy Reform Act of 1978 could build upon the streamlined security of art. 9 UCC.

[13] See *Drobnig, sub* II 1.

[14] See *Cabrillac,* in note 1, and *Drobnig, sub* II 1.

[15] See *Cabrillac* no. 32, and *Drobnig, sub* II 1, note 66.

[16] See *Ayer, sub* I 2.

unfairly prejudices the interests of secured creditors; and certainly no other country (even though the Common Law countries permit the debtor to initiate proceedings in order to obtain the ultimate discharge of his debts) goes as far as the United States. In the case of insolvency of corporations, in the United States a sophisticated system of reorganization exists to which the interests, proprietary or personal, of all creditors are subordinated[17].

The other countries in this study all stand somewhere *between these two extremes*. Hence, England and Australia both recognize that the bankruptcy process, whether of individuals or of corporations, can be initiated either by creditors or by the debtor, and it appears that most proceedings today are in fact started by the debtor[18]. The debtor, if an individual, does this because for him the bankruptcy proceedings will end with his release from his debts, either formally by his discharge as a bankrupt or by some compromise or arrangement properly agreed upon with his creditors. If he is a corporation, then the law provides for the dissolution of the corporation as an unsuccessful business venture or, if the majority of the creditors agree, for its attempted rehabilitation through reorganization. However, the ability of secured creditors to resist proposals for rehabilitation and to enforce their claims to the full extent of their collateral is far stronger than in the United States[19]. Nevertheless, the trend of both reform and legal opinion in both countries is moving strongly in favour of protecting the interests of the debtor. In Australia this has been reinforced by the development of procedures designed to detect at an early stage a potential commercial insolvency and to avoid it[20]. These procedures operate for the benefit of debtor and creditors alike.

Perhaps the most interesting position is occupied by Japan, where the formal law of property and security is derived from the French and is clearly "creditor-oriented". But after the enactment of this formal law, American influence has been strong and is manifested both in later statutes and in commercial practice. Hence, reorganization of insolvent enterprises is the most important aspect of Japanese practice[21].

We conclude from our study that there is strong *public interest* and approval in all six countries for the development of rehabilitation policies in insolvency laws for both large and small enterprises, reserving liquidation only for those that can not be made viable and competitive. But this public interest is variously manifested. Often it expresses itself outside the field of insolvency law proper, by the grant of public subsidies, loans, or credit guarantees for faltering enterprises, but falling short of the coercion of dissentient secured creditors into making concessions. Only the United States

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[17] See *Ayer, sub* III 1.
[18] See *Goode, sub* III 2 a.
[19] See *Goode, sub* III 5, and *Allan/Hiscock, sub* VI.
[20] See *Allan/Hiscock, sub* VI.
[21] See *Hiscock/Sono, sub* III 5.

has so far faced the issue that the implementation of this policy may involve some reduction of the rights of secured and preferential creditors; and it is still too early to assess the consequences of this new legislation.

3. Law and Commercial Practice

The nature and extent of commercial practice is often difficult for the lawyer to assess. Most commercial activities occur at levels that are informal and discreet, and this may be particularly true in the relations of creditors *inter se* and with the debtor and where insolvency of the debtor is apprehended. Concessions and extensions will be granted to the debtor with a view to overcoming his difficulties and saving his enterprise. As long as no one dissents, the matter will be satisfactorily arranged without ever reaching a formal or official level, or calling in aid the institutions and mechanisms of the law[22].

The nature of this commercial practice and the extent to which it differs from the formal law is important for the law reformer, because the *gap between law and practice* will reveal the extent to which the law may no longer reflect commercial expectations[23]. But it is often difficult to discover and assess the practice. It is clear, for example, from the national studies that the gap between formal law and practice is very wide in Japan. On the other hand, it has apparently been closed in the United States by the Bankruptcy Reform Act of 1978, even though the practice under the new law will in due course need to be assessed. The other countries are moving to close that gap. In England, Australia, France, and Germany official committees are examining some of these problems, and in Australia the preparation of a new national Company Law includes a review of the provisions relating to insolvent companies.

If the existence of a gap between law and practice is the basis of a case for reform, it should not necessarily be assumed that the *non-existence of such a gap* indicates that the law is satisfactory. Law still needs to be assessed by objective criteria. Nevertheless, it is significant that in most of the countries studied (except perhaps in Germany) any real pressure for improving the relation between different types of creditors in an insolvency is lacking. Does this mean that preferential, secured, and unsecured creditors, debtors, and those concerned with the public interest all are content with the present position? Do unsecured creditors merely write off their bad debts, regarding the tax saved thereby as exceeding their likely recoveries from costly and prolonged bankruptcies? Would a strengthening of the legal position of unsecured creditors correspondingly weaken the position of secur-

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[22] This feature obviously distorts all official statistics on bankruptcy.

[23] *Cf. Goode, sub* IV 3, *in fine.*

ed creditors and therefore achieve no more than a transfer of the tax loss? Would reforms of this nature restrict the flow of credit? Do insolvent debtors simply walk away from their businesses in despair?

The absence of real pressure and of reliable data leads to speculation of this nature. However, in the next section it is proposed to examine, comparatively and in some detail, the situation of various classes of creditors and of the insolvent debtor, as well as to examine the public interest, in order to determine the strength of a case for reform.

III. The Case for Reform

1. Basic Assumptions

By the very nature of insolvency, the claims of all the persons affected by it can not be satisfied in full. It is the function of the law to find a proper balance between them based upon deliberate decisions of public policy and not on historical accident. In this part, we examine and compare the strengths and weaknesses of the position of each class of interested persons, both in reorganizations and in liquidations. We are aware that, as well as the interests of individual debtors and creditors, a public interest is also involved in each insolvency. This is concerned with the economic and social well-being of the community and with the achievement of social and economic justice through the processes of law.

Describing the interests of individual debtors and creditors, and even more the public interest, introduces a subjective element into our study. It is appropriate therefore to detail the basic assumptions we have made in assessing the situation of persons involved in insolvency procedures:

First, we have assumed that the public interest requires that insolvent commercial enterprises should be rehabilitated and thus saved from liquidation and destruction if it is commercially possible and realistic to do so. However, it must be clearly spelt out that a price has to be paid for the benefit of rehabilitation. Usually these costs are borne by the creditors, through the postponement or reduction of their claims, preferences or securities; and indirectly by the public, through increased tax burdens, price increases, and the general risk of continuing operation of possibly inefficient or uneconomic enterprises. Each insolvency therefore calls for an analysis of costs and benefits, the most difficult element of which is the public interest.

Secondly, we have assumed that, if rehabilitation is not practicable, the public interest requires the liquidation of the enterprise. This should proceed quickly and in an ordered way, properly balancing the interests of all persons involved. No creditor should obtain advantages over others that

are clearly unjustified or rest on defective legislative drafting. Social and commercial ethos may change over a period in a community, and the law should respond to this change. Thus in commercial financing, it is recognized today that all creditors have a role to play and that they are interdependent. The allocation of risks between secured and unsecured lenders, investors, and entrepreneurs is more as to type than as to quantum or priority. This new insight may call for a modification of the priorities traditionally granted to some creditors.

2. The Insolvent Debtor

a) Needs

If the insolvent debtor is an individual, he is interested in obtaining the widest possible measure of relief from his debts, optimally his discharge. If the insolvent debtor is an enterprise, its interest is the rehabilitation through a restructuring of its debts so that it can continue to function with increased chances of success.

Against this must be balanced the interests of both the creditors and the public to ensure that those who have supplied money and credit should be repaid. In the case of a corporate debtor, rehabilitation and reorganization can mean the preferring of one class of investors (the equity participants) as against the other (the providers of loans and credits).

We suggest that a due balance of the interests of the debtor on the one hand and those of the creditors on the other hand does require (1) in the view of the Australian co-author which is not shared by the German co-author, that, if the debtor is an individual, insolvency proceedings give him prospect of eventual release from his debts even though he is not able to satisfy them in full; (2) that, whether he be an individual or a corporation, coercive procedures ought to exist to compel a minority of creditors to concur in concessions which the majority are prepared to extend him in order to secure his rehabilitation; (3) that, if the debtor is a corporation, the law ought to provide adequate machinery for its reorganization (again coercive, if necessary) in appropriate cases; and (4) that in any insolvency proceedings secured creditors be prevented, at least temporarily, from frustrating the purpose of the proceedings by withdrawal of the collateral.

b) National Responses

The law and practice in the six countries included in this study reveal an astonishing range of responses to these basic, and in our view justified, needs of the debtor.

(1) On the question of the *debtor's discharge*, the old dichotomy between the Civil and the Common Law has been essentially confirmed. The Common Law jurisdictions are clearly more debtor-oriented, offering him the

release from his debts, although on differing conditions[24]. Among the Civil Law countries, France and Germany have preserved their traditional creditor-oriented attitude so that the debtor can not be discharged from his debts by bankruptcy. Japan which had earlier followed this approach changed lines in 1952, under American influence. In fact, however, because of social pressures, the bankruptcy process is rarely invoked by individuals as distinct from commercial enterprises[25].

(2) The *rehabilitation* of an individual and the *reorganization* of a corporate debtor are increasingly becoming a major, if not the primary purpose of insolvency proceedings. This is particularly pronounced in the United States where the new Bankruptcy Reform Act has generalised an earlier trend[26]. American law has had a strong impact upon Japan, where it met with a general predisposition and therefore was received wholly. Bankruptcy, already socially discouraged for individual debtors, is in declining use for business debtors as well[27]. Commercially and legally, corporate reorganization now takes priority[28]. Australia provides for the supervision and official management of companies that are experiencing financial difficulties[29] and quite generally prefers rehabilitation to liquidation[30].

In England, France and Germany, compromises or compositions and company reorganizations play a modest role[31], perhaps because of the restrictions on their coercive nature.

(3) The effectiveness and utility of rehabilitations and reorganizations depend to no small degree upon their *coercive nature*. While unsecured creditors are everywhere even against their will subjected to concessions voted by a majority, the position of secured creditors varies.

Here again, the countries of the Common Law are more debtor-oriented. This trend is particularly strong in the United States: The new Bankruptcy Reform Act permits coercive measures to scale down the claims of secured creditors in several cases, including where it is "fair and equitable" to approve a plan for reorganization[32]. The Australian Uniform Company Law provides for reorganizations that may affect non-participating secured creditors[33]. Also the Japanese Corporate Reorganization Law authorises the binding of both secured and preferred creditors by a reorganization[34].

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[24] American law is particularly liberal in this respect; see *Ayer, sub* I 2. Release from his debts is a major goal of the debtor in applying for bankruptcy, especially in the United States (see *Ayer, sub* I 2 and note 7), but increasingly also in England and Australia (see *Goode, sub* III 1 b, and III 2 a).

[25] See *Hiscock/Sono, sub* III 5.

[26] See *Ayer, sub* I 2.

[27] See *Hiscock/Sono, sub* III 5.

[28] See *Hiscock/Sono, sub* III 3.

[29] See *Allan/Hiscock, sub* VI.

[30] See *Allan/Hiscock, sub* IV 2.

[31] See *Goode, sub* IV 4; *Cabrillac* no. 32; *Drobnig, sub* II 1 note 67.

[32] See *Ayer, sub* III 1 c.

[33] See *Allan/Hiscock, sub* IV 2.

[34] See *Hiscock/Sono, sub* III 3.

On the other hand, the creditor-oriented approach dominates in the three European countries. Neither in England nor in France nor in Germany may secured creditors be constrained to sacrifice parts of their claims or of their security in a composition[35].

If we attempt to summarise by countries, the new law of the United States clearly represents an extreme debtor-orientation. The principles of rehabilitation and reorganization have been realised as fully as possible, and therefore to the detriment of all creditors, including preferred and secured creditors. Japan seems to come closest to the American position. Perhaps even stronger than in the United States, bankruptcy is giving way to corporate reorganization; for individual debtors it has fallen into disuse. Australia has also introduced corporate reorganization and emphasises the desirability of rehabilitation rather than liquidation where rehabilitation is possible. Wherever corporate reorganization has been introduced, it implies of necessity sacrifices by the secured creditors, even against their will.

The three European countries, by contrast, are more creditor-oriented; in particular, they can not at all or not effectively constrain secured creditors to participate in compromises, either with their claims or even with their collateral.

e) Conclusion

Do these very considerable divergencies of the legal solutions really reflect corresponding differences of the underlying commercial ethos and conceptions of social and economic justice? Or do not the discrepancies represent various evolutionary stages? Indeed, we think that the variations between the models are explicable more by their (accidental) date of enactment than as conscious policy decisions.

3. The Secured Creditor

a) Needs

The secured creditor is interested in receiving payment of the debt (including interest, etc.) upon the contractual terms. In the event of the debtor's default (however defined by contract or statute), the creditor wishes to seize the collateral, to retain or dispose of it, and to satisfy his claim out of the proceeds – with deliberate speed and undisturbed by other claimants[36].

These "selfish" interests of secured creditors must, of course, be balanced with those of other persons – with that of the debtor, to be relieved from

[35] See *Goode*, *sub* III 5, and *Drobnig*, *sub* II 2 c.

[36] For a consideration of why creditors seek security, see *Allan/Hiscock/Roebuck*, Credit and Security, The Legal Problems of Development Financing (1974) Ch. 4.

his debts and to be enabled to make a fresh start; of the unsecured and the preferred creditors, to obtain also maximum satisfaction of their claims; of the public, to allow as much satisfaction as possible of the claims of all creditors, but also to rehabilitate or reorganise the debtor so as to preserve him as an active economic unit.

Once again, any attempt to state the justified limitations of secured creditors' rights involves subjective value judgments. The following guidelines appear to the authors to be appropriate under present conditions:

(1) A secured creditor should be able to *realise the collateral,* by appropriation either of the *res* for an appropriate price or, after disposal, of its proceeds. However, satisfaction should be limited to the outstanding amount of the credit, plus accrued interest[37] plus reasonable expenses of realization.

(2) If *ownership* is used for security purposes, it should be treated merely as a *security interest.* Upon the debtor's default, a creditor therefore should not be entitled to appropriate either the collateral or that part of its proceeds that exceeds the claim secured.

(3) The right of the secured creditor to separate his collateral from the debtor's estate upon default may be subjected to *limitations,* provisionally or permanently, if the collateral is required to rehabilitate or to reorganise the insolvent debtor, provided there is reasonable prospect for the success of such an operation. The "compensation" to be granted to the secured creditor for this sacrifice will have to be worked out.

The purpose of these guidelines is to limit, not to do away with security for credits. The lending of money is an economic necessity: it carries a risk against which it is legitimate for the creditor to seek protection; the more effective such protection is, the lower is the cost to be paid for it by the debtor. And yet on the other hand, in commercial financing and in terms of economic function, it may not be realistic to distinguish providers of equity from providers of loans. The latter seek higher priority and a fixed yield, but may enjoy an unduly privileged position in relation to the former. Their arbitrary power to foreshorten the reasonable prospects of success for the enterprise may not be compatible with a financing plan based on co-operation between providers of different forms of finance.

The national responses are here much more complex than with respect to the insolvent debtor's position. It is therefore necessary to divide the following discussion by turning, first, to general problems of security interests; second, to special problems of the different types of collateral; third, to ownership of tangible movables as a security; and finally, to the question of how secured creditors are affected by rehabilitation or reorganization proceedings.

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[37] *"Accrued interest"* should not include interest for future periods which according to the contract falls due immediately upon default.

b) General Problems of Security Interests

The general character (and many specific rules) of security depend upon whether a country has a unified security interest or rather several, perhaps competing security devices. A uniform security interest also facilitates a comprehensive coverage of fluctuating or diverse collateral. Discussion will therefore start on these general issues.

(1) *Unified v. Plural Systems of Security Interests.* – Only in America, art. 9 UCC offers the successful legislative model of a unified security interest. Its rules supply a uniform frame for all conceivable forms of security which the parties may wish to create[38]. Article 9 UCC has been imitated in some Canadian provinces and has served as a model for recommendations in England and Australia[39]. Whether it is also exportable to Civil Law countries, appears to be more doubtful[40].

Everywhere else, a picture of complexity and confusion arises. A great variety of statutory and contractual security interests exist, with widely differing prerequisites and incidents. The result is a bewildering pattern of priorities, and in some countries, such as France, beset with perplexing uncertainties. This picture is obviously the result of historical accident, of stop-gap legislation or case law. Even the *numerus clausus* of the Civil Law countries has not prevented the multiplication of forms of security that disfigures the Common Law. Where that principle was taken rigidly, as in France, the legislator stepped in repeatedly and produced patchwork; elsewhere, as in Germany and Japan, non-security institutions such as ownership were misused for security purposes, as in the Common Law.

It is obvious that a multiplicity of forms of security makes an orderly administration of insolvency proceedings more cumbersome, expensive and time-consuming. Any insolvency reform must therefore be interested at least, or aspire at most, to produce a unified and simple system of security interests.

(2) *Comprehensive Security Interest.* – A major characteristic trend in all modern industrialised countries appears to be the pressure to use an all-embracing security interest to secure a high volume of more or less permanent credit to an enterprise by diverse types of fluctuating collateral. While the creation of such a comprehensive security interest does not depend on the existence of a uniform security interest (*supra* (1)), it is definitely faciliated by it.

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[38] See *Ayer, sub* II 3.

[39] See *Goode, sub* IV and IV 1, and *Allan/Hiscock, sub* V 3, note 48.

[40] See the reserved replies from the viewpoint of German and Quebec law by *Drobnig,* Is Art. 9 UCC Exportable? A German View, in: *Ziegel/Foster (ed.),* Aspects of Comparative Commercial Law (1969) 368–373; *Caron,* L'article 9 du Code Uniforme de Commerce peut-il être exporté? Point de vue d'un juriste Québecois, in: *ibid.* 374–395.

The umbrella effect of a comprehensive security interest necessitates that a wide range of the debtor's assets, present and future, be covered. Technically, this requires that in describing the collateral in the security agreement and, where applicable, its registration a general form of words (instead of a specific description) be acceptable[41].

The Common Law countries have developed *two major variations* of a comprehensive security interest: In England and Australia the *floating charge* may encompass all the present and future assets of a company or all assets of a particular class; it is "floating" until it "crystallises", to become a fixed charge upon an event of default, as defined in the underlying agreement. It is used as the basic security in commercial financing, especially by banks supplying working capital or where issues of debentures to the public are secured by a trust deed[42]. Its comprehensive nature is to some degree offset by limitations on its priority, coupled with the use of subordination agreements[43]. These limitations enable other financers to take fixed charges having priority over the floating charge although subsequent in time, either for financing the acquisition of specific capital assets or even for sharing in the general financing of the enterprise. – The American "*floating lien*" is, as the doctrinal, not statutory term indicates, of a somewhat different nature. It may encompass, like its English counterpart, all the present and future assets of a particular class or of several classes. But in contrast to England, this lien does not float and therefore need not crystallise; rather it is from its inception a fully effective security interest. Since the debtor is empowered to dispose in the course of ordinary business of the charged assets, these can to that extent be released from the lien. On the other hand, as a fully effective security the floating lien, as a rule, takes priority over all subsequent security interests. However, an exception is here provided for securing purchases by the debtor[44]. The Japanese Enterprise Security Law, probably enacted under English and American influences, reaches very similar results[45].

Outside Japan, the notion of a comprehensive security has not openly developed in the Civil Law countries. In Germany, it is possible for a debtor to use all the present and future assets of a specific class or of several classes for securing finance, but this requires skilful drafting and the combination of several security devices[46]. In France, not even such makeshift arrangements are allowed.

The reluctance of the Civil Law countries to adopt a comprehensive

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[41] This is admissible in the Common Law countries (see, *e.g.*, s. 9–402(1) and (3) UCC; *Goode, sub* II 2 e), but not in the Civil Law countries (see, *e.g.*, on the German principle of "specificity" *Drobnig, sub* I 1 b).

[42] See *Goode, sub* II 2 f, and *Allan/Hiscock, sub* III 3.

[43] See *Goode, sub* II 2 k.

[44] See s. 9–312(3) and (4) UCC.

[45] See *Hiscock/Sono, sub* II 6.

[46] See *Drobnig, sub* I 3.

security is inspired both by the desire to protect the other creditors against excessive security and by an apprehension about giving excessive control of the enterprise to one lender. The protection of other creditors can only be achieved effectively by statutory limitations upon time-based priority. Experience in England and Australia shows that the fear of a credit monopoly is unfounded in practice since lenders frequently seek to spread the burden and risk of financing.

(3) *Formalities.* – The historical accidents which led, outside the United States, to the multiplication of security interests, also produced widely differing formalities. Only such formalities will be reviewed here which are necessary for making the security interest effective vis-à-vis third parties (especially other creditors of the debtor), *i.e.* to grant it perfection[47], as distinct from formalities required for the underlying security agreement.

At the one extreme of the multicoloured spectrum of national responses stands *registration*, prescribed either as the general method of giving publicity (United States and France) or for certain important types of securities (England and Australia) or only for marginal forms (Japan and Germany). However, registration has today many meanings: these range from filing of minute details of the security agreement, especially of all items of the collateral *(e.g.*, the English bill of sale) to the filing of a general notice of intention to charge assets of (a) certain type(s) (United States). At the other extreme is complete freedom from any means of publicity, especially in Germany, but also to some degree in England, Australia and Japan.

No coherent policy appears to have fashioned these various solutions, especially where they differ within a country. In most countries there is a distaste for secret charges, but in some the acceptability or desirability of registration[48] and in others the cost, both public and commercial, of extending existing schemes is controversial[49]. Only in America is there apparent a public and general acceptance of the need for registration as the means of perfection and the determination of priority.

The reluctance to require *filing* is in part due to the special status of security devices based upon ownership (see *infra* d) which have not been widely regarded as security proper.

In England and Australia, some of the registration statutes themselves are defective. They require filing in order to perfect security interests against purchasers and secured creditors, but not vis-à-vis unsecured creditors and against the trustee in bankruptcy[50]. The legislator ought to make registration a prerequisite of validity in insolvency proceedings.

[47] On this new, American inspired term see especially *Ayer, sub* II 4 and III 1; furthermore *Goode, sub* II 2 i and IV 2; and *Allan/Hiscock, sub* II, *in fine.*

[48] See *Drobnig, sub* III 2 a.

[49] See *Goode, sub* II 2 b and IV 2; *Allan/Hiscock, sub* II, *in fine.*

[50] See *Goode, sub* II 2 i and IV 2; and *Allan/Hiscock, sub* V 3 and 4. See also d, *infra.*

The main point of controversy, of course, remains whether filing or registration is basically necessary or desirable. However, this problem can not be meaningfully discussed in the context of insolvency only; that requiring registration might reduce the number of secured creditors in bankruptcy does not suffice as a justification.

(4) *Priorities.* – The secured creditor will wish to rank highest in priority; if there are to be higher ranking creditors, he must at least be able to predict the order of priority at the time when he advances his credit.

In most countries, the secured creditor usually precedes all other creditors. And among several creditors secured by the same collateral, usually priority in time gives the better right. However, there are important exceptions to these two basic rules. The most significant deviation from the "*prior tempore*" principle is the precedence which fixed charges in England take over a prior floating charge and in Japan over an enterprise security[51] – thus compensating for the comprehensive nature of the latter. Another typical exception is that in favour of later purchase money security interests in the United States, in order to secure the financing of new acquisitions[52]. Also in other countries, in certain situations preference is given to subsequent purchase money security interests[53].

Outside Germany and the United States, priority rules are often highly complex, as in Japan[54]; on many points uncertain, as in France[55]; or unsatisfactory and inconsistent in substance, as in Australia and England, as is stated trenchantly in the English report[56]. Neither country, for example, even where it prescribes registration as necessary for the perfection of a security, has made the date of registration the point of priority[57].

The United States and Japan allow the priority rules to be disregarded in reorganization proceedings *(infra* e).

(5) *Avoidance in Insolvency Proceedings.* – In all countries the trustee in bankruptcy may set aside certain security interests in the same way as other transactions and for the same purposes, namely to undo arrangements conferring, in view of the debtor's imminent insolvency, an undue advantage upon a particular creditor.

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[51] See *Goode, sub* II 2 k (4), and *Hiscock/Sono, sub* II 6.

[52] See s. 9–312(3)–(4) UCC.

[53] Thus in Germany according to case law; see *Drobnig, sub* I 3 c.

[54] See *Hiscock/Sono, sub* II 3. [55] See *Cabrillac* no. 1.

[56] See *Goode, sub* IV 3: "The priority rules in general are confused and lacking in consistency, depending partly on the time of creation of the security interest, partly on whether it is legal or equitable, partly on whether it is registered or unregistered, ... These deficiencies are symptomatic of a more fundamental weakness, namely, the failure of English law to prescribe priority rules which have regard to the cycle of assets involved in commercial dealings ..."

[57] See *Goode, sub* IV 3.

The nature and extent of powers of avoidance vary considerably from country to country. They are most extensive and complex in America, where there are a number of bases of attack and a wide range of both derivative and inherent powers in the trustee[58]. In England and Australia, whilst not identical, they are broadly similar, but simpler and less sophisticated[59]. The relevant factor in these countries for determining the avoidability of transactions is not the impact of the transfer on other creditors, but the motive of the debtor in making it, and this may not be altogether realistic today. Also, in France, Japan and Germany, where there is an extensive range of powers of avoidance, the test is whether there was an intention to take an unfair advantage, and it is suggested that this test is far too subjective[60].

(6) *Enforcement and Realization.* – In most countries outside France[61], the secured creditors may generally exercise their rights without court action or prior approval by the court. This presupposes a valid and unimpeachable security and, at least in theory, a perfected one[62]. There are three main remedies.

(a) In all countries reviewed there exists in the secured creditor the right of *separation of the collateral* from the bankrupt estate.

The rights of the secured creditor who claims by virtue of ownership are discussed separately; *infra* d (2). The same is true of the impact of rehabilitation and reorganization proceedings upon the secured creditors' right; *infra* e.

(b) For security interests in the traditional sense, the secured creditor is obliged *to dispose* of the collateral *and to satisfy* his secured claim from the proceeds, *any excess to be paid over* to the bankrupt estate[63]. The ancient Anglo-American remedy of foreclosure which allowed the secured creditor to appropriate the collateral requires a court decree[64] and is now rarely used.

As to the special rules with respect to the enforcement of security interests based upon ownership, see *infra* d (2).

(c) In England and Australia, the *appointment of a receiver* is a most useful method of safeguarding the interests of the creditors or of rehabilitating the debtor, where that appears to be feasible[65].

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[58] See *Ayer, sub* III 2.

[59] See *Goode, sub* III 2 d and 3; *Allan/Hiscock, sub* III 2.

[60] See *Cabrillac* no. 9; *Hiscock/Sono, sub* II 8 c and III 8 b; *Drobnig, sub* II 2 a.

[61] See *Cabrillac* no. 29.

[62] See discussion of "perfection", *supra* (3).

[63] See, *e.g., Ayer, sub* II 3 and III 1; *Goode, sub* II 2 a(5), III 3 and 4; *Allan/Hiscock, sub* III 1; *Cabrillac* no. 29; *Hiscock/Sono, sub* II 8 b; *Drobnig, sub* II 2 b.

[64] See *Goode, sub* II 2 a (6) and j.

[65] See *Goode, sub* II 2 b and f, III 1 b and 4; *Allan/Hiscock, sub* VI.

Is the Civil Law world precluded from access to this interesting institution because it does not have at its disposal the flexible instruments available in Equity? Scotland shows that this is not so. It has introduced not only the floating charge, but also, although with some hesitation and delay, receivers for these charges[66].

c) Availability of Collateral

(1) The interests of both the secured creditor and the debtor require that *all assets* of a debtor enterprise *should be available* as collateral to secure credit. This general postulate has been fulfilled in all countries reviewed except France. The latter makes available as non-possessory security only those few types of assets for which special statutes have been enacted[67]; characteristically, these are mainly designed to secure purchase money. On the other hand, such a limitation of assets available as collateral leaves more chances for the satisfaction of unsecured creditors.

(2) The use of *intangibles* as collateral (rights and especially choses in action) has vastly increased in the last two or three decades. In the Common Law countries, security over intangibles can be created by way of mortgage, charge or pledge according to the nature of the right[68]. Some difficulties can arise over perfection[69]. In the Civil Law countries, apart from France, the pledging or the (security) assignment of intangibles are true alternatives – comparable to the choice between a (possessory) security interest and a security transfer of title. In Japan, it is difficult to distinguish between the pledge of a right and a *joto tampo* transfer[70]. In Germany, there is no such difficulty because pledging of a right requires notification of the debtor; avoidance of this burdon is the main reason for preferring (security) assignments[71].

d) Ownership as Security

All countries outside the United States have been tempted to develop new forms of non-possessory security based on retention or transfer of title. In England and Australia, this has been motivated by the desire to avoid the bills of sale legislation, and in the Civil Law countries by the absence of a statutory non-possessory security. In all countries, these efforts have been more or less successful in the end, but have caused many difficulties in theory and in practice.

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[66] The Companies (Floating Charges) (Scotland) Act 1961 was amended by the Companies (Floating Charges and Receivers) (Scotland) Act 1971.

[67] See *Cabrillac* no. 7.

[68] See *Goode, sub* II 2 e.

[69] See *Allan/Hiscock, sub* II, *in fine.*

[70] See *Hiscock/Sono, sub* II 7.

[71] See *Drobnig, sub* I 3 c.

Except for two short statutory authorisations[72], ownership as security has been developed in the Civil Law countries of Japan and Germany outside the written law. Functionally, ownership as security has been used for two distinct types of financing: Primarily by sellers for purchase money, in the form of retention of title (conditional sale), and the Anglo-Australian hire-purchase or leasing; but sometimes also for general credit by lenders, in the form of retention of title (conditional sale), and the Anglo Australian "security transfer of title" by the debtor to the creditor. The two techniques of retaining and transferring title differ, of course, as is demonstrated, *e.g.*, in the German report[73]. Assignments for security, incidentally, would raise problems similar to those of a security transfer of ownership, but for the intervention of equitable principles.

More important in the present are the *common features* of these two substitute forms of ownership as security. The most significant one is that, if corporeal movables are involved, the debtor possesses the collateral, while title to it is in the creditor. Three problems deserve to be mentioned here: First, whether the debtor (buyer) has any interest in the "collateral" which can be made available to his creditors; second, the owner-creditor's rights upon the debtor's insolvency; and third, whether in a system of registration of security interests the owner-creditor can, without registration, assert his title to the goods and reclaim them in the debtor's insolvency.

(1) Whether the *debtor* (buyer) *has an interest* in a collateral owned (for security purposes) by the creditor (seller) is, of course, not only relevant in the debtor's insolvency, but more generally[74].

Among the Common Law countries, England represents the most formal position in favour of the secured creditor, at least for title retention. The debtor is treated merely as a hirer or purchaser of the assets and does not acquire any interest in them before formal transfer of title[75].

By contrast, Australia and in part also Germany have strengthened the debtor's position and thus incidentally also that of his general creditors. The (uniform) Hire-Purchase Acts of the Australian states grant the debtor, both under a hire-purchase or a conditional sale, an interest in the goods according to a legislative formula[76]. In Germany, the debtor, under a conditional sale, is recognized by case law as acquiring an expectancy in the purchased goods; but prevailing opinion refuses to grant a corresponding interest to the debtor under a security transfer of ownership[77].

The treatment of ownership securing general credit occasionally also differs elsewhere from that of securing purchase money. In the Common Law

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[72] See *Cabrillac* no. 9 note 25, and *Drobnig, sub* I 3 a.
[73] See *Drobnig, sub* I 3 a and b.
[74] See *Drobnig, sub* I 3 a (4).
[75] See *Goode, sub* II 2 b and IV 1.
[76] See *Allan/Hiscock, sub* V 3.
[77] See *Drobnig, sub* I 3 a (4) and b, in note 44.

countries, the mortgage has developed from an outright (security) transfer of ownership into a properly limited security interest. This has been achieved by Equity which recognised the debtor's (morgagor's) equity of redemption and controlled the creditor's right of foreclosure[78]. In addition, various statutes, including the much maligned bills of sale legislation in respect of goods have been enacted.

(2) The *owner-creditor's rights* upon the debtor's insolvency sometimes depend upon whether the debtor is recognised as having an interest in the collateral. The creditor may either be entitled to reclaim his property, as an owner; or to separate it for purposes of his satisfaction, as an ordinary secured creditor; or he may be denied any right.

Where the debtor is denied any interest in the collateral, the owner-creditor usually may reclaim and retain it. This is so in England except where the reputed ownership-clause (see *infra*) applies, in Australia, and in France[79].

Where, on the other hand, the debtor is granted an interest in the collateral, the owner-creditor's right is generally restricted to separation and preferred satisfaction, like any ordinary secured creditor[80].

In Germany, the creditor's rights are independent of whether or not the debtor is granted an interest in the collateral. Although he is denied such interest in assets transferred by him into the creditor's ownership as security, the latter may not reclaim, but can only separate[81]. On the other hand, although the buyer-debtor has an expectancy of a proprietary nature in the assets (still) owned by the seller, the seller may reclaim his assets, but subject to the right of the trustee in bankruptcy to adopt the contract of sale by paying the outstanding part of the purchase price[82].

In the Japanese *joto tampo* it is not clear, whether the creditor may reclaim or can merely separate[83].

Finally, in England in bankruptcies of individuals only, the creditor's property possessed by the debtor with the former's consent in his trade or business in such circumstances that he is its reputed owner will pass to the trustee[84]. This "reputed ownership clause" precludes the creditor both from reclaiming and separating the collateral although, outside bankruptcy, the buyer is not recognised as having an interest in assets bought on credit.

Extensions of the security interest into proceeds from the collateral by contractual agreement do not always share the status of the original collateral. Thus German court practice has limited the secured creditor's rights to proceeds from a retention of title clause (such as the claim for the pur-

[78] See *Goode, sub* II 2 a (6).

[79] See *Goode, sub* II 2 j and III 2 b; *Allan/Hiscock, sub* III (Introduction), and *sub* III 1; *Cabrillac* no. 9, note 25.

[80] See *Goode, sub* II 2 j.

[81] See *Drobnig, sub* II 2 b.

[82] See *Drobnig, sub* II 2 b.

[83] See *Hiscock/Sono, sub* II 7.

[84] See *Goode, sub* III 2 b.

chase money of the collateral) to separation and separate preferential satisfaction[85], although retention of title in the original collateral would entitle the creditor to reclamation. In England, however, the recent *Romalpa* case extended the creditor's right of reclamation into certain proceeds from the original collateral[86].

(3) Except for bills of sale in England and Australia, *registration of ownership* retained or transferred as security generally is not provided for. Only in Australia and Japan is the registration of a few major items such as motor vehicles or aircraft possible, if and insofar as a title registration system has been prescribed[87]. Under any functional rather than formal analysis, all devices based upon ownership, but typically serving security purposes should be regarded as securities, as in the American UCC art. 9; they should therefore be subjected to the same formalities as the orthodox forms of security.

On the whole it is obvious that the ultimate purpose of amalgamating ownership with the ordinary security devices has so far only been achieved to a minimal degree. The most radical and therefore most successful step has been undertaken in the United States which has simply reduced ownership as a security to the same status as an ordinary security interest. However, the American example also shows that such a step can best, and perhaps only, be undertaken within the framework of a comprehensive reform of the whole system of security; in such a broader context one must also examine whether perhaps certain incidents of ownership should be adopted for the new, uniform security interest.

e) How Are Secured Creditors Affected by Rehabilitation or Reorganization Proceedings?

The interests of the secured creditor may require even more modification in proceedings whose object is not the liquidation and distribution of the debtor's assets, but rather his rehabilitation or the reorganization of the debtor-enterprise as a profitable venture. The greater sacrifice is justified by the fact that only a common effort in which creditors of all classes assume an equitable share of the burden will succeed in the common goal of re-establishing the debtor or the debtor-enterprise on a basis on which he

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[85] See *Drobnig, sub* II 2 b.

[86] See *Goode, sub* II 1 b. It is to be noted that tracing into mixed products would probably not be possible without an express clause to this effect, which would be registrable as a charge, but this reasoning may not apply to proceeds mingled with other money.

[87] See *Allan/Hiscock, sub* V 3; for Japan see *Tanikawa/Allan/Hiscock/Roebuck*, Credit and Security in Japan, The Legal Problems of Development Finance (1973) 96–97, 100, 111, 112.

or it will be able to repay his or its debts. In view of the great share which secured financing usually occupies in the whole financing of an enterprise today its share of the total burden must also increase correspondingly.

The most far-reaching measures have recently been introduced in the United States[88]. Not only does filing of a bankruptcy petition operate to stay many creditor actions (including separation of collateral), but also in the interest of reorganization the trustee may call a halt to any realization of collateral commenced before the bankruptcy, may recover that collateral, and may use it in the affairs of the bankrupt enterprise. He may do this in some cases even though the debtor had no equity in the collateral. The process is, however, subject to court supervision. By its "cram down" power the court can confirm a plan for the restructuring or scaling down of the debtor's obligations over the dissent of secured creditors, even though it may reduce their rights, if it is "fair and equitable" to do so. In this way the trustee is able, as the American report says, "to enjoin creditor harrassment and to permit unhampered operation of the business, with orderly payments on debt"[89].

A similar situation exists, in effect, in Japan. Once a corporate reorganization is begun, most secured creditors are forbidden to act outside this procedure[90]. Furthermore, the trustee's powers of avoidance of securities are extended in a corporate reorganization to include certain acts that would be inimical to the reorganization[91]. The filing of an application for reorganization authorizes the court to suspend any executory processes affecting the enterprise and, once the court approves the commencement of reorganization, the suspension is automatic and most securities are converted to "preferred reorganization obligations" giving preferred status in the reorganization. Accordingly, the failure of the secured creditor to participate in the reorganization procedure results in the complete forfeiture of his rights[92]. The right of separation is nullified, although rights of reclamation continue and these cause problems with security transfers of ownership[93].

In no other country considered here has the philosophy behind these measures yet been accepted. In England there is virtually no inroad on the rights of secured creditors[94]. In Australia, the court has only very limited power to approve company reorganizations over the dissent of a minority of secured creditors[95].

Neither in France nor in Germany can secured creditors be forced by majority vote to participate in a compromise and thus to accept a reduction

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[88] See *Ayer, sub* III 1 c and 3.
[89] See *Ayer, sub* III 1 c.
[90] See *Hiscock/Sono, sub* II 8 a and III 3.
[91] See *Hiscock/Sono, sub* II 8 c.
[92] See *Hiscock/Sono, sub* III 3.
[93] See *Hiscock/Sono, sub* II 7 and III 3.
[94] See *Goode, sub* III 5.
[95] See *Allan/Hiscock, sub* IV 2.

of their claim or security. In France, the secured creditors are invited to participate; unless they expressly decline this invitation, they are considered as having agreed[96]. In Germany, the security agreement (or clause) underlying the security interest remains, as a rule, in force so that the debtor is bound to continue his payments in full. The debtor may, however, with court approval decline performance of the contract, in which case the creditor may reclaim the collateral[97].

f) Conclusion

It seems obvious that the strong position which the secured creditor still occupies in most countries, apart from the United States and Japan, does not permit effective management of the debtor's financial crisis. American and also Japanese law will serve as a source of inspiration for improvement.

4. Preferred Creditors

In all countries certain creditors without consensual securities may nevertheless enjoy a preference over other creditors – sometimes ranking even before secured creditors. These preferential rights may be general, charging all of the debtor's property, or special, charging only specific assets.

The growth and the *present pattern* of the various preferential rights is everywhere haphazard, reflecting little rational policy. One can perhaps identify three major purposes: First, the protection of the public interest, especially the collection of tax claims and claims for contributions to social security; second, a social policy protecting the recovery of wages of labourers and employees; and third, a rather diffuse general commercial policy in the interest of certain classes of creditors who are often unable to demand a consensual security from their debtor. Especially this latter class of creditors varies widely in both number and type from country to country. The number of preferred claims is more limited in the Common Law countries[98] and in Germany[99]; it increases enormously in France[100] to make up for the restricted admission of consensual security interests, but also in Japan[101] where not even this justification applies today.

In the Common Law countries, exceptionally, some preferential claims take limited priority over floating charges[102]. On the other hand, it is

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[96] See *Cabrillac* no. 29.

[97] See *Drobnig, sub* II 2 c.

[98] See *Ayer, sub* II 3; *Goode, sub* II 2 d, and *Allan/Hiscock, sub* III 1, note 27a.

[99] See *Drobnig, sub* II 1.

[100] See *Cabrillac*, nos. 3–5, 10–11.

[101] See *Hiscock/Sono, sub* II 1–3 and Chart E.

[102] See *Goode, sub* II 2 k, *in fine*.

noteworthy that Australia has recently considerably restricted the preference for tax claims[103].

There is clearly a case for *restructuring preferential rights* in all the countries here reviewed in order to obtain rational patterns complying with the demands of the day. Because of modern high tax rates and the resulting great amounts of tax claims, this preference deserves particularly careful scrutiny. Any restrictions that are imposed on secured creditors in order to redress the balance in favour of the debtor or the unsecured creditors, should also be imposed on preferential creditors. Otherwise they would reap the whole benefit of the secured creditors' sacrifices.

5. Unsecured Creditors

a) Treatment

There is only sparse information about who the unsecured creditors are and about their role in the commercial financing of enterprises. It is believed that in all countries they will include trade creditors and suppliers unless they are privileged or secured, sub-contractors similarly, employees (insofar as they are not privileged), and, in some cases, lenders against unsecured notes.

Unsecured lenders can be considered to be taking a calculated risk in not demanding security. But employees, trade creditors, and sub-contractors are frequently not in a position to take security for reasons of pure commercial convenience and practicability. Instead they are supplying goods and services to an enterprise on trade terms of typically 30 days unsecured revolving credit.

The role they play in commercial financing has been described in the English report[104] in terms that are probably a fairly accurate statement for all countries: By providing capital or credit for part of the current expenses and thus keeping the enterprise operational on a day-to-day and turnover basis, they enhance the value of fixed assets already committed as collateral to the secured creditors. They provide their finance or credit often on the appearance of creditworthiness in the debtor enterprise that may be illusory because of the existence of secret securities and charges, or because they are often unable to determine the precise scope of even perfected securities as to the extent of the collateral and of the indebtedness secured. They are generally at the mercy of secured creditors who will usually determine the timing of an insolvency or withdrawal of collateral and who, until that time, are able to prop up ailing companies to their own advantage and the disadvantage of the unsecured creditors.

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[103] See *Allan/Hiscock, sub* III 1, note 27a.

[104] See *Goode, sub* IV 6.

How the unsecured creditors actually fare in practice must be largely a matter of surmise. Such statistics as are available reveal pathetically poor dividends paid to unsecured creditors[105], who in fact pay the price for the debtor enterprise having been allowed to trade too long or its having been aborted before it could trade out of its problems. Probably many unsecured creditors write off bad debts and deduct them from taxes, rather than waste time and money chasing inadequate dividends in insolvency.

b) Protection

There is very little specific protection given to unsecured creditors. One important form of protection are the trustee's powers of avoidance or suspension of certain securities, which are found in all countries. They have been considerably extended in America and Japan in both liquidations and reorganizations. In Japan, there is a strong policy of paying off small creditors in full in order to clear the estate and simplify the reorganization procedures.

However, elsewhere, the extent of legal protection of unsecured creditors must be deduced from limitations on the rights of secured and preferred creditors and restraints on the exercise of those rights. Since the rights of the privileged creditors have already been described, it is not necessary to repeat all of their negative effects once more. A brief summary of three salient points will suffice:

Firstly, most detrimental to unsecured creditors is the *power of reclamation*[106] which allows a creditor to reclaim "his" collateral as an owner, although he had retained or acquired ownership in the collateral merely for security purposes. This power has the double vice of withdrawing collateral from the bankrupt's estate which may be required for his rehabilitation or reorganization, and of denying the estate that portion of the value of the collateral that exceeds the creditor's secured claim. The power of reclamation is the typical consequence of placing the form of ownership above its function as security – a dogma that is followed almost everywhere except in the United States, and partly in Germany.

Secondly, the secured creditor's *power of separation*[107] shares some, though not all of the vices of the power of reclamation. The secured creditor may withdraw the collateral from the bankrupt's estate in order to dispose of it and to satisfy his secured claim from its proceeds. He is accountable to the trustee merely for any surplus in excess of the secured claim. This power of withdrawal is recognized everywhere, and only America and Japan restrict it to some degree.

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[105] See *Drobnig, sub* II 3. – Statistics anyhow are usually limited to actual and formal liquidations; they do not reveal the picture in unofficial liquidations, settlements, compromises, and reorganizations.

[106] Discussed *supra*, at 3 d(2).

[107] Discussed *supra*, at 3 b(6).

Thirdly, another threat to the position of unsecured creditors (or even some secured creditors) is the *lack of publicity* as to the scope of the collateral charged or of the claims secured[108]. While some countries, especially Germany, have practically no registration system at all, the systems existing in England and Australia are in many respects incomplete and defective. The French system has very recently opened a gap by admitting an unregistered reservation of title[109]. Only the United States have a complete system: however, the American approach of notice filing furnishes only incomplete information both as to the precise assets charged and the claims secured.

Any redress of these and other powers of the secured creditors which, at least in certain circumstances, must be regarded as excessive, has to be based on the idea of the necessarily complementary character of the financing of an enterprise by creditors of all classes. Also unsecured creditors, by assuming a portion of the current credit financing, enable the debtor to carry on business and thus to repay his debts, both secured and unsecured. And only by carrying on business does the collateral used in the debtor's business preserve its value as current, working assets and does not decrease to dead, liquidation assets. This community of interests requires a restriction of the right of secured creditors, especially as far as is necessary for a rehabilitation of the debtor enterprise.

IV. Proposals for Reform

1. Introduction

In this section some of the proposals that have been made for achieving a more effective interaction of security and insolvency and the issues they raise will be examined. The editors do not urge any particular reforms[110]. And they eschew any notion of common reforms that would be desirable or acceptable in all or several countries. In view of the astonishing diversity of laws and also of social and commercial practices and ethos, the appropriateness of any reforms has to be assessed in relation to each particular country. This study can merely point to common issues and trends, and to the range of solutions that may have been tried or postulated.

The editors do suggest that most of the problems raised by the national reports and summarised in the previous section of this paper, are due to a lack of consistent theory, policy or practice in most countries in respect of both security and insolvency. Many difficulties and real or potential

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[108] Discussed *supra*, at 3 b(3).

[109] See *Cabrillac* no. 9, note 25.

[110] But see our conclusions *infra*, *sub* V.

injustices are not the consequence of deliberate decision but of the haphazard development of both branches of the law.

We shall review first proposals for the reform of security law, and secondly proposals for the reform of insolvency law.

2. *Proposals for the Reform of Security Laws*

a) The Case for Reform

In all countries, except America where the Uniform Commercial Code has provided the sort of coherence that is required, the law of security in tangible movables is a jumble of historical anachronisms and ingenious devices that have brought about the abuses described in the previous section. Anyone taking a dispassionate view of the range of chattel securities described in five of the national reports must be convinced of the need for reform. Its aim must be to produce clarity and coherence of principle and operation by eliminating the existing complexities and inconsistencies.

b) Ownership as Security

A major issue is the use of ownership of goods and of assignment of claims for security purposes.

Technically the most efficient and elegant solution is that adopted by the *American UCC art. 9*. It regulates alike all transactions intended to operate as security, whatever the form chosen by the parties and thus including also any retention of title by, or transfer to, the creditor. It would seem that this solution can be as easily implemented in Civil Law as it can in other Common Law countries.

If this comprehensive solution is not adopted, then the *particular issues* call for separate resolution. The two most important individual issues are: First, registration or any equivalent form of publicity for the perfection of securities based upon ownership. This requirement is, of course, only justified if and insofar as there exists a general system of publicity for security interests proper. Second, reducing the secured creditor-owner's rights of reclamation of the collateral in the debtor's insolvency to one of separation and preferred satisfaction, under the same conditions as the right of any other secured creditor.

c) Publicity for Security Interests

Another major issue is the use of a general system of publicity for security interests. In this respect, desirability and feasibility are difficult to divorce.

Clearly, the *inconvenience and cost* of a system of registration of chattel securities deserves serious consideration. In Common Law countries, the inefficiency and unpopularity of the registration of bills of sale is often a

strong argument in favour of maintaining freedom from registration. Yet no study has been attempted of the costs to the parties and to the public of the present system. Today publicity can be achieved through various forms of registration, notice-filing or notification procedures supplemented by electronic and computerized systems of information storage and retrieval. These modern technical systems make obsolete any arguments based on nineteenth-century full-fledged registration of security agreements. These systems, which today are considered indispensable when booking airline or theatre tickets, are rejected as too costly for secured credit and business financing. True, they involve a cost element that must increase the cost of secured credit; but a major part of these additional costs would be compensated by the savings through the elimination of inefficiencies, injustice and expensive litigation. Some form of registration or notification, subject to whatever exceptions may be justifiable according to local conditions, seems to be essential.

An additional aspect arising in the Common Law countries concerns the *effects of registration.* In some instances, an unregistered security interest is valid against the trustee in bankruptcy, but not against subsequent secured creditors and purchasers. This distinction is difficult to justify if the lack of registration created the wrong impression of the debtor being creditworthy. Could unsecured creditors be less deceived than secured ones?

d) Extensions of Security Interests

In Germany (the only Civil Law country considering a reform of its security interests), an additional suggestion has been submitted. It seeks to curb the parties' freedom to extend the scope either of security interests into proceeds or of the indebtedness secured by adding further claims[111]. These contractual attempts at achieving comprehensive, long-term security are particularly obnoxious in the debtor's insolvency since they tend to perpetuate the secured creditor's grasp of portions of the bankrupt estate. By excluding or at least limiting the security to the original collateral or/and indebtedness, considerable savings both in simplifying administration (determining competing claims and marshalling the collateral) and in amounts available for the unsecured creditors could be achieved.

Some of these proposals have been realised in the United States, whereas official proposals in England and Australia and private suggestions in Germany still await implementation.

3. Proposals for the Reform of Insolvency Laws

Proposals for the reform of insolvency laws, aimed at redressing the balance between the various parties, relate (a) to limiting the contractual

[111] See *Drobnig, sub* III 2 d.

powers of debtors, (b) to enlarging the powers of trustees, liquidators, and the court, (c) to limiting the exercise of rights by secured creditors, and (d) to limiting the number and consequences of preferred claims.

a) Limiting the Contractual Powers of Debtors

A first set of proposals aims at restricting the debtor's contractual powers in order to preserve a free pool of assets for the satisfaction of unsecured creditors.

In England and Germany it has been suggested that debtors should not be authorised to charge all the assets of their business up to the full value; security interests infringing the prescribed *free margin* would to that extent be unenforceable[112]. While such a requirement appears justified as a sanction for monopolising the debtor's property for security interests, considerable doubts remain: it is difficult to find a reasonable basis for fixing the free margin; and it is even doubtful whether any fixed portion of the debtor's assets is an appropriate relief for the unsecured creditors.

Other proposals would limit the power of debtors to charge or dispose of assets in a *pre-bankruptcy period*. For example, it has been suggested that the security margin of a floating charge should not be capable of being enhanced during the six months before the commencement of a winding up, or that security interests might be subordinated to the extent of advances made during a similar period if the company was at that time manifestly insolvent[113].

b) Enlarging the Powers of Trustees or Courts

In all countries examined, traditionally powers of disallowing or avoiding transactions and security interests have been invested in the trustee or liquidator or in the court. A re-evaluation of these powers under modern conditions is now overdue. This could involve not only a more systematic scheme but also their extension.

For example, should the voidability of a pre-bankruptcy transaction depend upon the intent or knowledge of the advantaged creditor at the time of the transaction[114]? Or should it depend, as in England, Australia and Japan[115], primarily on the intent of the debtor at that time, although with savings for creditors who are bona fide purchasers for value? Or should there be a fixed pre-bankruptcy period during which all transactions by and with the debtor are voidable or subject to review[116]?

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[112] See *Goode, sub* IV 6, *in fine*, and *Drobnig, sub* III 2 c and 3 d.

[113] See *Goode, sub* IV 6; see also *Ayer, sub* III 2 c (1).

[114] As in France (see *Cabrillac* no. 16) and in Germany (see *Drobnig, sub* II 2 a).

[115] See *Goode, sub* III 2 d; *Allan/Hiscock, sub* III 2; *Hiscock/Sono, sub* II 8 c.

[116] This topic is obviously related also to the question of the avoidance of unperfected securities discussed *supra*, at III 3 b (5).

Whichever solution is chosen, if commercial confidence and credit are to be maintained, it will be necessary to work out a satisfactory system for protecting those who transact business with the debtor in good faith.

c) Limiting the Rights of Secured Creditors

Various proposals seek to restrict the exercise of rights of secured creditors arising from their security and otherwise valid in insolvency.

One of these proposals is the *suspension of the rights* of secured creditors to enforce or realize their security in any way pending the investigation of rehabilitation prospects or of the determination of an orderly and reasonable liquidation[117]. This in no way diminishes the security right of the secured creditor or his priority. But the secured creditor's power to determine unilaterally and arbitrarily whether and when he will withdraw assets from the enterprise is commercially unrealistic today[118]. Where insolvency proceedings now emphasise the preservation of the debtor enterprise as a going concern so that either it may be rehabilitated or disposed of as a whole for the benefit of all creditors, secured creditors are required to suspend such of their powers as are contrary to this policy. Provided insolvency proceedings are implemented without depreciating the assets of the debtor enterprise, the suspension of the security interests may cause little, if any harm to the interests of the secured creditor. On the other hand, it may more realistically give effect to the nature of secured financing as a cooperative venture, and reflect the interdependence of all creditors. It follows as a corollary from this proposal that secured creditors should be allowed to participate in meetings of creditors and to vote in them as long as the exercise of their rights is thus suspended[119].

Another proposal would *limit the amount* that secured creditors can recover from the realization of their collateral by reserving a small percentage of the value of all collateral to form a pool for unsecured creditors[120]. The English report points out that the only effect of this measure on secured credit would be a correspondingly lower valuation of the collateral when the security is arranged. However, it has so far received little support.

d) Limiting Preferred Claims

If any alterations are made to the position of secured creditors in order to redress the balance with unsecured creditors, then similar restrictions and limitations must be placed on preferred creditors. If this is not done, the

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[117] This is particularly pronounced in the United States (see *Ayer, sub* III 3) and in Japan for reorganizations (see *Hiscock/Sono, sub* II 8 a). See also *Goode, sub* IV 6, *in fine*.

[118] See *Goode, sub* IV 4.

[119] See *Ayer, sub* III 4.

[120] See *Goode, sub* IV 6, *in fine*, and *Drobnig, sub* III 1 b.

benefit from any restrictions on secured creditors will inure for the preferred creditors rather than the unsecured creditors. It is not thought anywhere that preferred creditors are in need of this added benefit or protection.

All contributors, but particularly those from Civil Law countries, have expressed concern at the haphazard unsystematic way by which preferred claims have proliferated. In all countries it is long overdue that they should be reviewed as to their number, extent, and priority. In particular, tax claims tend to operate as substantial concealed charges that can provoke a bankruptcy or totally distort any credit evaluation.

V. Conclusions

Our study has sought to identify undesirable features in the security and insolvency laws of six countries so far as these affect the relations of secured, preferred, and unsecured creditors and of the debtor enterprise itself. In six quite different countries it has sought to identify common issues and trends. Reform proposals must, however, be considered separately for each country against its respective commercial, economic, and social background. This study has therefore refrained from proposing solutions to the problems revealed, either generally or for particular countries.

Nevertheless, the editors do believe, that certain basic propositions can and should be made here about desirable directions for development of the law.

1. All the systems of law examined embody the assumption that some classes of creditors are entitled to be paid in *preference* to others in the debtor's insolvency. Whatever the reason for that preference may have been, it has now become a corner-stone of business financing and therefore must be retained, subject to an examination of incidents and scope.

2. But the reformer faces a *dilemma:* On the one hand, a substantial revision of the preference may jeopardize the terms and availability of business finance particularly for weaker, more speculative enterprises; on the other hand, because bad debts may be tax deductible, a reallocation of the benefits is of little value unless it is substantial. It may well be that all this would achieve would be to transfer from one class of creditors to another the claim for a tax deduction. In the last resort, the loss may fall on the public finances whatever system is adopted.

3. In any event, commercial law must establish the *appropriate sequence* in which creditors of a debtor must primarily bear the consequences of his insolvency. In addition, it is important in each country to ask whether the classes of creditors to whom the commercial law accords preference for payment in insolvency are the appropriate classes today. This question is of particular importance in respect of unsecured preferred creditors.

4. Concurrently with any revision of insolvency laws, it is important that the *laws governing security* be also reviewed. The lack of a coherent theory of security is the cause of inconsistencies of treatment of secured claims and abuse of powers by secured creditors in insolvencies. If preferences and privileges are justified, their abuse is not.

a) A major issue of reform of security law will be the widespread use of ownership for security purposes, but without the limitations that attach to ordinary security interests. For the position of the secured creditor it should be irrelevant whether he does, or does not, own the collateral.

b) In order not to deceive subsequent creditors of any class, any security for preference should publicize the extent both of the collateral and the claims secured. The lack of any required publicity should make the security interest ineffective in any insolvency proceedings.

c) The secured creditor's power to assert, in the debtor's bankruptcy, his rights in the collateral should be limited by taking into account also the interests of other creditors and requiring to act at least in consultation, if not in co-operation, with other classes of creditors.

5. The growing trend to emphasize *reorganization* where possible, rather than liquidation, should be encouraged. It would seem that everywhere the public interest requires, on the one hand, the dissolution of enterprises that are not viable or competitive, and, on the other hand, the rehabilitation of those which after reorganization have a reasonable change to function successfully.

6. While the chances of rehabilitating an (actually or potentially) insolvent enterprise are being investigated, the *exercise of rights by secured creditors* must be restricted. Further, in order to enable the assets of the enterprise to be economically used in its rehabilitation, it may be necessary to curtail the secured creditor's power to withdraw his collateral – in exchange for an equivalent protection of his interests. It may even be necessary to convert the secured creditor's proprietary claim to a non-proprietary preferred claim, with a designated rank of priority.

7. The *powers of trustees*, liquidators or courts to disallow or avoid certain securities (including quasi-securities without publicity or perfection) should be reviewed.

8. The preceding detailed conclusions can be summarised in *three principal theses:*

a) Secured and preferential creditors should, in principle, preserve their priorities if liquidation proves inevitable, subject, however, to a review and rationalization of the categories of secured and preferred creditors and the nature and scope of their priority.

b) On the other hand, they should be required to assume a fair share of the burdens which must be carried by all creditors during the investigation

of the chances, and for the realization, of a rehabilitation of the debtor enterprise.

c) The sacrifices that are imposed upon secured and preferred creditors in both liquidations and rehabilitations are justified by the co-operative nature of modern business financing. This involves not merely different types of financers, but also trade suppliers, contractors and sub-contractors, and employees in the success of the enterprise; and it is this success which determines the chances of realizing their respective claims against the debtor enterprise.