Enforcement of Security Interests in Transnational Commercial Law: Balancing Tradition and Innovation

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I. Introduction

Writing a contribution to a *liber amicorum* for as omni-talented a jurist and teacher as Herbert Kronke offers a wide range of topics and perspectives. Choosing the prism of enforcement of security interests allows me to highlight at least one aspect of Herbert's long-standing contribution to the development of transnational commercial law. Well-versed in the principles underlying commercial, comparative and private international law as a professor at Heidelberg University, he was the intellectual initiator of several UNIDROIT capital markets projects on intermediated securities and close-out netting. As the organization's Secretary-General, he also stood at the cradle of the innovative approach adopted in the successful Convention on International Interests in Mobile Equipment (the 'Cape Town Convention'). These projects reflect the different angles from which the enforcement of security interests may be approached and as such inspire and shape ongoing and future developments, also in relation to the draft Protocol to the Cape Town Convention regarding mining, agricultural and construction equipment and in the debate on non-performing loans.

II. Prototypical Elements of Secured Transactions

One of Herbert Kronke's joint undertakings, together with Sir Roy Goode and Ewan McKendrick, was the launch of the transnational commercial law project. This consists of a textbook for students, *Transnational Commercial Law*, the first edition of which was published in 2007, coupled with annual conferences involving both teachers and students from around the globe to discuss the underpinnings of and the latest developments in the realm of transnational commercial law.[1]

The 2015 revised second edition of *Transnational Commercial Law* contains a chapter on 'Transactions in Securities' penned by the author of this contribution. This chapter contrasts prototypical property law elements of secured transactions with newer

* The English of this contribution was checked by Patricia de Seume-Nissing, who for many years collaborated with Herbert Kronke on the editorial team of the *Uniform Law Review*.

1 For more information on these yearly gatherings of teachers and students, with Herbert Kronke as their driving force, see https://www.ipr.uni-heidelberg.de/tcl-teachers/ (accessed 6 August 2019). This contribution will be presented at the 11th Transnational Commercial Law Teachers' Meeting at Queen Mary University of London on 12–13 September 2019.

approaches in relation to intermediated securities.[2] Such elements, which may of course vary from one jurisdiction to another, include formal requirements for vesting a security interest; the accessory connection between a security interest and the debt it secures; the security taker's duty to take care of encumbered assets; the borrower's (or, if the security is provided by a third party, also that party's) right to redeem an encumbered asset by paying the secured debt; and a limitation of the security taker's right to dispose of encumbered assets to cases of default. Specifically in relation to enforcement upon default, prototypical characteristics are the duty to notify the borrower and other interested parties of intended enforcement; the obligation to realize optimum value for the benefit of the borrower and other interested parties (commonly with the help of independent third parties, such as a court official, bailiff, or notary); and an obligation to pay any residual value to the borrower and/or other interested parties. Most of these characteristics in one way or another reflect the fiduciary relationship between the parties involved in a secured transaction.[3]

Similar principles regarding enforcement are reflected in the 2010 UNCITRAL Legislative Guide on Secured Transactions (the UNCITRAL Legislative Guide)[4] and the 2016 UNCITRAL Model Law on Secured Transactions (the UNCITRAL Model Law).[5] Both instruments envisage a duty to give notice of the intent to enforce to a number of interested parties in an extrajudicial context that does not involve application to a court or other authority,[6] whereas national procedural law, including adequate notices envisaged therein, governs judicial enforcement. The purpose of realization of maximum value is explicitly mentioned in the UNCITRAL Legislative Guide.[7] In this context, also, both the UNCITRAL Legislative Guide and the UNCITRAL Model Law distinguish between judicial and extrajudicial proceedings. In the case of judicial proceedings, external parties (the court or other authority or experts appointed by them) are likely to contribute to optimum valuation. In the case of out-of-court proceedings, the instruments do not specify how optimum value is realized,[8] but rather rely on a

2 Roy Goode, Herbert Kronke, Ewan McKendrick (eds.), *Transnational Commercial Law: Texts, Cases and Materials* (Oxford: Oxford University Press, 2015), chapter 15 at 15.47. Intermediated securities are further discussed in section III.

3 A note on terminology: the primary actors in the UNCITRAL Legislative Guide and the UNCITRAL Model Law are the debtor, the grantor and the secured party; the collateral provider and the collateral taker feature in the context of financial collateral; the Cape Town Convention mentions the chargor and the chargee; whereas the proposed EU instrument relating to non-performing loans identifies the business borrower and the creditor. This contribution generally follows the terminology used in each instrument.

4 United Nations, New York, 2010. During his tenure at UNIDROIT, Herbert Kronke followed the work towards this instrument with a view to coordinating the work on secured transactions conducted by UNCITRAL and UNIDROIT. In light of the contemporaneous work on the Geneva Securities Convention (see further section III), this resulted in the exclusion of securities from the scope of the UNCITRAL Legislative Guide (see Recommendation 4(c)).

5 United Nations, Vienna, 2016.

6 Recommendations 149–151 of the UNCITRAL Legislative Guide and Article 78(4)–(8) of the UNCITRAL Model Law.

7 See Recommendations 131–177, Purpose (b), p. 310.

8 Recommendation 148 of the UNCITRAL Legislative Guide and Article 78(3) of the UNCITRAL Model Law establish that the secured creditor may determine the 'method, manner, time, place and other aspects' of extrajudicial enforcement, but are silent on methods of optimum valuation. Only in the case of appropriation is the value of the encumbered assets mentioned explicitly; see Recommendation 157(b) of the UNCITRAL Legislative Guide and Article 80(3)(a) of the UNCITRAL Model Law.

standard of good faith and commercial reasonableness[9] (discussed in more detail below). The obligation to pay any overvalue is apparent from Recommendations 152–153 of the UNCITRAL Legislative Guide and Article 79 of the UNCITRAL Model Law.

III. The UNIDROIT Capital Markets Projects

In 1999, shortly after taking office as Secretary-General of UNIDROIT in Rome, Herbert taught the summer course on private international law at the Hague Academy of International Law.[10] His choice of topic for his series of lectures on 'Capital Markets and Conflict of Laws' was no coincidence. Financial markets at the time were going through a period of profound change. One important feature of that change was a shift within the securities markets from direct contact between investors and issuers (on the basis of paper certificates/entries in the issuer's register) to a world in which, including for reasons of efficiency and speed, intermediation by one or more tiers of financial institutions became the norm. Intermediation meant that investors and issuers were no longer necessarily directly connected, and that investors' holdings were no longer represented by paper certificates and/or entries in the issuer register (certificates now often being immobilized or even dematerialized at central securities depositories) but rather by electronic entries on accounts with intermediaries.

This change of paradigm also required a new approach from a legal point of view. The Hague Conference for Private International Law, at the time of Herbert's lecture, was about to start the work on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the Hague Securities Convention)[11] focusing on the international private law aspects of intermediated securities. Not long after, in 2002, UNIDROIT followed suit with a complementary project to develop substantive rules for this new type of asset, which resulted in the 2009 UNIDROIT Convention on Substantive Rules for Intermediated Securities (the Geneva Securities Convention).[12]

Chapter V of the Geneva Securities Convention addresses financial collateral arrangements, such as securities lending and repurchase agreements. This chapter mirrors the 2002 EU Financial Collateral Directive.[13] Content-wise these instruments represent a fairly radical break with the prototypical features of security interests outlined in section II. For the sake of market liquidity, formal requirements for vesting a security in-

9 Recommendation 131 of the UNCITRAL Legislative Guide and Article 4 of the UNCITRAL Model Law.

10 Herbert Kronke, 'Capital Markets and Conflict of Laws' (2000) 286 *Recueil des Cours* 245–385.

11 The Hague Securities Convention was 'adopted' (at a diplomatic Conference) in 2002 and 'concluded' (following the first signature) in 2006. On this old practice of distinguishing between adoption and conclusion, see Herbert Kronke, 'Brüsseler Springprozession: Die Harmonisierung des Rechts zentralverwahrter Finanzinstrumente als Lehrstück über Privatautonomie, Regulierung, Lobbyismus und Verwaltung' in Cordula Stumpf, Friedemann Kainer and Christian Baldus (eds), *Privatrecht, Wirtschaftsrecht, Verfassungsrecht: Privatinitiative und Gemeinwohlhorizonte in der europäischen Integration* (Nomos 2015) 759–766 at 762.

12 Adopted at a diplomatic Conference in Geneva in 2009.

13 Directive 2002/47/EC on financial collateral arrangements (as amended). On this directive, see Thomas Keijser, *Financial Collateral Arrangements: The European Collateral Directive Considered from a Property and Insolvency Law Perspective* (Kluwer Legal Publishers 2006); reviewed by Herbert Kronke in (2007) 12(2) *Uniform Law Review* 397–400.

terest are relinquished, the collateral taker may be given the right to dispose of encumbered assets as if it were the owner (so also in the absence of default), the accessory connection between a security interest and the debt it secures is accordingly loosened, while the collateral taker can no longer fulfil its duty to take care of encumbered assets once these have been disposed of, in which case the collateral provider is likewise unable to redeem the assets. Specifically in relation to enforcement, whether by way of sale, appropriation or close-out netting, Chapter V of the Geneva Securities Convention and the Financial Collateral Directive envisage that no prior notification of the intention to enforce is required, that the terms of enforcement (including valuation) do not need to be approved by a court, public officer or another independent third party, and that enforcement does not need to be conducted by public auction or any other prescribed manner. Only the obligation to pay any surplus value to the collateral provider (or other interested entities) is thus left intact. In this way, enforcement has become a tool tailored to the (perceived) needs of collateral takers. Its fiduciary features have been hollowed out.[14]

The only relief given to collateral providers is a non-mandatory option to challenge the outcome of enforcement proceedings in court (including the crucial matter of valuation of the assets involved) on the basis of a standard of commercial reasonableness. A pig in a poke, some might argue (although the German equivalent 'eine Katze im Sack' may well be more accurate),[15] since (i) the standard is non-mandatory and States may decide not to implement it (although general principles of law may in that case apply), (ii) safeguards during enforcement are replaced by a post-enforcement mechanism, and (iii) the collateral provider may in effect face the burden of detecting and proving any misconduct by the collateral taker, and of shouldering the related costs, which is likely to be particularly onerous for smaller, non-specialized entities, not to speak of ordinary consumers.[16]

In light of the above several authors have argued that the approach taken in the Financial Collateral Directive and in Chapter V of the Geneva Securities Convention may be appropriate for transactions between wholesale market participants, but not in other contexts, particularly where the parties involved do not enjoy equal bargaining positions.[17]

Several years after the adoption of the Geneva Securities Convention, when Herbert had already returned to his old *métier* in Heidelberg and taken up his new role at the Iran-United States Claims Tribunal, his visionary idea of developing a series of capital markets instruments bore fruit in the shape of the 2013 UNIDROIT Principles on the

14 Transnational Commercial Law (n 2) 15.48–56.

15 A tribute to Herbert's interest in comparing proverbs in different languages. Both idioms refer to a farmer selling a cat for a suckling pig to a buyer who does not inspect the contents of the bag with the purchase and can thus be tricked. The English expression refers to the possibility of deceit, the German one to an actual scam.

16 See Laura Franciosi, 'Commercial Reasonableness in Financial Collateral Contracts: A Comparative Overview' (2012) 17(3) *Uniform Law Review* 483–495; Michele Graziadei, 'Financial Collateral Arrangements: Directive 2002/47/EC and the Many Faces of Reasonableness' (2012) 17(3) *Uniform Law Review* 497–506; Financial Collateral Arrangements (n 13) ch V.2, especially p. 287; Transnational Commercial Law (n 2) 15.54–55.

17 E.g. Louise Gullifer, 'What Should We Do about Financial Collateral?' (2012) 65 *Current Legal Problems* 377–410; Financial Collateral Arrangements (n 13).

Operation of Close-Out Netting Provisions and the 2017 UNIDROIT Legislative Guide on Intermediated Securities. In the wake of the global financial crisis of 2007 and onwards, both instruments, to some extent, reflected an extensive debate on the micro- and macro-economic pros and cons of enhancing liquidity in the securities markets, easing enforcement and the creation of insolvency 'safe harbours' to those ends.[18]

IV. The Cape Town Convention

Another flagship project with Herbert at the steering wheel during his ten years in Rome is that of the Convention on International Interests in Mobile Equipment (the Cape Town Convention)[19] with its separate Protocols for aircraft equipment,[20] railway rolling stock,[21] and space assets,[22] while a draft Protocol for mining, agricultural and construction (MAC) equipment is currently in the making.[23] Chapter III (Articles 8–15) of this Convention relates to default remedies. These enforcement provisions are modified on some points in the Protocols relevant to specific industry settings.

Chapter III of the Cape Town Convention contains several provisions that echo the prototypical features of enforcement outlined in section II. Article 8(4), for example, requires prior notice of intended enforcement by way of a sale or granting a lease, Article 9(4) relates to the possibility of redemption, and Article 8(6) addresses the distribution of any surplus value upon enforcement. The Cape Town Convention, however, also contains provisions that focus on party autonomy rather than on pre-established enforcement rules involving a court or other independent third parties. This becomes evident in the context of remedies upon default, as well as in that of speedy relief measures.

Articles 8(1) and 9(1) of the Cape Town Convention allow the parties to exercise remedies in accordance with an agreement they may have concluded. Such remedies include taking possession and control of charged objects, selling of or granting a lease concerning such objects, collecting or receiving income or profits in relation to such objects, or appropriation ('vesting of the object in the chargee in or towards satisfaction' in Convention-speech). Courts play no role or only a limited role in the context of enforcement. The courts may become involved where a State has made the declaration contemplated under Article 54 of the Convention specifying that any default remedy may only be exercised with leave of a court; by choice of the chargee under Article 8(2) (who may, however, also opt to enforce its rights itself in accordance with the agreement between the parties); and, in the context of the enforcement mechanism of appropriation under Article 9(2)–(3), as an alternative to an agreement between the parties.

18 See Riz Mokal, *Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts* (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2694285 (accessed 6 August 2019); Marcel Peeters, 'On Close-Out Netting' in Thomas Keijser (ed), *Transnational Securities Law* (Oxford: Oxford University Press, 2014) chapter 3 (as updated in the online Oxford Legal Research Library). Both contributions contain a host of references to further literature.

19 Signed at Cape Town on 16 November 2001.

20 Signed at Cape Town on 16 November 2001.

21 Signed in Luxembourg on 23 February 2007.

22 Signed in Berlin on 9 March 2012. Although by that time Herbert had already left the UNIDROIT Secretariat, he was elected President of the diplomatic Conference for the adoption of the draft Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets.

23 Draft protocol as set out in UNIDROIT 2018 – DCME-MAC – Doc. 3 (June 2018).

To 'compensate' for the quasi absence of an independent third party such as a court during enforcement, Article 8(3) of the Cape Town Convention provides for a standard of commercial reasonableness, which also applies in the context of interim relief proceedings (Article 13(4)). Contrary to the standard in the Financial Collateral Directive and the Geneva Securities Convention, the standard in the Cape Town Convention is both mandatory and more strict. Article 8(3) of the Convention states: 'A remedy shall be deemed to be exercised in a commercially reasonable manner where it is exercised in conformity with a provision of the security agreement except where such a provision is manifestly unreasonable.' This means that the parties may determine what is commercially reasonable and that only 'manifest unreasonableness' can prevail over their agreement.[24]

Similarly, party autonomy may prevail over the role of a court in determining how interested persons should be protected in the context of speedy relief proceedings. The respective (draft) Protocols envisage the possibility of excluding the application of Article 13(2) of the Cape Town Convention (and thus the role of the courts in this context) by way of a written agreement.[25]

This focus on party autonomy (implying a diminished role for independent third parties) was originally developed for highly sophisticated actors in the aircraft, rail, and space sectors and may indeed work well in economic sectors involving parties with equal bargaining power (such as the aircraft industry, which is characterized by a limited number of principal actors). However, in situations where there is a disparity between the negotiating parties, such an approach may yield undesirable results. A case in point might be the MAC sector, which is much less homogeneous than the aircraft, rail and space sectors, and would appear to have a far greater number of market participants ranging in size and level of sophistication. How does the power balance play out where a small farm-holding transacts with a major manufacturer/supplier of agricultural equipment?[26] As in the case of financial collateral, such a scenario may lead to (un)'reasonable' standards being forced upon weaker parties pre-default, while the weaker party may – absent an independent third party such as a court during enforcement – face the burden (and related costs) of detecting and proving 'manifest unreasonableness' post-default.[27] Moreover, one may wonder whether it is desirable to envisage the sale of the charged assets as a 'speedy' (but irreversible and – to the business of the chargor – potentially devastating) relief measure in such a context, in particular where the court is prevented from imposing terms to protect interested parties.[28] Specifically in the con-

24 See also Article IX(3) of the Protocol for aircraft equipment; Article VII(3) of the Protocol for railway rolling stock; Article XVII(1) of the Protocol for space assets; Article VIII(3) of the draft MAC Protocol.

25 See Article X(5) of the Protocol for aircraft equipment; Article VIII(5) of the Protocol for railway rolling stock; Article XX(5) of the Protocol for space assets; Article IX(5) of the draft MAC Protocol. Roy Goode, *Official Commentary on the Convention on International Interests in Mobile Equipment and Protocol thereto on Matters Specific to Aircraft Equipment* (UNIDROIT: Rome, 2019, fourth edition, 5.59, cites 'transaction costs' as a justification for this approach.

26 As discussed with Anna Veneziano, pursuant to her presentation on 'The contours of "commercial reasonableness" under the CTC" at the 7th Cape Town Convention Academic Project conference on 12–13 September 2018.

27 Possible ways to alleviate such consequences include involving independent third parties in the enforcement process, softening the standard of manifest unreasonableness and/or reversing the burden of proof.

28 Article IX(3) of the draft MAC Protocol.

text of agriculture also concerns of food security come to mind: without equipment it may be impossible to take necessary steps in the production cycle – such as sowing, sprinkling, or harvesting – in a timely manner.

V. The Debate on Non-performing Loans in Europe

Another secured transaction instrument that is currently being debated in Europe is the so-called 'Accelerated Extrajudicial Collateral Enforcement' mechanism, set out in Title V of the proposed Directive on credit servers, credit purchasers and the recovery of collateral (the 'proposed Directive').[29] This enforcement mechanism is part of a range of other measures envisaged to combat the unsustainable levels of non-performing loans (NPLs) that appeared on the balance sheets of financial institutions in Europe in the wake of the global financial crisis of 2007 and on. Such other measures include rules on putting aside sufficient resources for NPLs in a financial institution's portfolio and developing secondary markets for NPLs, as well as a blueprint for setting up and operating national asset management companies in compliance with current state aid and bank resolution rules. As to the proposed extrajudicial enforcement mechanism, it should be noted that this is not limited to NPLs held by financial institutions, but is much wider in scope and covers credit agreements secured by movable and/or immovable assets between creditors and business borrowers generally.[30]

The prototypical elements of enforcement discussed in section II are relatively easy to spot in the proposed mechanism. The requirement of prior notification is set out in Articles 23(1)(c), 25(1)(c) and 26(1)(b) of the proposed Directive, while the provisions on the realization of optimum value feature in Articles 24–26. The overall picture is that the extrajudicial regime in the proposed Directive appears more appreciative of the interests of both borrower and secured creditor than are the creditor-oriented regimes for financial collateral and of the Cape Town Convention, yet it is not wholly beyond reproach. Although Article 24(2) envisages the possibility of a role for independent parties such as a notary, bailiff or other public official in the enforcement process, that role is not mandatory; the creditor organizes the valuation, without involving the borrower (Article 24(4)); it is unclear whether the independent valuer, which in itself is a concept in line with the fiduciary relationship between the parties, may be appointed only by means of a post-enforcement agreement or also by a pre-enforcement arrangement (Article 24(4)(a)–(b));[31] a standard of 'fair and realistic' (but not maximum) valuation, akin to that of 'commercial reasonableness', appears in Article 24(4)(c); the safeguards concerning valuation in Article 24(4) apply to an extrajudicial public or private sale (Article 24(2)) but not to appropriation (Article 24(3)); and finally, the valuation may be contest-

29 Brussels, 14 March 2018, COM(2018) 135 final.

30 See Articles 1(c) and 2(2) and (5) of the proposed Directive. Statements such as that indicating that the proposed Directive should not 'replace existing national enforcement measures' (recital (40)) and does not concern borrower rights (Explanatory Memorandum, p. 7) are rather nonsensical, since a new enforcement regime that is applied in practice (because it is attractive to and thus negotiated by credit providers), in effect, replaces other national regimes and affects borrower rights.

31 If the appointment could be concluded pre-enforcement, the collateral taker could use negotiating leverage and the valuer would in that case not be truly independent. Cf. Recommendation 133 of the UNCITRAL Legislative Guide and Article 72(3) of the UNCITRAL Model Law that prohibit relinquishing borrower rights pre-enforcement.

ed in court (Articles 24(4)(e) and 28), but may imply hurdles in the path of the borrower comparable to those discussed above (burden of proof, cost). The 'prototypical' obligation to pay any residual value is set out in Articles 24(3) and 29 of the proposed Directive. These provisions envisage the payment of surplus value to the business borrower, and as such fail to consider the interests of other involved parties, such as other secured creditors.[32]

VI. Concluding Remarks

The enforcement of security interests is an area that reflects different paradigms. Some stress the importance of party autonomy and the advantages of making it easier to obtain credit and may therefore be inclined to enhance the position of the secured party. Others focus on the fiduciary relationship between borrower, grantor and security taker, and stress the importance of protecting weaker market participants against more powerful credit providers, and so primarily advocate a fair balance between the parties. These views have crystalized in legal frameworks for different market segments, each with their own focus. The context of financial collateral and close-out netting is probably what reflects the primacy of party autonomy most markedly. A comparable, albeit somewhat more moderate, approach may be detected in the context of the Cape Town Convention and its current protocols. Transactions that involve only a relatively small group of major players are typical for these contexts, but to extend such a 'liberal' regime to situations involving less powerful entities would appear unwise. An approach, in which the interests of the parties are more balanced is reflected in 'prototypical' secured transactions and (with a number of exceptions) in the proposed regime for non-performing loans in Europe. Much, therefore, depends not only on favoured paradigms, but also on the type of market that is the focus of regulation.

32 Much has been written about the proposed Directive. One source that deserves mention here is a thesis of 2019 by Kyriaki Marina Platsa, entitled 'Legal Aspects of the Enforcement of Non-Performing Loans in Europe', available at https://repository.ihu.edu.gr/xmlui/handle/11544/29356 (accessed 6 August 2019), with which she concluded an LLM in Transnational and European Commercial Law, Banking Law, and Arbitration and Mediation at the International Hellenic University. Herbert was closely involved in the set-up of this LLM programme, and the International Hellenic University is one of the institutions that awarded Herbert a well-deserved honorary degree.