



# USAID | BUSINESS CLIMATE REFORM

To: Olin McGill, Chief of Party

From: Yair Baranes Secured Financing Advisor

Date: April 20, 2007

Re: Secured Financing Law Reform, Week 5

This memorandum describes the fifth week's proceedings in the intensive seven-week discussion process with NAPR to finalize key collateral registry design issues. Discussion centered on the types of security interests subject to registration, including proceeds of collateral, inventory financing, accessions, fixtures, future property, and a small value property exemption

- 1. Background:** Week 5 of the working group for Phase 1 of the Project's Secured Financing Reform Work Plan with NAPR had two meetings. One on Wednesday April 18<sup>th</sup> and the other on Friday April 20.

Participants included:

- Jaba Ebanoidze – NAPR, Chairman
- Murman Tsertsvadze – NAPR, Legal Department, Head
- Teimuraz Bigvava – NAPR, First Deputy Chairman
- Yair Baranes – Project Secured Financing Advisor
- Sandro Amashukeli – Project Attorney
- Maia Pirtskhalaishvili – Project Interpreter

The weekly format is designed to simultaneously build NAPR's capacity to make key design decisions for the collateral registry, and begin legislative drafting to implement the decisions made. Each week covers a discrete set of critical issues.

## 2. Preliminary notes

- Topics discussed – The following topics were discussed during week five: proceeds collateral, inventory financing, accessions, fixtures, future property and the small value property exemption.
- Discussion also began on the payment system to be used for the future collateral registry. The working group did not reach a conclusion on how to handle payments for registry services. The head of NAPR requested more time to analyze whether the banking community can undertake the accounting related to payment of fees. Further discussion on this topic will take place during Weeks 6 and 7 and will likely continue during the institutional reform phase.

### 3. Discussion -- Other Legal Components:

The discussion of the legal concepts of proceeds collateral, inventory financing, accessions, fixtures, future acquired property, and the small value property exemption aimed at adding new concepts or new approaches to existing concepts. The discussion involved introducing the concepts through scenarios following by further discussion regarding possible legislative solutions.

Some of the concepts like proceeds collateral already exist under current Georgian legislation although it is different from the concept as implemented in modern secured financing systems.

**Proceeds collateral:** Proceeds collateral is commonly described as any property which is generated from dealing with the original collateral. The working group received an overview of various situations where collateral is exchanged, replaced or traded for other property. An example is insurance payments resulting from loss or damage to the original collateral or proceeds collateral. Such insurance payments become proceeds collateral as well.

Based on this discussion, the following draft definition for proceeds collateral is proposed:

**Proceeds collateral** is collateral that derives directly or indirectly from dealing with other collateral. It includes second and later generation proceeds of the original collateral as well as insurance payments.

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#### EXPLANATORY COMMENT

This definition describes a kind of collateral that is defined on the basis of its ancestry rather than its present form. In order for the property to be proceeds collateral, it must be property derived directly or indirectly from the original collateral.

The definition includes second and later generation proceeds (*i.e.*, proceeds of proceeds of collateral).

The discussion continued then on some of the more practical aspect of proceeds collateral and the implications of allowing creditors to take a security interest in proceeds collateral. When a creditor has a pledge on a borrower's property and the borrower sells that property to a buyer, the money paid or property given in exchange by the buyer to the borrower is proceeds collateral and the original pledge will attach to it. The group also discussed how the pledge continues to cover the original collateral at the same time.

Based on the discussion above the following basis for a provision in the law is proposed:

A pledge continues in the collateral notwithstanding its sale, lease, license, exchange, or other disposition thereof.

A pledge on collateral extends to proceeds collateral that can be identified.

**Inventory financing:** The working group discussed one of the exceptions to the rule that a pledge remains attached to collateral despite the disposition of the property. The working group discussed the notion of sales in the ordinary course of business, its practicality, and the determination of when a sale is in the ordinary course of business.

This very important concept of sale in the ordinary course of business is crucial to inventory financing. For obvious reasons, it is not practical to expect a consumer who enters a business' premises and purchases an item from the business' inventory, a television for example, to be concerned with the existence of a pledge on such property. In order to ensure continuation of commercial activity, buyers who purchase in the ordinary course of business of the seller should enjoy full ownership rights protection.

The following proposed provision is perhaps one of the most important in any modern secured financing law. Accordingly, the comment provided for this provision is elaborated in considerable detail.

**Article XX**  
**Priority of Buyers of Goods**  
**in the Ordinary Course of Seller's Business**

A buyer in the ordinary course of the seller's business takes free of a completed or uncompleted pledge on goods created by the seller of the goods, even if the buyer knows of the existence of the pledge.

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**EXPLANATORY COMMENT**

This provision applies only to sales made by a debtor who is in the business of selling such property.

The Article ensures that a buyer who buys the property from a seller under a transaction carried out as part of the seller's business need not be concerned about prior pledges. The purpose of the provision is to avoid disruption to commerce and the injustice to unsuspecting ordinary course buyers that would otherwise result if such buyers were required in every case to conduct a search of the collateral registry before buying movable property.

A creditor who takes a security interest in inventory, property held by the borrower for the purpose of selling it to others as part of the borrower's regular business activity, is fully aware that the collateral must be sold by the borrower if the borrower's business is to survive. While the creditor may restrict the right of the borrower to sell the inventory, for example, a restriction in the agreement that the inventory will not be sold without the consent of the creditor or below a specified price, such restrictions cannot be allowed to affect the buyers who buy the inventory in the ordinary course of business. Consequently, a buyer is protected under this provision even if the pledge limits the right of the seller to sell the property.

The fact that the buyer is aware of the existence of a security interest in the property of the seller, the pledgor, does not disqualify the buyer from having the protection of this provision. Many buyers are aware that wholesale or retail sellers with whom they deal may have given pledges on their inventory. It makes no commercial sense to require these buyers to discover the identity of the secured creditor, and then contact the creditor to get a release of the security interest on the property. If this were required, commercial activity would be impeded.

Sales in the ordinary course of the business of the seller are sales made by a debtor who is in the business of selling of such property. These sales to the public at large are of the type normally made by sellers in the business of selling property of that kind when the business dealings between the buyers and sellers are carried out under normal terms and are consistent with general commercial practices. They do not include private sales between individuals or commercial sales made under very unusual terms. A determination as to whether or not a particular sale is “in the ordinary course of business” is ultimately a question of fact that may involve a multi-faceted inquiry into the business practices of the seller. The following are just few examples of relevant factors:

- (i) Transaction Type: The transaction should be one that is a normal part of the seller's business.
- (ii) Place of Sale: If it is at the business premises of the seller, it is more likely to be in the ordinary course of business. If it is away from the business premises of the seller and the seller does not ordinarily sell other than at its premises, the sale is not likely to be in the ordinary course of business.
- (iii) Parties to the Transaction: if the buyer is an ordinary everyday consumer, the likelihood of the sale being in the ordinary course of business is greater. If the buyer is not an ordinary consumer, then the sale is less likely to be in the ordinary course of business.
- (iv) Quantity of Property Sold: If the quantity of the aarticles sold is typical of the quantities sold by those in the business of selling such property then the sale is more likely to be a sale in the ordinary course of business. On the other hand, if an unusually large number of items are sold, more than are usually sold by dealers in such property in the ordinary course of business and perhaps forming a substantial proportion of the stock of the seller, then this is not a sale in the ordinary course of business.
- (v) Price Charged: If the price charged is in the range of the usual market price, the sale is more likely to be a sale in the ordinary course of business. An unusually low price is evidence that a sale in the ordinary course of business has not occurred.

- (vi) Advertising: If the seller advertises, holding itself out to be conducting a certain business, then the transaction is more likely to be in the ordinary course of business.

**Accessions** – the working group discussed the issues pertinent to accessions or movable property that attaches to other movable property.

Modern secured financing enables a pledgee with a pledge on an accession to maintain his pledge against a person who has a property right in the movable property to which the accession is attached. This tends to increase the stability of commercial transactions by reducing the risk of loss of a financier of the accession. It also prevents an unanticipated windfall to the owner of the movable property to which the collateral is attached.

A well constructed provision should allow a pledge that attaches to goods before they become an accession to have priority over any person with property right in the movable property to which the accession is attached. The operation of this provision is illustrated in the following scenario:

Pledgor gives a pledge on a truck to Pledgee1. Pledgee1 register the pledge. Later Pledgee2 finances the acquisition of new tires and takes a pledge on the tires. The tires are then installed on the truck.

In this scenario, Pledgee2 has special priority (PMSI) over Pledgee1. Timing of registration of the pledge on the tires is relevant when there is a priority dispute between the holder of the pledge in the tires and a person who subsequently becomes the owner of the truck and tires. If the truck and tires were sold to a third party, or if the debtor granted a pledge in the whole to another pledgee the failure to register the pledge on the tires would result in loss of the priority of Pledgee2 to the new owner. On the other hand registration will allow Pledgee2 to remove the tires.

The working group did not form its recommendation on this point. The main issue involved the question whether buyers should suffer the consequences in the event that creditors do register their claims (Pledgee2 registered his pledge on the tires). This will be discussed further during the process of drafting.

**Fixtures** – The working group also discussed the situation where pledged movable property attaches to immovable property and that property is then sold to buyers of the real estate. The situations which were discussed involved issues related to priority to the attached property.

The working group identified three approaches to resolution of such dispute:

- A pledge disappears once the movable property is attached to immovable property.
- Priority of the pledge depends on the creditor registering his pledge under the correct ID of the end seller to the buyers.

- Priority of the pledge depends on the creditor registering his pledge under the correct serial number in case the property is identified by serial number.

The working group could not decide on the correct approach in the context of some types of properties. Further examination will be done during the drafting phase.

***Future property*** – discussion on future property was brief and without issues. It was agreed that since it is currently possible to both finance the acquisition of future property and to use it as collateral, this approach will continue with the necessary refinements.

The working group agreed that when a property description is provided in the registration before the property actually exists there is no need to describe it again in a second registration when it comes into existence.

***Small value property exemption*** – The discussion regarding the special priority for buyers who purchase small value goods was in the context of a requirement in some jurisdictions related to the buyer. In Canadian provinces and Albania, the buyer will have priority over a pledge if the buyer did not know about the existence of the pledge.

In Bosnia however, the buyer of small value property will have priority over an already existing pledge only if he had no knowledge about the existence of that pledge.

The working group discussed the advantages of each approach. While the first approach which requires no knowledge on the part of the buyer is more fair and allows better protection to pledges over small value goods, the other one offers a much more simple and easily implemented legal system without the need to involve unnecessary litigation as to whether a buyer had knowledge or not.

The recommendation of the working group will follow further discussions during the drafting process.