

IRAQI II ECONOMIC GROWTH PROJECT

SECURED TRANSACTIONS LAW REFORM

**DESCRIPTION AND ASSESSMENT OF CURRENT IRAQI
SECURED TRANSACTIONS LAW AND APPROACH TO REFORM**

A Report prepared by

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I. FACTORS REQUIRED FOR THE DEVELOPMENT OF MODERN SECURED FINANCING MARKET

It is axiomatic that there is a direct, inverse relationship between the availability and cost of credit, on the one hand, and the degree of risk of non-payment, on the other. The greater the risk, the greater the reluctance on the part of credit suppliers to grant credit (loans and other forms of financing) or grant credit on terms that are manageable by small enterprises or consumers.

There are two related elements to risk: business risk and legal risk. Business risk involves the failure of borrowers to meet their contractual obligations to repay loans or discharge credit obligations. Control of this risk involves assessment of a range of factors such as the potential income and the reliability of borrowers. Legal risk is a function of the adequacy of legal mechanisms designed to facilitate recovery through seizure and sale of defaulting borrowers' assets.

When the law permits ready access to assets of borrowers as an alternative source of repayment in the event of default in discharging obligations under credit transactions, there is a reduction in risk and a concomitant increase in the willingness of credit grantors to grant credit under conditions more favourable to borrowers. Differently stated, there is a direct relationship between the availability of business and consumer credit and the effectiveness of legal remedies that can be invoked by credit grantors in the event of default by borrowers. A modern, efficient system of law dealing with the creation and enforcement of security interests in movable property provides encouragement to credit grantors to expand their activities to include a wider range of borrowers. It accommodates and encourages the use of different types of financing devices with the result that more and different kinds of credit grantors participate in the market. The result is a significant net increase in business activity at both the business and consumer levels.

In the states with developed economies, a large portion of business and consumer credit, whether in the form of loans, sales credit or leasing, is secured by interests in movable property of debtors. This is supported by modern, efficient secured transactions and judgment enforcement laws. The picture is quite different in countries which have a low level of economic development and ineffective secured transactions and judgment enforcement laws. Commercial credit grantors in these countries rarely make loans secured by movable property. In most of these states, the only way to have an effective security interest is to take physical control of the property offered by the debtor as security. Most businesses require their movable property such as equipment or inventory to conduct their businesses. Large value movables such as home appliances and automobiles are of no value to consumers who cannot have access to them for personal and family use. Consequently, a system that requires surrender of possession property to the credit grantor is a completely inadequate response to the need for a legal structure that facilitates the use of secured credit by businesses and consumers.

The essential features of a modern secured transactions law are:

- Recognition of non-possessory security interests in all types of movable property.
- Permitting creditors and debtors to use forms of credit transactions (including financial leasing) that meet their requirements.
- Giving to credit grantors the legal right and practical capacity, in the event of default, to appropriate in an efficient and cost-effective manner the value of the collateral to satisfy the debtors' obligations secured by the collateral,
- An integrated set of priority rules based on commercially recognized practices and reasonable expectations.
- An efficient, low cost, reliable registry system that is readily accessible to the public.
- An efficient court structure staffed by judges who have an understanding of the policy bases of a secured financing law and the importance of expedited proceedings relating to issues that arise in the context of secured financing arrangements.

II A DESCRIPTION AND ASSESSMENT OF EXISTING SECURED FINANCING MECHANISMS

Existing secured financing mechanisms in Iraq and the associated legal structure within which they function are briefly described and assessed under the following headings.

1. Possessory Mortgage (Pledge) of Tangible Movable Property

Description

The pledge is the only generic form of secured financing mechanism involving movable property¹ recognized by existing Iraqi law. The English versions of the *Civil Code* and *Law of Commerce* use the term “mortgage” to refer to this transaction. The pledge is the simplest and most primitive form of security agreement. It has the following characteristics as set out in the various statutory provisions applicable to it: (For the purposes of the following description, no distinction has been drawn between possessory mortgages created under the *Civil Code*² and those created under the *Law of Commerce*³)

- All forms of movable property may be mortgaged, including instruments and debts.
- A sale with a right of redemption is treated as a mortgage.
- In order to constitute a mortgage of movable property, actual or constructive possession of the property must be transferred to the mortgagee or to a trustee appointed by the mortgagor or mortgagee. The delivery of possession can be effected by delivery of an instrument or document representing the mortgaged property. A non-negotiable debt instrument can be mortgaged by assignment to the mortgagee recorded in the books of the issuer of the instrument.
- A debt may be mortgaged by delivery of the document establishing the debt to the mortgagee. In order for it to be effective notice of the pledge has been given to the debtor or the debtor must have accepted the mortgage. The debtor may raise against the mortgagee the same defences he/she could raise against the mortgagor.
- Upon default by the mortgagor, the mortgagee must apply to the court for an order for sale of the pledged property. The parties may not agree in advance of default that the mortgagee may keep the mortgaged property should the mortgagor fail to discharge the secured obligation.

¹ The *Civil Code* provides for what is referred to as an “authentic mortgage” which is defined as an *in rem* interest in immovable property to secure a debt that gives a preference over ordinary creditors and later ranking creditors. See *Civil Code, Book 4 - Accessory Rights in Rem, Title I, Authentic Mortgages*, Articles 1285-1320. This form of mortgage results in the mortgagor remaining in possession and the transaction being registered in the Land Registration Department.

² The *Civil Code* provides for possessory pledges in *Book 4 - Accessory Rights in Rem, Title II – Possessory Mortgages, Articles 1321-1360*.

³ The *Law of Commerce* applies only to mortgages where one or both of the parties are engaged in commercial activity. *Part IV - Commercial Contracts and Banking Operations, Chapter 1, Commercial Contracts, Section One, Commercial Mortgage*.

- Since the mortgagor remains the owner of the mortgaged property, he/she can dispose of that ownership subject, however, to the mortgagee's *in rem* interest in the property.

Assessment

The role of the mortgage (pledge) in modern secured financing is very limited. Commercial borrowers must have possession or control their business assets such as inventory, equipment and receivables in order to conduct their business activities. Consequently, for the most part, the pledge does not facilitate modern secured financing transactions. There are situations in modern business financing when physical control of the collateral by the secured creditor is necessary. For example, where the collateral is a negotiable instrument or negotiable security, the only way in which a secured creditor can gain full protection of his interest is to take control of the collateral. It is not acceptable to restrict the transferability of instruments that pass rights to payment by physical delivery of the instruments.

The requirement that a mortgagee obtain a court order when enforcing a security interest in property in his/her possession is an unnecessary restriction on the exercise of this right.

2. Mortgage of Shares in Joint-Stock or Limited Liability Companies

Description

Article 71 of the *Company Law* (Law No. 21 of 1997 as amended) provides that the owner of shares in a joint-stock or Limited Liability company may mortgage his/her shares "provided the mortgage contract is recorded in the company's special register." The Law provides no procedure for enforcement of the mortgage rights upon default by the mortgagor-shareholder. It can be safely assumed that this must be done by court order.

Assessment

While this approach can work reasonably well on a limited scale, the law should permit other methods to take and give public notice of security interests in shares, including registration of the security interests in a secured transactions registry.

If it is foreseeable that Iraq will implement in the near future a system of dematerialized securities, alternative approaches will be required.

3. Special Mortgages of Property in Possession of a Licensed Warehouse Operator (Public Depot)

Description

Articles 202-216 of the *Law of Commerce* provide the legal structure for the transfer and mortgage of tangible movable property deposited with a public depot (licensed warehouse operator) who has issued a certificate of deposit (a negotiable warehouse receipt) by itself or along with a mortgage deed. When these documents are issued in the name of the depositor “or order” they are transferable by endorsement and delivery by the depositor or endorsee. The mortgage deed can be transferred separately from the certificate of deposit. When the mortgage is endorsed to a creditor, the details of the debt obligation secured by the mortgage are noted on the mortgage and on the books of the depository. Since the mortgage deed is itself a negotiable instrument, it can be further transferred.

The holder of the mortgage deed is entitled, upon default in discharging the obligation secured by the mortgage, to apply to the court for leave to sell the goods covered by the mortgage and deposit certificate. If the amount recovered from the sale is not sufficient to discharge the mortgage debt, the holder may claim back against any priority endorsers of the mortgage deed.

Assessment

While this system can be integrated without much difficulty into a modern secured financing regime, it is likely to have very little commercial significance outside the context of a few specialized situations. It suffers from the same deficiency as the possessory pledge. Generally, commercial borrowers must have possession or control their inventor in order to conduct their business activities. In unusual cases a merchant may store bulk commodities such as grain in a commercial warehouse.

The requirement that a mortgagee obtain a court order when enforcing a security interest in property covered by a mortgage deed is an unnecessary restriction on the exercise of this right.

4. Assignments of Receivables (Rights to Payment)

Description

As noted above, the *Law of Commerce* provides for the mortgage of a debt by physical delivery of documents relating to the debt. However, in addition, the *Civil Code* provides for the assignment of a right to payment (hereafter referred to as “a receivable”) generally.⁴ While the law does not specifically so provide, it appears that an assignment

⁴ See *Civil Code, Part IV- Assignment of Obligations, Chapter 2 – Assignment of a Right*, Articles 362-374.

of a right to payment under this feature of the *Code* can be used as a method of giving security in the receivable to the assignee. The receivable is not assignable, however, if assignment is prohibited by agreement between the debtor and the creditor. It would appear that notice of the assignment to the debtor or acceptance of it by the debtor is a requirement of its validity (for it to be “effectual”). In any event, the assignment is not binding on the debtor until such notice or acceptance has been obtained and discharge of the debt prior to notice or acceptance is effective against the assignee. The debtor has the same defences against the assignee as he/she has against the assignor.

Priority among successive assignees of the same receivable is determined on the basis of time each assignment “became effectual.”

The assignment automatically brings with it any suretyship, privilege or mortgage rights held by the assignor and can be made with recourse to the assignor.

Assessment

Assignments of receivables under existing Iraqi law are subject to constraints that prevent this form of security agreement from being an important feature of modern secured business financing.

The efficacy of an assignment should not depend upon either notice to or the consent of the receivable debtor. It should be possible to transfer a receivable and leave to the assignee the risk that the receivable debtor who has not been informed of the assignment will discharge the debt by payment to the assignor. When receivables are taken as security, the assignor is often given the right to collect the assigned receivables until he/she has defaulted in discharge of his/her obligations to the assignee. Only then are the receivable debtors informed of the assignment and instructed to make payment to the assignee.

The *Civil Code* appears not to permit “bulk assignments” or general assignments of “all present and future accounts” generated by a specified business over a specified period of time. This is a major deficiency. Very often bulk assignment of future receivables are taken to secure commercial lines of credit granted to businesses that sell goods or services on open account. As noted in the preceding paragraph, under such an arrangement the assignor is given freedom to collect the accounts and generate new ones that fall within the scope of the assignment so long as he/she is not in default in discharging obligations to the assignee.

While the translation of the relevant provisions of the *Civil Code* leave some doubt in the matter, it appears that priority among successive assignees of the same receivable is determined on the basis of the time each assignment became effective. If a precondition to effectiveness is notification of the assignment to the receivable debtor, priority is determined on the basis of first to notify the receivable debtor. This approach to priority among assignees of the same account works reasonably well where a single account is involved. However, where a bulk assignment occurs, notification to the receivable

debtors is practically not possible either because of the number of such debtors or the fact that, at the date of the assignment, the identity of the receivables debtors has not been determined. This is the case with future receivables.

The most appropriate and commercial useful way to set the respective priority positions of competing assignees of receivables and, at the same time facilitate the use of bulk assignments, is to require registration of assignments in a secured transactions registry.

5. Forward Rate Sales Contracts

Description

The *Civil Code* recognizes the efficacy of a contract of sale under which the parties agree that the buyer acquires possession of the property sold but the seller retains ownership of it until the price has been paid.⁵ Once the price has been paid, the ownership transfers to the buyer unless the parties have agreed otherwise.⁶

Article 581 provides that, upon default in payment by the buyer, the seller has the option of claiming the unpaid amounts as a debt or of treating the sale as rescinded. Immediate rescission is allowed where there is a threat of loss of both the property sold and the recovery of the debt. If no such threat exists, a court may grant the buyer further time to pay the balance owing to the seller. If payment is not made during the extended period, the court must rule that the contract is rescinded. If the contract provides for automatic rescission upon failure of the buyer to pay the price as required by the contract, the buyer may nevertheless tender performance after an initial default if no notice of rescission has been served on him/her unless the contract provides that rescission occurs without such notice.

Rescission has the result of terminating the contractual relationship thereby giving the seller the right to the return of the property sold. However, Article 534(2) provides that the parties to a forward rate contract that provides for payment of the price in instalments can provide in the contract that upon rescission the seller can “retain part of price as compensation for rescission of the sale in case all the instalments have not been paid.”

The CPA Proposal

In April 2004 a proposal designed to be promulgated by the Administrator of the Coalition Provisional Authority of Iraq, provided for an CPA Order that would, in effect, qualify features of the *Civil Code* dealing with forward rate sales and would establish a

⁵ *Civil Code, Book 2 - Nominate Contracts, Title 1- Contracts as Regards Ownership, Chapter 1 – Sales, Article 534.* See also Articles 177-178.

⁶ Article 534(4) a contract described by the parties as a “hire” contract is treated as a forward rate sale if it has the characteristics of a forward rate sale.

public registry for seller's ownership rights in movable property other than property the ownership of which is current registered under applicable law.

The Order would function in the context of Article 534 of the *Civil Code*, but would implement priority rules not found in the *Code*. Section 8 of the draft Order provides that, upon default by the buyer in making payments under the contract, the seller has "the right to recovery against the Registered Property in accordance with applicable law on seizure and sale of movable property." The section merely states the obvious.

Section 7 of the draft Order provides explicit protection to buyers of "inventory property" in possession of a "seller (who is a buyer under a forward rate sale) if the seller was regularly engaged in selling inventory of the kind bought by the buyer, both the seller and buyer act in good faith and the sale does not involve the transfer of a major part of the inventory of a business organization or of the inventory held at particular places of business of that business organization." The drafting of this provision gives rise to some confusion. For example, if the seller (buyer under a forward rate sale) is acting in violation of a terms in the sales contract (and, presumably is not acting in good faith), is the buyer protected? Why does the first part of the provision apply to a seller but the latter part apply on to a "business organization"?

Furthermore there is some obscurity associated with section 6 of the draft Order. Under section 6, a person who acquires possession of, an ownership interest in, or a lien or pledge right against property registered would take subject to the ownership interest of the seller. The effect of the section would be to negate Article 1163 of the *Civil Code* which provides that "no case by any person who claims ownership may be heard against a person who has possession of a movable thing (acquired in good faith) and whose possession is based on a valid cause."

The unstated negative implication of section 6 is that, if the ownership interest is not registered, a person acquiring one of the enumerated interests takes priority over the seller's ownership interest. However, in the absence of a specific provision to this effect, it is unlikely that the provision would produce this result with respect to all of the interests enumerated in section 6. What would be required in order to make the draft Order effective as intended by its drafter is a provision stating that failure on the part of a seller to register his ownership results in the loss of that ownership to specified third persons.

The *Civil Code* regulates the retention and loss of ownership and priority of interest in a manner that does not dovetail with the section 6. It is a feature of all systems that, subject to a specific rule such as that contained in Article 1163 of the *Civil Code*, a person who does not own property cannot convey to someone else the title of the owner. If this fundamental principle is to be changed, a specific statutory provision is required. There is no such provision in section 6 of the draft Order with the result that a seller who has failed to register his ownership as contemplated by the draft Order can assert his/her ownership rights in any case not falling within Article 1163 of the *Civil Code* (e.g., a sale

of the property by the buyer to someone who does not take possession of it prior to the time the seller asserts his/her ownership).

Article 1325 of the *Civil Code* provides that any person who mortgages (pledges) property must be the owner of or “the holder of disposal over the thing mortgaged.” Since a buyer under a forward rate sale is not the owner and generally does not have a power of disposal, it is not possible for the buyer to create a valid pledge. This would continue to be the case under the draft Order even though the seller fails to register his/her ownership as provided in the order.

Assessment

A forward rate sales contract (conditional sales contract) is conceptual not a security agreement in the generic sense. A generic security interest is a hypothec (or charge) on the property of a debtor granted to secure an obligation of a debtor to a creditor (chargee). A forward rate sale contract is one under which a seller retains ownership of the movable property he/she agrees to sell to the buyer pending performance of the conditions of the contract, *i.e.*, payment of the price of the movables and any associated credit charge not incorporated in the price. It does not create a charge on the buyer’s ownership since the buyer is not the owner.

However, this type of arrangement functions in the same way as a security agreement. In legal systems that recognize non-possessory security interests, the seller could just as easily transfer ownership of the movables to the buyer and acquire a security interest in the movables from the buyer. This being the case, there is good reason to place more emphasis on the functional characteristics of the forward rate sales contract than on its conceptual nature. In practical terms, the seller retains ownership to secure the buyer’s obligation under the contract. The Iraqi *Civil Code* recognizes that, while the buyer does not get ownership of the movables until the price is paid, the buyer has an interest in the movables that warrants some protection through a court order giving the buyer additional time to pay after default and election of the seller to rescind the contract.

If forward rate contracts are to be brought into a secured transactions regime, it will be necessary to make some changes to the rights of the seller and buyer to bring them into line with the rights of secured parties and debtors. In the event of default by the buyer, the seller’s decisions to exercise a right to seize the movable property that is the subject matter of the sale should not be treated as rescission of the contract, but rather performance of rights given in the contract or the secured transactions law. In other words, the seller should be entitled to enforcement payment of any balance of the contract price that remains undischarged after crediting the amount recovered from the resale of the property.

If forward rate contracts are brought within the scope of a secured transactions law, priority among various claimants to the movable property would not be based on any right of ownership of the seller but based on the same priority rules as are applicable to

secured creditors who provide credit or loans to acquire the movable property in which they hold security interests.

Appropriate measures of the kind described in the preceding paragraphs would eliminate the necessity to give any consideration to the implementation of the CPA proposals.

6. Equipment Leasing

Description

While the *Civil Code* contains an extensive title dealing “Lease Contract”⁷ it is clear that this part of the *Code* was not designed to facilitate leasing as a financing mechanism. In fact, most of the articles in this title relates primarily or exclusively to leases of immovable property.

Assessment

It is the view of the author of this report that an entirely new regime for equipment leasing is required. Leasing has developed in many countries of the world as a very important financing technique for the acquisition of equipment.

Some types of leases are functional equivalents to forward rate contracts. This is recognized at least in part by Article 534(4) of the *Civil Code*.⁸ These can be referred to as “capital leases” or “security leases” since their function is to provide an alternative method through which a small business can acquire equipment on terms not substantially different from those contained in a forward rate contract. This being the case, it is not illogical to treat them as creating security interests in the same way that a forward rate contract is treated as having this effect. This approach necessitates developing a set of guidelines to determine the difference between a “security lease” and a true lease (i.e. a lease is not designed to give to the lessee other than temporary use of movable property.)

However, many states with modern secured transactions system bring true leases within the scope of the registration and priority features (but not the enforcement features) of their secured transactions law. Under this approach, the distinction between a true lease and a security lease is relevant only when it is necessary to determine whether the regulatory system of secured financing law dealing with enforcement of security interests is applicable also to a leasing transaction. In the case of a true lease, the lessor has enforcement rights applicable to a lessor-lessee relationship. Where a security lease is found to exist, the lessor has the enforcement rights and obligations of a secured creditor.

Modernized Iraqi commercial law should accommodate what are referred to as “financial leasing transactions.” These arrangements involve three parties and two contracts. The

⁷ Title 2 – Contracts Relating to the Use of a Thing, Chapter 1 – Lease Contract, Articles 722-804.

⁸ See also Article 155 of the *Civil Code*.

three parties are the supplier of the leased property, the lessor and the lessee. The two contracts are the supply (sales) contract between the supplier and the lessor and the lease contract between the lessor and the lessee which, in the greatest number of cases, will be a security lease. Generally, the property and the supplier of the property are selected by the lessee and the property is delivered directly from the supplier to the lessee. The role of the lessor is essentially that of a financing intermediary.

The essential purpose of statutory provisions dealing with financial leasing transactions should be to order the legal relationship between the lessor, lessee and supplier so as to reflect the economic realities and expectations of the parties involved, and to provide a statutory formulation of the rights of the lessor and the lessee as between themselves in the case of default by the seller. Reduced to its simplest, this involves recognition of the fact that the lessor is predominantly a financing intermediary between the supplier and the lessee and, as such, should not carry all of the legal responsibilities of a lessor who is supplying the leased property. It also means that, while there is no contractual relationship between the lessee and the supplier, the commercial reality is that the lessee-supplier relationship is very important when issues of product performance, warranties and other obligations of a seller arise. The following features are central to the relationships arising out of a financial leasing transaction:

- The lessee has the rights against the supplier that the lessor has under the supply contract. However, the supplier has no greater obligations to the lessee than it has to the lessor.
- Since many of the lessee's rights are dependent upon the supply contract, the lessee's rights are not be affected by modification or rescission of the supply contract.
- Once the lessee has accepted the property, the lessee must look to the supplier for any remedies for non-compliance with the requirements of the lease contract. However, prior to acceptance by the lessee, the lessor has the obligation to ensure that the property that complies with the lease requirements is delivered to and accepted by the lessee. If the leased property is not delivered, is delivered late or fails on delivery to comply with the lease contract requirements, the lessee should have full rights of rejection and damages.

7. Enforcement

One of the most controversial issues that arises when addressing secured transactions law reform in a civil law jurisdiction⁹ is the role of the courts and the execution department in the process of enforcement of security interests (i.e., seizure and sale of tangible property or collection of receivables). Consistent with civil law traditions, current Iraqi law does

⁹ While some common law (or mixed systems) jurisdictions provide for court involvement in enforcement, the general pattern in jurisdictions with common law traditions is to allow the secured party to seize and sell collateral without court involvement except in cases where a breach of the peace is threatened.

not permit self-help enforcement by secured creditors when debtors default in discharging the obligations secured. In every case, enforcement requires an order of the court and the direct involvement of the Executions Department in the process of seizure and sale.

In a perfect world, the civil law approach would be superior to the approach of the common law (which accepts a large measure of creditor implemented enforcement – here after referred to as “self-help enforcement”) since it addresses three important issues associated with enforcement: protection of the interests of defaulting debtors, ensuring that seizure does not result in breaches of the peace or violence and ensuring that the sale of the collateral is carried out in an honest and efficient manner. However, experience in many countries demonstrates that mandatory court and public official enforcement is a significant obstacle to the use of secured financing arrangements.

This report does not contain a detailed examination of the processes involved in getting a court order for sale of collateral, as provided in the *Civil Actions Law* of 1969 or having that order carried out by the Executions Department as provided the *Executions Law* of 1980. If, as is very likely the case, these features of the judicial system in Iraq are similar to those found in many other countries, it is necessary to conclude that any modernization of the substantive secured transactions law that does not provide for a much more efficient system for enforcement of security agreements will be ineffective.

Courts are generally overworked and applications for orders are not quickly obtained. Debtors can delay seizure of collateral by exercising rights of appeal against seizure orders. The Executions Department adds another layer of bureaucracy and an opportunity for debtors to delay enforcement. Furthermore, fees payable for its services (which generally must be paid by the secured party) are considerable and its officers are given little incentive act in an expeditious manner. The result is that the process of security interest enforcement is very expensive and inefficient. Both of these factors diminish the economic value of taking security interests. The delay often results in the collateral depreciating significantly. The method of sale dictated by the *Executions Law* is not one that necessarily results in recovery of the full market value of the collateral. These factors can result in reducing the secured creditor to the status of an unsecured creditor and, at the same time, providing little real protection for debtors.

Jurisdictions that permit self-help enforcement prescribe the procedural steps a secured party must take when seizing and selling collateral. Very little scope is given for modification of these steps by agreement between the debtor and the secured party since, in most cases, the chargeholder has the dominant position.

Self-help enforcement in the form of seizure of collateral by the secured party alone is not permitted if there is a reasonable possibility that a breach of the peace will occur. In such a case, the secured creditor must get a court order instructing a peace officer (police) to accompany the secured party when seizure is being made.

Debtors are given a reasonable time after seizure to discharge the obligation (and, in some jurisdictions to correct any default) and to regain possession of the collateral. These systems do not exclude courts entirely from involvement. A debtor whose property has been seized by a secured creditor is able to invoke court intervention to ensure that the requirements of the secured transactions law are being met or to provide a remedy in cases where a sale of collateral has been improper. In addition, courts are always available to interpret the secured transactions law where ambiguity is involved. However, what is significant is that, in most cases, the disposition of the collateral is not delayed by proceeding invoked by the debtor. The result is that depreciation of the collateral is minimized. The debtor is compensated if the secured creditor has acted illegally or in violation of the rights of the debtor.

8. Privileges

Description

Title 3 (Privileged Rights) of the *Civil Code* provides a structure for the recognition of “privileged rights”, that is, priority to payment of a specific types of debts.¹⁰ It recognizes both general (affecting all of the movable and immovable property of the debtor) and special privileges (affecting only specific property of the debtor). The priority rank of a privilege is generally set out in the law creating the privilege. However, a privilege may not be asserted against a possessor in good faith of a movable.

The *Civil Code* sets out a list of privileges. Those listed below are ones that are likely to be important in the context of secured financing arrangements are:

- Amounts due to the State for taxes and duties that create a general privilege which has priority over any claim secured by a mortgage (including a pledge) and all other privileges listed below.
- Amounts that became due within 6 months (prior to claim of the privilege) to wage-earners or salaried employees that create a general privilege.
- Alimony that creates a general privilege.
- Amounts for crop in-puts that create a special privilege on the crops.
- Amounts due in respect of agricultural implements that create a special privilege on the implements.
- Amounts due to landlords for rent of “constructions” and agricultural land that create a special privilege on “attachable movables” and agricultural products of

¹⁰ In common law jurisdictions these privileges are often stated in property terms as a “lien” or “charge” on the property of the debtor.

the lessee located on the leased property or removed from the property without the permission of the landlord.

- The amount of the price and accessories “which accrue to the vendor of a movable (that) creates a special privilege right over the thing sold.”

Assessment

The current Iraqi system under which absolute priority is given to state claims makes risk assessment by creditor grantors very difficult since it is not possible to determine whether assets of potential borrowers offered or taken as security are or will become subject to State claims that will have priority over security interests. While there are public policy reasons for recognizing state privilege for tax obligations, measures should be implemented designed to reduce the negative effect of the this privilege on the willingness of credit grantors to provide credit facilities to businesses.

III. A GENERAL ASSESSMENT OF CURRENT SECURED TRANSACTIONS LAW OF IRAQ

Current secured transactions law of Iraq contains very few, if any, of the features of a modern secured financing system noted above.

As is the case with many other states that have a legal structure based on the Civil Law tradition, Iraqi law does not recognize the possibility of a generic non-possessory security interest or charge. As noted earlier in this report, the core concept of existing secured transactions law is what is inaccurately referred to in the English translation of the *Civil Code* and the *Law of Commerce* as a “possessory mortgage” or “mortgage”. Technically, what is involved is a “pledge”, that is, delivery of possession of items of the debtor’s property to the secured creditor or to a third party to be held on behalf of the creditor.

Given the extremely limited scope of the pledge and the fact that movable property taken in pledge is, of necessity, in the possession of the creditor, it is unlikely that successive, competing interests in the property will be created. While this has the beneficial effect of dispensing with the need for explicit priority rules and a registry system, it also means that any excess value in the pledged property over that necessary to secure the obligation owing to the pledgor is cannot be offered as collateral to any other credit grantor. It also means that the pledge cannot be used as a financing device for inventory or equipment that businesses require.

While current law recognizes the transferability of receivables, the applicable rules of the Civil Code are too restrictive to facilitate the general assignments of receivables.

Current Iraqi law precludes any form of self-help enforcement of pledges. It requires an application to the court to permit sale of the pledged property. The procedure for sale of the collateral is complex, and, consequently, time-consuming and costly.

The use of “quasi-security transactions” such as forward rate contracts (in North American terms, conditional sales contracts) and financial and other forms of leasing is frustrated by the lack of a modern legal infrastructure to support these methods of financing the acquisition of equipment and high-value consumer goods.

Although existing law does not accommodate modern secured financing transactions, it does embody the doctrinal features of secured transactions law. The articles of the *Civil Code* and the *Law of Commerce* relating to possessory mortgages and “authentic mortgages” embody the basic principle that the *in rem* interest the mortgagee acquires under a mortgage is an accessory right only and that ownership of the mortgaged property remains with the mortgagor.

In summary, it is clear that, while the conceptual underpinnings of secured financing law are recognized in current Iraqi law (in the context of authentic mortgages), very substantial modernization measures will have to be introduced if the law is to be an important factor in the rapid expansion of private sources (including a broad range of different types of credit suppliers) of development capital for small and medium-sized businesses and durable goods financing for consumers. These new measures should be implemented along with new structures designed to facilitate the development of the private banking sector in Iraq.

IV. GOALS IN DRAFTING MODERN SECURED TRANSACTIONS LAW FOR IRAQ

A. New Substantive Secured Transactions Law

1. A Separate Law or a New Chapter of the Civil Code

It is the conclusion of the author of this report that no amount of “tinkering” with existing features of the Civil Code or the Law of Commerce will meet the need for a legal structure that will support secured financing of small and medium size businesses and consumers in Iraq. A discrete, sui generis system of secured transactions law is required. Existing Iraqi law was drafted at a time when secured financing on the basis of interests in movable property was of little significance to the commercial community or to consumers. In this respect, Iraq is in no different position than many other states with Civil Law traditions.¹¹ A system that is much more extensive and complex is required to

¹¹ This is not to suggest that the situation is much better in states with common law traditions. It is relevant to note, however, in this context the law of these states at least recognizes the possible existence of non-possessory secured financing devices such as chattel mortgages, equitable charges and floating charges that involve movable property as collateral.

support and encourage modern types of secured financing that are crucial to the development of a modern economy.

There are precedents for each of two approaches to the creation of modern secured transactions law in a Civil Law jurisdiction: a new, separate title of the Civil Code¹² or a stand-alone secured transactions law. In either case, it is necessary to make changes to the Civil Code and to other related laws.

There are advantages associated with enacting a new secured transactions law as a separate law or as part of the Law of Commerce rather than including it in the Civil Code. The tradition in most civil law jurisdictions is to treat a Civil Code as a statement of general principles rather than a source of detailed technical rules. This approach is reflected in Iraq in the fact that there is a separate Law on Commerce.

Experience in other jurisdictions has demonstrated the necessity to make “fine tuning” changes to newly enacted secured transactions law during the first year of operation. There is reluctance among legislators to make frequent changes to a Civil Code. Furthermore, a central feature of a secured transactions law is the registry. Most of the detailed procedures associated with a modern registry are most appropriately contained in regulations. As statements of general principles, a Civil Code is only infrequently amended and, generally, do not provide for regulations.

2. A Modern Conceptually Integrated Secured Transactions Law

A modern, conceptually integrated secured transactions law should be adopted in Iraq. The law should address all types of transactions that have been designed to secure obligations through interests in movable property (including accessions to immovable property and growing crops).

The conceptual structure of the law should be consistent with civil law principles but should be based on modern systems implemented in states in which a high level of secured financing is provided by different types of commercial and consumer credit grantors using a range of different secured financing arrangements. This diversity encourages competition and innovation in the secured financing market.

3. Adopt Hypothec as Core Concept But Provide for Extended Scope

This legislature structure should accommodate diversity. The core concept should be the “hypothec” which entails the grant of a real right (charge or security interest) in movable

¹² This approach was used in Quebec (a Canadian province that has a French Civil Law heritage). See Quebec Civil Code, Book Six, Title Three, Chapters I & II.

property of one person (the debtor) to another person (the secured party) for the purposes of securing an obligation owing by the debtor (or some third person) to the creditor.

However, the law should apply in relevant part to transactions such as long term (more than one year) leases, sales of receivables, and forward rate contracts that do not create hypothecs but that, nevertheless, have as their principal function the securing of obligations¹³ or that give rise to the potential for third person deception resulting from the separation of possession and ownership of the property involved.

4. Flexible Law Designed to Accommodate Needs of Parties

The law should be designed to accommodate the needs of parties to secured financing arrangements rather than requiring the parties to conform to rigid legal rules. This involves conceptual flexibility not found in existing Iraq law including the following:

- *Recognition that security interests can be created in any form of movable property by a simple agreement between the parties without the need to transfer possession of the property (or documents representing the property) to the secured party.*
- *Recognition that a security interest can charge not only movable property owned (in whole or in part) by the debtor at the date the security agreement is made but, as well, property of the kind described in the security agreement acquired by the debtor at any time in the future during the period of the agreement.*
- *Recognition that a security interest can secure any obligation (that can be monetized) owing at the date of the security agreement or arising any time thereafter.*
- *Recognition that a security interest in (original) property automatically extends to replacement property acquired by the debtor as a result of any dealing with the original property or to insurance payments or other payments consequent on damage, destruction, loss or expropriation of the original property.*

5. Priority Rules that Permit High Level of Legal Risk Assessment

The law should contain priority rules that permit a high level of legal risk assessment without the need for extensive judicial interpretation and application. These rules should be designed to allow persons who deal with a debtor (including a buyer, lessee or assignor) the opportunity to assess risk associated with acquiring an interest or buying property in the possession or under the control of the debtor on the basis of publicly disclosed information as to the existence or potential existence of prior interests in the property.

¹³ As noted later in the report, it is the view of the author that, for public policy and commercial reasons, the registration and priority structure of the law should apply to leases and sales of receivables that do not function as security devices.

6. A Special Purchase Credit Priority Status

The law should contain a special priority rule under which a published security interest of secured party who provides credit to the debtor to acquire collateral is given first priority to the collateral over any other security interest in the collateral regardless of the order of registration.

7. Special Priority Rules Relating to Negotiable or Quasi-Negotiable Property

The law should permit security interests in any kind of movable property and, as a general rule, should give to these interests a priority status through publication in the secured transaction registry. However, the priority obtained in this way should not interfere with existing law and commercial practices relating to the transfer of negotiable or quasi-negotiable property

8. Flexible Rules Providing for Security Interest in Receivables

The law should recognize the possibility of a business debtor giving a security interest in or selling specified existing receivables, future identifiable receivables or all present and future receivables created in the operation of the business. These interests should be valid without the need to notify the receivable debtors. Priority among competing interests in the receivables should be based on the date of registration of the interest in the secured transactions registry.

9. Priority Rules Relating to Unsecured Creditors and Trustee in Bankruptcy

The priority structure of the law should address competing claims of secured parties, on the one hand, and unsecured creditors and trustees in bankruptcy, on the other.

10. Priority Rules Dealing with Privileges

The law should address the priority position of state (and other) privileges in such a manner as to facilitate legal risk assessment by credit grantors.

One approach that addresses creditors' need for predictability and, at the same time, preserves special priority rights that are based on public policies, such as the need of the state to collect taxes, is to provide that a security interest is subordinate only to state privileges when notice of the state claim is registered in the secured transactions registry before the charge has been created.

When the debtor defaults in discharging his/her tax obligations, the public authority would register a charge that would have priority over any new security interests created after that point including any interests that arise as a result of the operation of after-

acquired property clauses in security agreements or interests arising as a result of future advances tacked to an earlier created and published security interest.

The privilege given to tax claims should not affect new property that is subject to a security interest taken by the creditor who supplied credit or money to acquire the property and who has taken a security interest in it.

The privilege relating to agricultural equipment should be abolished. Creditors who sell or financing agricultural equipment should be able to take security interests in the equipment that are given a first priority status (purchase credit priority).

11. Priority Rules Protecting Buyers and Lessees of Collateral

The law should contain priority rules protecting a buyer or lessee of collateral subject to a security interest under the following circumstances:

- *where the security interest has not been published by registration by surrender of possession of the collateral to the secured party;*
- *where the secured party has expressly or impliedly authorized the debtor to sell or lease the collateral;*
- *where tangible movable property subject to a security interest has been acquired by the buyer or lessee in a transaction carried out in the ordinary course of business of the seller or lessor [and the security interest in the goods was given by the seller or lessor];*
- *where tangible movable property subject to a security interest having a small (specified) value and the buyer or lessee acquired his or her interests without knowledge of that the goods are subject to a security interest; and*
- *where the collateral is negotiable property that has been left in the possession of the debtor and the buyer is a good faith transferee of the property;*

12. Priority Rules for Interests in Accessions and Growing Crops

The law should include a structure under which security interests can be taken and protected in movable property (other than ordinary building materials that are integrated into a building) that is an accession to immovable property and in growing crops. The structure should contain priority rules that provide protection (in the form of risk assessment measures) for secured creditors who take security interests in movable property that becomes an accession or in crops and persons who have or acquired interests in the immovable property to which the movable property has become an accession or on which the crops are grown.

13. A Greater Measure of Self-help Enforcement

The law should contain a detail enforcement regime that permits as large a measure of self-help enforcement by secured parties as is consistent with maintenance of the peace and protection of the interests of defaulting debtors and holders of subordinate interests.

Perhaps the most important decision made by the designers of a new Iraqi secured transactions law will relate to the system for enforcing security interests upon default by debtors. As noted earlier in this report, experience in other jurisdictions in which modern secured financing occurs on a large scale demonstrates that self-help enforcement is a key factor in the efficacy of a secured transactions system. The designers of such a system for Iraq must weigh the benefits associated with court and public official involvement in enforcement against the negative effect that the delay and costs endemic to the current approach will have on the willingness of credit grantors to expand their secured lending activities. The simple fact is that there is a clear inverse relationship between the availability of secured credit and the extent to which courts and public official are involved in enforcement. Admittedly, the negative effects of public enforcement can be minimized by ensuring that:

- *courts are very efficient and honest;*
- *opportunities for appeals by disgruntled debtors are limited;*
- *execution department officials involved in actual seizure and sale of collateral have real inducements to act expeditiously and honestly; and*
- *these officials have the necessary expertise and flexibility to ensure that the full market value of collateral is realized through sale.*

However it must be recognized that full implementation of these measures will require major changes in the existing infrastructure that cannot be implemented as part of the modernization of secured transactions law but can be implemented only as part of a much larger and more broadly-based undertaking.

Self-help enforcement does not necessitate acceptance that the rights of debtors must be sacrificed to efficiency. Most of the benefits associated with judicial and public official involvement in enforcement can be obtained (without the high cost and delay) through a balanced structure that accepts self-help enforcement accompanied by measures to provide protection to debtors. Such a system has the following general characteristics:

- *Parties are permitted (within reasonable limits) to define in their security agreement what constitute default by the debtor;*

- *Upon default the secured party is permitted to take possession of tangible collateral from the debtor or third party in possession of it so long as this can be done without breach of the peace.*
- *When the collateral is receivables, the secured party is permitted to collect the amounts owing directly from the receivable debtor.*
- *A secured party who induces or create a breach of the peace through enforcement is subject to penalties specified in the criminal law.*
- *The law prescribes the procedural steps a secured party must take when seizing and selling collateral. Very little scope should be given for modification of these steps by agreement between the debtor and the secured party.*
- *The secured party is able to get from a court an order requiring the debtor to surrender possession of the collateral to the secured party or, when breach of the peace is likely, to require policing authorities to accompany the secured party when making seizures.*
- *The debtor and any other person whose property interest will be affected by sale of the collateral must be given a reasonable time after seizure to discharge the obligation or correct the default and to regain possession of the collateral.*
- *The debtor has the right to apply to the court in cases where the secured party has acted in violation of the term of the security agreement or the applicable law.*
- *When such an application is made, the court has the power to order that collateral be held by the secured creditor under the supervision of the Execution Department and that depreciable collateral be immediately sold and the proceeds of the sale deposited with the court.*
- *When the court determines that a secured party has acted in violation of the security agreement or the applicable law, it has the power to require the secured party to pay to the debtor actual damages suffered by the debtor along with penal damages.*
- *When the court determines that the debtor's application to the court is without justification, it has the power to require the debtor to pay any extra costs incurred by the secured party as a result of application.*
- *The secured party has the right to sell seized collateral but only in a commercially reasonable manner.*
- *A sale conducted by the secured party results in the buyer (acting in good faith) obtaining ownership of the collateral purchased free from any interests in the*

collateral subordinate to that of the secured party but not an interest that has a higher priority than that of the secured party.

- *The secured party has the legal obligation to provide a full accounting of the sale to the debtor and any other person whose interest in the collateral is affected by the sale.*

14. Special Private International Law Rules

The law should contain private international law rules that have been designed specifically to address the recognition and public disclosure in Iraq of security interests created under the law of a state other than Iraq. These rules would supplement Articles 24-33 of the Civil Code.

15. Transition

The law should contain priority and registration rules designed to facilitate transition from for pre-existing law to the new law so that secured transactions, leases, forward rate contracts and privileges created under pre-existing law can be brought within the regulatory structure of the new law.

B. Public Disclosure of Security Interests and Interests of Lessors, Sellers and Privilege Holders

1. Operational Principles

As noted above, the law should recognize security interests in movable property that is left in the possession or under the control of the debtors and should bring within its scope leases, forward rate contracts and privileges. Possession or control of property by a debtor creates the potential that third persons who acquire interests in the property in transactions with the debtor or under judgment enforcement proceedings will be deceived by that possession or control into thinking that the debtor has full ownership of the property that can be transferred to such person.

The problem of third person protection that arises in the context of security interests is also present when the person in possession or control of property is a buyer under a forward rate contract or a lessee under a lease of movables.

The solution to this problem should not be found in Article 1163 of the Civil Code that gives possession acquired in goods faith primacy over in rem rights (ownership) in

movable property. Indeed, the secured transactions law should expressly provide that this Article does not apply to any interest that is governed by the law.

The solution to third person protection should be based on the principle that the third person acquires movable property subject to a security interest, lessor's interest, seller's interest or privilege in the property only if the interest has been published in one of the methods provided by the secured transactions law. Another way to state the operational principle is that a person who has contracted with the debtor to acquire movable property or who has acquired rights in it under judgment enforcement proceedings, takes free of a security interest, lessor's interest, seller's interest or privilege in the property if the required steps for giving publicity to such an interest have not been taken. Some exceptions to this general approach are required.

For this purpose, the law should recognize three types of publication: possession of tangible movable property by the secured party (i.e., a pledge), registration in a secured transactions registry (or Vehicle Registry) and deemed publication under specified circumstances set out in the law.

In the great bulk of cases, registration in the secured transactions registry will be the method of publication that will be used by secured parties and privilege holders. (Registration in the Vehicle Registry will be used by sellers of vehicles under forward rate contracts and lessors of vehicles).

Other forms of publication will be used only when registration does not provide the necessary protection. For example, as noted above, while the law should recognize that security interests can be taken and registered in any kind of collateral, the priority rules of the law should protect good faith transferees (holders-in-due course) of negotiable instruments. Transferees should not be required to search the registry before taking negotiable instruments through negotiation. Consequently, the priority rules of the law should provide that transferees of negotiable instruments take free from registered security interests in the instruments. The result under this approach is that a secured party who wishes to protect his/her security interest in a negotiable instrument must take possession of it so that it cannot be negotiated to a holder-in-due course.

The current approach contained in Articles 202-216 of the Law of Commerce should be retained in modified form in a secured transactions law. A secured party who has taken a security interest in property that is stored with a commercial warehouse operator should be treated as having a published security interests by:

- *registering the security interest in the secured transactions registry;*
- *acquiring the written commitment of the warehouse company to hold the property subject to the instructions of the secured party;*

- *taking possession of a negotiable warehouse document issued by the warehouse operator.*

In the following paragraphs, the central features of a modern secured transactions registry are described. It is no longer feasible to have a registry system based on paper documents. All modern systems have computerized data bases. Many of them provide electronic access to the data base for the purposes of registering and searching.

2. The Vehicle Ownership Registry Under Section 5 of the Coalition Provisional Authority Order Number 86 Traffic Code and Chapter 5 of the Law No (33) of 1996 (Notaries Public)

Current Iraqi law contained in the Vehicle Ownership Registry as provided in Section 5 of the Coalition Provisional Authority Order Number 86 Traffic Code and Chapter 5 of the Law No (33) of 1996 of Notaries Public provides for the registration of ownership in a wide range of self-propeller vehicles. Registration in this registry creates a presumption of ownership. Article 33 of Law No. (33) of 1996 suggests that it is possible to include in the registry “special privilege rights mentioned on the machine by the consent of its owner or by judicial judgment or legal judgment” ... taking into consideration the laws concerned with the matter.”

The existence of this registry gives rise to two matters that must be addressed in the context of a modern secured transactions law: (i) should the vehicle registry be the registry for all security interests in registerable motor vehicles; and (ii) is there need to amend the Traffic Code to ensure that there is no conflict between it and the secured transactions law?

While there is superficial attractiveness to using an ownership registry as the registry for security interest in movable property, it is the view of the author of this report that, subject to the exceptions set out below, this approach should not be used in Iraq.

A secured transaction registry is not an ownership registry; it is a registry of existing or potential interests in the movable property. A secured transactions registry creates no presumptions as to the validity of a registered interest. Whether or not the registration relates to a valid interest is determined by the applicable law. Consequently, the requirements of the secured transactions registry are very different from those of an ownership registry that creates an irrebuttable presumption of ownership in a registered item of movable property.

As noted above, it should be possible to effect a registration in a secured financing registry relating to property to be acquired by the debtor at a time later than the date of registration. This would not be possible if the security interests were registered in the ownership registry.

It has been suggested elsewhere in this report that leases and forward rate sales contracts be subject to registration since they are functionally similar to security

agreements and they create the same problem of third person deception that non-possessory security interests do. However, since a seller of a motor vehicle (as defined in the Traffic Code) under a forward rate sales contract and a lessor of a motor vehicle are owners, their ownership must be registered under Section 5 of the Traffic Code unless the motor vehicle is held as inventory. This gives rise to the question as to whether there is any need to require registration of such sellers or lessors interests under the secured transactions registry.

It is the conclusion of the author that dual registration is not warranted and that registration under Section 5 of the Traffic Code is sufficient for purposes of the secured transactions law.

It is presumed that as a result of Article 31 of Law No (33) of 1996 (Notaries Public), a motor vehicle held as inventory is not subject to registration under Section 5 of the Traffic Code. It is only when the vehicle is sold that registration is required. The request for registration is made by the seller and buyer. It follows from this that, unless the buyer takes free from a security interest in the vehicle under a priority rule of the secured transactions law, the ownership of the buyer remains subject to the security interest in the vehicle that has been registered in the secured transactions registry. [This should create few problems for good faith buyers of vehicles bought in the ordinary course of business of the seller since, in most cases, the buyer will take free from the security interest.]

It will be necessary to amend the Traffic Code to provide that the presumption of ownership set out in the Code is subject to the priority and enforcement rules of the secured transactions law. For example, if an owner gives a security interest in a motor vehicle owned by him and fails to discharge the obligation secured, any sale of the vehicle by the secured party pursuant to his/her enforcement rights under the secured transactions law must be recognized as valid by the Vehicle Registration Office and the buyer must be registered as owner in the registry without the consent of the debtor.

3. Centralization

There should be a modern, nationwide, computerized registry created under the secured transactions law for publication of security interests and sales of receivables and privileges. It should be presumed that registration of the ownership under the Traffic Code and Chapter 5 of the Law No (33) of 1996 (Notaries Public) of a seller of a motor vehicle under a forward rate contract and that of a lessor of a vehicle is registration in the secured transactions registry.

[In the balance of this part of the report, a reference to a “security interest” should be read as including interests is sellers under forward rate contracts, lessors under leases of movables and privilege holders.]

4. Electronic and Other Means to Access the Registry Database

Registrations and searches of the registry should be done through direct electronic access to the registry database using internet or other electronic communications methods. Frequent users such as banks, leasing companies and taxing agencies should be given direct access to the database from their own computer systems. Casual users or those who have not made arrangements with the registry for direct access should be able to access the registry through facilities located in government agencies or through private service providers that have arranged for direct access to the registry for registration and search purpose.

If circumstances in Iraq do not permit for the immediate future the creation of a completely electronic system, the regulations may provide that registration information can be submitted to the registry through physical delivery or telecopier in hardcopy format on forms provided by the registry. This information is entered into the registry data base by registry personnel.

A completely electronic system is much more efficient and much less costly to operate since registration and searching is done by its users. Secured creditors have complete control over the timing of registration and, there is much less potential for error since there is no need to rely on registry staff to manually enter or scan registration information submitted in hardcopy form. The potential for error, omission or fraudulent conduct on the part of the registry personnel in dealing with registration data is eliminated with the result that the need to provide compensation to users of the system who suffer loss or damage as a result of a failure in the system is dramatically reduced.

5 Notice Registration

The registry should be a notice registration system that does not require or permit delivery of security agreements to the registry. Under a notice registry system, only very basic information relating to the existing or potential existence of a security interest is submitted to the registry. This information is the factual particulars needed to alert third parties to the potential existence of a security interest in the identified items or kinds of movable property of the named debtor.

The information required to effect a registration should be an identifier of the secured party, an identifier of the debtor and a description of the collateral in either specific or generic form. It should not be necessary to include the amount of the obligation secured or any of the terms of the security agreement.

A notice registration system minimizes the registry's administrative and archival costs since the data are stored in electronic format and the volume of data relating to individual registrations is small. It also provides significant advantages to system users. Under a notice registration system it is possible to have a single registration cover

successive agreements between the same parties. It responds to the needs of modern commercial financing where the relationship between a business debtor and a commercial lender involves indeterminate credit obligations, such as lines of credit and credit facilities for ongoing advances. Under a notice registration system, the terms of charge agreements can be amended in response to changing circumstances without the need to amend a registration relating to the agreements so long as the changes do not affect the basic information in the registration.

Furthermore, a notice registration system reduces disclosure of sensitive business information to competitors of the debtor named in the registration. The minimal information contained in a registration is available to anyone willing to pay the price of a search. However, the details of the relationship between the parties to the security agreement (such as the amount of indebtedness secured, the terms of repayment and, in some contexts, the details of the collateral involved) are not recorded in the registration and, consequently, are not disclosed in a search of the registry.

Since there are few details of the relationship between the parties identified in a notice registration placed on the public record, it is necessary to have a procedure under which the appropriate third parties can get access to further details directly from the secured party. The secured transactions law should specify the types of persons who have access to this information. They include persons with a property interest in the collateral described in the registration, representatives of unsecured creditors and the debtor.

6. Variable Registration Period

Registrations should not be effective for a uniform fixed period prescribed by law. The registry should provide that the secured party effecting a registration may select the period of the registration that reflects the actual or potential period of the relationship between the secured party and the debtor. However, measures should be included to discourage the selection of registration periods that are unwarranted in the light of the relationship between the secured party and the debtor.

7. Pre-Agreement Registration

A feature found in most modern notice registration systems is the facility given to secured parties to effect a registration relating to the a named debtor or specified property before a security agreement has been executed or a security interest has come into existence. The value of advance registration is that it enables a secured party to establish a first-ranking priority position against potential subsequently registered charges at an early stage in the negotiation process.

However, this is not an essential feature of a modern system. A more conservative approach permits registration only after a security agreement has been signed.

Nevertheless, such a registration should be effective for later security agreements between the same parties relating to the same items or kinds of collateral. See 8 below.

8. *Single Registration for Several Security Interests*

The secured transactions law should provide that a single registration may give priority status) to one or more security interests arising under one or more security agreements between the same parties relating to the same collateral. This feature reduces registration costs for the parties and gives them flexibility to amend and change their financing arrangement to meet changing circumstances without fear of loss of priority or the need to amend the registration. Third persons who rely on registry information obtained in a search of the registration are not prejudiced since the registration is effective in relation to multiple security agreements only if the registered information, including the collateral description, accurately reflects the terms of all related security agreements between the identified secured party and debtor.

9. *Registration-Search Criteria*

The registry must employ standardized indexing criteria (hereafter referred to as registration-search criteria) to enable the accurate entry and retrieval of registration information. Many modern systems use one or both of two types of data as registration-search criteria: information specific to the chargor (the name of debtor, or government issued identification number, hereafter referred to as the “debtor-identifier”) and identification information unique to the collateral (such as the serial number of a motor vehicle), hereafter referred to as the “collateral-identifier”.

Where the debtor is a business and the collateral is business assets such as inventory and receivables it is not feasible to require collateral-identifiers as the registration-search criterion for registrations. What is required is a registration-search criterion that enables a single search to capture a security interest taken on the debtor’s movable property generally, or on generic categories of property. Consequently, a debtor identifier must be used as the registration-search criterion.

Business corporations can be identified by registration numbers issued to them when they are incorporated. The availability of personal identification numbers issued by the government avoids the necessity to use names of individual debtors.

A major problem of remote party protection is endemic to a registry system that is based solely on the debtor-identifier as the registration-search criterion where the collateral is a specific capital or consumer asset such as a motor vehicle or a piece of large equipment for which there exists a ready resale market. This problem is displayed in the following scenario:

Debtor (D) gives a security interest in his car to Bank (SP). Bank effects a registration in the secured transactions registry using D's name as the registration criterion. D sells the car to Buyer 1 who then offers it for sale to Buyer 2. Buyer 2 obtains a search of the registry using Buyer 1's name as the search criterion. This search does not reveal Bank's security interest.

It is unfair to require Buyer 2 to suffer the consequences of D's and Buyer 1's fraud or negligence in not informing Buyer 2 of the SP's security interest. However, it is important that SP's security interest not be lost through the actions of D. An effective solution to the problem is to require SP to include in the registration information relating to the car a specific collateral-identifier (e.g., its serial number) as a supplementary registration-search criterion. When the system records security interests by reference to specific collateral identifiers, Buyer 2 will discover the charge by using that collateral-identifier.

A requirement that all registrations relating to security interests in tangible movable property contain collateral identifiers is not feasible. Not all items of movable property have unique, reliable identifiers such as serial numbers. Some types of property such as cattle or bulk commodities cannot be identified other than by a generic description. Furthermore, such a requirement would be especially problematic for assets of a kind that are constantly being received and disposed of or changed by debtors. This would apply to inventory, raw materials and other supplies consumed in the course of production.

However, the use of collateral-identifiers as registration-search criteria is feasible where the collateral comprises tangible assets not held for sale by the debtor that possess a unique, reliable identifier. The use of a collateral-identifier in this context is particularly important where the collateral is property, such as motor vehicles and large, mobile construction, farming, mining or oil production machinery, for which there is an active resale market with the result that ownership is changes over the life time period of the collateral.

10. Unauthorized Change in or Discharge in Registry Information

The secured transactions law should provide that a secured party or its agent has complete and exclusive control of the information submitted electronically for registration and any amendments to or discharge of that registration. All registered discharges and amendments, whether transmitted to the registry electronically or in hardcopy form physically transferred to the registry should be treated as having been authorized by the secured party identified in them. However, secured parties should be notified of any changes made to their registrations and given the right to promptly reinstate or correct the registrations, subject only to intervening third party interests acquired in the collateral.

11. Liability of the Registry for Users' Losses

The registry should not be liable for loss resulting from factors outside the control of its operators such as fraudulent or negligent conduct on the part of users of the system. This includes the submission of inaccurate registration information and unauthorized amendments or discharges of registrations. The registry cannot guarantee the reliability of registration information.

Persons who use the system must determine whether registered information accurately reflects an existing security agreement between the parties identified in the registration. The registry cannot ensure that information in a registration will not be tampered with by unauthorized persons. It is administratively impossible for a registrar to ensure that every person who submits a discharge of or amendment to a registration has the requisite legal authority. Consequently, the secured party who effects a registration must bear the entire loss from unauthorized amendment or discharge of registration information. In a completely electronic system, the secured party has complete control over who has access to registry data he/she submits.

Instances of loss suffered by system users as a result of operational errors or omissions and for malfunctions of the registry system raise different considerations. One approach is to impose on the users of the system the obligation to self-insure against system malfunctions or errors made by registry employees. This approach is acceptable where a well-designed and managed registry system is involved. The absence of indemnification against loss caused by malfunctions of the system is not a significant concern when problems occur only rarely. The infrequency of such malfunctions reduces user risk to an acceptable level. Reliance on the efficacy of the system is only marginally affected.

An alternative approach is to require the registry to compensate system users for loss resulting from operational errors or omissions and for malfunctions of the registry system. The cost involved in providing this protection would be covered by a small surcharge on the fees paid by all users. However, it may be necessary, at least during the start-up period of a system, to limit the amount of damages recoverable from the registry for any single loss. Under this approach, users must be prepared to self-insure to the extent that the amount involved in the transaction exceeds the recovery limits. Recovery must be dependent upon proof of actual loss by a system user. This may be difficult where registration has been effected electronically. It is very difficult to establish conclusively that data electronically transmitted to the registry was the data received by the registry. If the claimant is required to prove that the error or omission in publication was not caused by the user or by a factor outside the control of the registry, the number of unsubstantiated claims will be small.

12. Publication of Security Interests in Intellectual Property

Intellectual property is an important type of collateral in a modern economy. Under the laws of most states, transfers of intellectual property rights are recorded in the government office responsible for the administration of those rights. Two approaches to publication of charges in intellectual property rights should be considered.

One approach is to provide for publication of security interests in intellectual property right in the secured transactions registry. The other is to provide for publication of these rights in the relevant office of the government agency administering the intellectual property law. The advantage of the second approach is that anyone acquiring an interest in intellectual property rights would be able to determine on the basis of a search of the records of the relevant government office administering the right, what prior interests exist in that right. However, there are disadvantages to this approach. It would necessitate establishing registries for security interests in intellectual property rights in each government office that administers those rights. Furthermore, it would not be possible to effect a registration with respect to future acquired rights.

13. Publication of Security Interests in Company Shares or other Transferable Securities.

Security interests in company shares and transferable debt securities should be publishable by employing one or the following:

- *registration of the security in the secured transactions registry (but subject to special priority rules that protect transferees of negotiable shares or securities);*
- *transfer of the share or security into the name of the secured party or agent of the secured party;*
- *making the appropriate entries in the records of the issuer, clearing agency or depository where the transfer of the security may be effected only by an entry in such records;¹⁴*
- *surrender of possession of the share or security to the secured party.*

¹⁴ This is now provided in Article 71 of the *Company Law* (Law No. 21 of 1997 as amended).