

# Study Concerning a Possible Convention on Inventory Financing

For the past five years CFA has been actively involved with the United Nations Commission on International Trade Law (UNCITRAL) in the development of the Convention on Assignment of Receivables in International Trade. Now that work on this convention is almost complete (a final draft is expected in July 2001), UNCITRAL has begun work on a new project: the study of the desirability of developing model legislation concerning security interests in collateral other than receivables.

To that end, UNCITRAL invited various experts in finance, including CFA, to submit papers on three specific types of collateral — inventory, intellectual property and investment securities — which would identify issues (and propose solutions) relating to cross-border loans secured by these types of collateral which might be considered in connection with the study. UNCITRAL also convened a meeting at its headquarters in Vienna on January 30-31, 2001 to discuss the papers.

CFA submitted papers on all three types of collateral. The papers were prepared by a working group consisting of Keith Karako, managing director, Citibank, N.A.; Richard Palmieri, managing director, Credit Suisse First Boston; Michael Sharkey, president & CEO, LaSalle Business Credit, Inc.; Michael Carsella, first vice president, LaSalle Business Credit, Inc.; Richard Kohn, partner, Goldberg Kohn Bell Black Rosenbloom & Moritz, Ltd.; Jonathan Cooper, partner, Goldberg Kohn Bell Black Rosenbloom & Moritz, Ltd.; Oscar Alcantara, partner, Goldberg Kohn Bell Black Rosenbloom & Moritz, Ltd.; Edwin Smith, partner, Bingham Dana, LLP; Marsha Simms, partner, Weil Gotshal & Manges LLP; Ronald F. Daitz, partner, Weil Gotshal & Manges LLP; Michael Crosby, associate, Weil Gotshal & Manges LLP; Jeffrey Turner, counsel, Kaye Scholer Fierman Hays & Handler, LLP; and Chris Teano, vice president and senior counsel, Citibank, N.A.; with different members of the group taking the primary role on each paper. Keith Karako and Richard Kohn attended the Vienna meeting on behalf of CFA. Other attendees included Professor Dr. Ulbrich Drobniig of the Max-Planck-Institut für Ausländisches und Internationales Privatrecht in Hamburg, Germany; Nicholas From of Lovells in London, England; Guy Morton of Freshfields Bruckhaus Deringer in London, England; Richard Potok of Potok & Co. in London, England; Professor Catherine Walsh of University of Brunswick in Fredericton N.B., Canada (currently at McGill University School of Law in Montreal, Quebec, Canada); and Professor Peter Winship of Southern Methodist University School of Law in Dallas, Texas. The meeting was chaired by Franco Ferrari, legal officer at the United Nations Office of Legal Affairs, and was also attended by Jernej Sekolec, secretary of UNCITRAL and Spiros Bazinas, legal officer of UNCITRAL.



*(Continued on page 36)*

Keith Karako and Richard Kohn attended the Vienna meeting on behalf of CFA. Other attendees included Professor Dr. Ulbrich Drobniig of the Max-Plank-Institut für Ausländisches und Internationales Privatrecht in Hamburg, Germany; Nicholas From of Lovells in London, England; Guy Morton of Freshfields Bruckhaus Deringer in London, England; Richard Potok of Potok & Co. in London, England; Professor Catherine Walsh of University of Brunswick in Fredericton N.B., Canada (currently at McGill University School of Law in Montreal, Quebec, Canada); and Professor Peter Winship of Southern Methodist University School of Law in Dallas, Texas. The meeting was chaired by Franco Ferrari, legal officer at the United Nations Office of Legal Affairs, and was also attended by Jernej Sekolec, secretary of UNCITRAL and Spiros Bazinas, legal officer of UNCITRAL.

At this point, it remains unclear whether UNCITRAL will undertake the project and, if it does, whether the project will focus on one or more of the three specific types of collateral mentioned above or on security interests in general. However, *The Secured Lender* felt that the three papers submitted by CFA are of interest in their own right insofar as they discuss particular issues and concerns inherent in cross-border commercial finance transactions under the current laws of various countries, and is therefore reprinting them, in full, in three issues of this magazine. Reprinted below is the paper on inventory financing, the primary authors of which were Richard M. Kohn, partner, Goldberg Kohn Bell Black Rosenbloom & Moritz; Jonathan M. Cooper, partner, Goldberg Kohn Bell Black Rosenbloom & Moritz; and Michael Carsella, first vice president, LaSalle Business Credit, Inc. The paper on investment securities will be reprinted in a future issue.

## I. Introduction

The Commercial Finance Association (“CFA”) is pleased to submit this Memorandum to the United Nations Commission on International Trade Law (“UNCITRAL”) in connection with a study being conducted by UNCITRAL concerning the desirability of developing conventions pertaining to various forms of secured financing, with the goal of promoting such forms of financing in States that become parties to the conventions.<sup>1</sup>

This Memorandum focuses on forms of financing in which inventory<sup>2</sup> owned by the borrower<sup>3</sup> serves as the primary collateral (for convenience, these forms of financing are collectively referred to as “inventory financing”). Inventory financing represents a major form of working capital financing for commercial enterprises located in North America. Unfortunately, lenders attempting to provide inventory financing in many other jurisdictions are frequently confronted with legal obstacles which make such financing impractical or cost-prohibitive to the borrower, thereby depriving borrowers of access to a highly effective form of financing. CFA strongly believes that a properly constructed convention on inventory financing (referred to for convenience as an “Inventory Convention”) could

effectively address these legal obstacles, thereby dramatically enhancing the flow of low-cost working capital credit to jurisdictions governed by the convention from lenders throughout the world.

This paper first presents a brief overview of the types of inventory financing regularly provided by CFA members, and then discusses those characteristics of an Inventory Convention which would, in the opinion of CFA, serve to significantly promote the availability of inventory financing to commercial enterprises within jurisdictions governed by the convention.

By way of background, CFA is a trade association for financial institutions that provide asset-based commercial financing and factoring to

business borrowers. Although most of the members of CFA are headquartered in North America, many are located, or have affiliates or branches, in other countries, or are owned by entities headquartered in other countries. Among the nearly 300 members of CFA are substantially all of the major money center and important regional banks and other large and small commercial lenders in North America. CFA members provide financing to businesses on an international, national, regional and local scale. Most of the borrowers served by CFA members depend on secured financing to operate and grow. Although much of this financing is used by businesses for working capital purposes, a substantial amount of it is used to finance the acquisition of other companies. Financing provided by CFA

(Continued on page 38)



CFA strongly believes that a properly constructed convention on inventory financing...could effectively address these legal obstacles, thereby dramatically enhancing the flow of low-cost working capital credit to jurisdictions governed by the convention from lenders throughout the world.

members is generally secured by various forms of personal and real property collateral<sup>4</sup> owned by the borrowers, including accounts receivable, inventory, equipment, real estate, intellectual property and investment securities. In 1999, secured financing provided by CFA members totalled almost USD 300 billion.

In recent years, CFA members have become increasingly active in making cross-border loans, including loans predicated on the value of collateral located in other jurisdictions and denominated in local currencies. This increased activity in cross-border lending flows naturally from the increased globalization of borrowers that has occurred during recent years, fueled by reductions in trade barriers, a robust world economy and explosive developments in technology.

The proliferation of cross-border financing, including cross-border inventory financing, has posed many legal challenges for CFA members as they have attempted to obtain, in countries other than their home countries, legal rights equivalent to those that they enjoy under their domestic laws. In some countries, obtaining such rights is a relatively easy matter. In others, it is difficult or impossible under the current legal regimes. In still others, although the legal regimes may be conducive to secured lending, the judicial systems do not provide a level of predictability sufficient to attract foreign lenders.

Several additional preliminary points should be made. First, this Memorandum does not purport to be comprehensive; rather, it seeks only to highlight some of the legal issues encountered by CFA members in cross-border inventory financing, and to suggest ways in which an Inventory Convention might address those issues and thereby promote cross-border inventory financing.

Second, this Memorandum does not presume that favorable legal systems in other countries must be mirror images of the legal systems in those countries in which CFA members have a significant presence in order to attract inventory financing from CFA members. On the contrary, in recent years many CFA members have shown a strong willingness to adapt to the legal systems of other countries which lack some of the basic attributes of their own legal systems, and to respect the cultural differences that have given rise to such legal systems. Moreover, in some instances, the laws of other countries are more favorable to lenders than are the laws of their home countries.

Finally, CFA believes that the proposals set forth in this paper will promote inventory financing, not only by CFA members, but by all lenders, wherever located.

## II. Overview of inventory financing

The following is a brief overview of the types of inventory financing regularly engaged in by CFA members. Please note that this overview is not intended to cover all forms of inventory financing engaged in by CFA members, but is merely illustrative of the more prevalent forms.



Inventory financing engaged in by CFA members can generally be classified into two categories. The first category consists of revolving loan facilities in which the lender makes periodic advances to the borrower based upon the value of the borrower's inventory. The second category consists of "purchase-money" loan facilities in which the lender makes loans to finance the acquisition of all, or a specific portion, of the borrower's inventory.

Each of these categories is briefly discussed below. However, the basic principle with respect to both categories of inventory financing is the same: A lender will only provide such financing to the extent it determines that, if the borrower fails to repay the loans, the lender may look to the inventory for repayment. Clear and predictable secured lending laws are critical to enable the lender to make this determination.

### 1. Revolving inventory loan facilities

A form of inventory financing frequently provided by CFA members is a revolving loan facility secured by a security interest in all existing and future inventory of the borrower.<sup>5</sup> The proceeds of this type of loan facility generally are used by the borrower to finance its ongoing working capital needs, but may also be used for other purposes with the consent of the lender.

Under this type of facility, advances are made, from time to time, at the request of the borrower, based upon a specified percentage of the value of the borrower's inven-

*(Continued on page 40)*

tory which the lender determines to be “eligible” for borrowing purposes. Although standards for determining eligibility vary, they generally include the requirements that the inventory be owned by the borrower, located on the borrower’s premises, free from security interests and encumbrances other than in favor of the lender and accept-

purchaser to enable the purchaser to acquire the goods or (ii) a lender loans funds to the purchaser to enable the purchaser to acquire the goods. In each case, the seller or lender will receive a security interest in the goods to secure the extension of credit or loan.

One common type of purchase-money financing is known as “floor-planning.” Under a floor-planning facility, a lender makes loans to finance the acquisition of a borrower’s stock of inventory. This type of facility is often provided to borrowers that are dealers in items such as automobiles, trucks or other vehicles, computers and large consumer appliances. The lenders in these arrangements are often finance entities affiliated with the manufacturers.

Another common type of purchase-money inventory financing is known as “purchase-order financing.” Under this type of facility, the lender typically will provide funds to finance the fulfillment by the borrower of specific purchase orders, which often includes the purchase by the borrower of the inventory required to complete the orders. The loan will be secured by the purchase orders, the purchased inventory and the resulting receivables. Among its other benefits to borrowers, purchase-money inventory financing serves a

pro-competitive purpose in that it enables a borrower to choose different lenders to finance different components of the borrower’s inventory in the most efficient and cost-effective way.

### **III. Characteristics of an inventory convention**

It is the view of CFA that the following are characteristics of an Inventory Convention which would encourage lenders to make loans secured by inventory located in contracting States, thereby providing greater access to credit for borrowers in those States and, by stimulating competition among lenders, reducing the costs of credit to borrowers in those States.<sup>6</sup>

#### ***A. Characteristics pertaining to the creation of security interests in inventory***

The cornerstone of inventory financing is the ability of a lender to obtain a security interest in the borrower’s inventory which is both enforceable against the borrower as a matter of contract, and which also has the requisite priority as against the borrower’s other creditors (including an insolvency administrator). This concept actually represents a bundle of rights which are important to an inventory lender. Unfortunately, many of these rights are seriously limited or impaired under the existing laws of many countries.

*(Continued on page 42)*

*The cornerstone of inventory financing is the ability of a lender to obtain a security interest in the borrower’s inventory which is both enforceable against the borrower as a matter of contract, and which also has the requisite priority as against the borrower’s other creditors...*

able in terms of type and age. The specified percentage of the value of the inventory which the lender is willing to advance (generally known as the “advance rate”) is determined by the lender based upon the lender’s estimate of the amount it would realize on the inventory if it were to look to it as a source for repayment of the loan. Typically, the advance rate ranges from 40 percent to 60 percent. If the inventory is located in a country which has unfavorable secured lending laws, the inventory may well be deemed ineligible for borrowing purposes altogether.

By matching borrowings to the borrower’s cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), the revolving inventory loan structure is, from an economic standpoint, highly efficient and therefore beneficial to the borrower. This type of inventory facility is very often combined with a revolving receivables loan facility under which the lender will make loans to the borrower, from time to time at the request of the borrower, predicated on the value of the borrower’s eligible receivables.

#### ***2. Purchase-money inventory facilities***

CFA members regularly engage in various types of inventory financing often referred to as “purchase-money financing.” This term refers to a financing arrangement under which either (i) a seller of goods extends credit to its

### 1. *Nonpossessory security interests*

Because inventory lenders generally finance companies conducting ongoing businesses, it is essential that these borrowers be able to retain possession of their inventory for use in their businesses. However, the laws of many countries stipulate that the borrower must be “dispossessed” of the inventory — that is, the lender must, either itself or through an agent, maintain physical possession of the inventory — in order for the lender to obtain a security interest in the inventory that has priority over other creditors and insolvency administrators. These laws frequently

---

CFA recommends that an Inventory Convention contain provisions enabling a lender to obtain a security interest in all inventory of a borrower,



including after-acquired inventory and returned inventory, without the need for any additional documentation or action on the part of the lender.

---

render such property useless as collateral in situations where possession of the inventory by the borrower is essential for the operation of its business, and thereby discourage inventory financing.

There are certain situations where such dispossession is not inconsistent with the borrower’s business. For example, some distributors of goods may routinely store the goods in a public warehouse pending shipment to customers. In this situation, the warehouse can, in some countries, agree to serve as the agent for the lender, with the result that possession by the agent can constitute possession by the lender for purposes of perfecting a security interest in the inventory. Another example of a situation in which dispossession may be possible is an arrangement known as

“field warehousing,” in which an agent of the lender resides on the borrower’s premises to monitor the inventory. However, in both of these situations, in order to be deemed to have possession under applicable law, the lender must exercise a substantial degree of control over the outflow of the inventory, which either may be impractical or may add a significant layer of cost to the lending arrangement, thereby inhibiting financing by making it more expensive for the borrower.

CFA submits that the inclusion in an Inventory Convention of a provision establishing a nonpossessory security interest in inventory would be a meaningful step in promoting inventory financing in contracting States. Although possessory security interests should be retained inasmuch as they are a cornerstone of the secured lending laws of many nations, CFA is of the opinion that nonpossessory security interests are critical to the growth of cross-border inventory financing.<sup>7</sup> In order to publicize the existence of nonpossessory security interests so as not to mislead third parties relying on the borrower’s possession of the inventory as an indication of the absence of any security interest in the inventory, CFA recommends the implementation of a public notice filing system as discussed below.

### 2. *After-acquired inventory; future advances*

In many countries, a lender is only able to obtain a security interest in assets that are currently owned by the borrower. Although this may be acceptable for a loan secured by equipment or real estate, it is generally not acceptable for lenders that lend against assets which continually turn over, such as inventory. It would be cost-prohibitive and administratively impractical for an inventory lender to amend its security documents with sufficient frequency to reflect acquisitions and sales of inventory and returned goods in the ordinary course of the borrower’s business.

Additionally, the laws of many countries provide that a security interest in inventory can only secure obligations that presently exist, and cannot serve as collateral for future advances, a circumstance that is inconsistent with the concept of a secured revolving loan facility.

Accordingly, CFA recommends that an Inventory Convention contain provisions enabling a lender to obtain a security interest in all inventory of a borrower, including after-acquired inventory and returned inventory, without the need for any additional documentation or action on the part of the lender.<sup>8</sup> CFA also recommends that an Inventory Convention provide that a security interest in inventory may secure future advances in addition to existing obligations. A

(Continued on page 44)



...a lender's security interest in inventory subject to such retention of title claims may be a nullity, inasmuch as a company is not able to grant a security interest in inventory that it does not own.

security interest in inventory that automatically extends to after-acquired inventory and secures future advances is essential to the concept of a revolving inventory loan facility. CFA believes that the inclusion, in an Inventory Convention, of provisions recognizing and implementing such a security interest would greatly promote this highly efficient and cost-effective form of financing for borrowers located in contracting States.

### **3. Collateral descriptions**

Another potential obstacle to inventory financing is the fact that the laws of some countries require that, in order for a security interest in certain types of property to be enforceable against the borrower, the property must be described with great specificity. Often, the security documents must attach collateral listings that contain detailed information concerning each item of collateral. This requirement can be especially problematic in the case of a security interest in inventory, where the requirement of specificity can make it impossible or impractical to obtain a security interest in a stock of inventory that turns over frequently or is comprised of many different products. In response to this problem, the laws of many jurisdictions only require that collateral descriptions pertaining to inventory contain enough detail to reasonably identify the inventory covered by the security interest. For example, in some jurisdictions a collateral description such as "all of the borrower's existing and after-acquired inventory" is sufficient.<sup>9</sup> CFA recommends the adoption of this approach in an Inventory Convention.

### **4. Proceeds of inventory**

Because inventory is continually sold in the ordinary course of a borrower's business to purchasers who take title to the inventory free of any security interest, it is important that the security interest of an inventory lender extend to the borrower's right to receive payment from its customers for the inventory sold (whether evidenced by receivables or otherwise), as well as the payments themselves when received by the borrower (referred to for convenience as "Proceeds"). Without a security interest in Proceeds, an inventory lender's collateral would be depleted each time that the borrower sells inventory.

Accordingly, CFA recommends that an Inventory Convention provide that a security interest in inventory extends to the Proceeds of such inventory. To the extent that such Proceeds constitute receivables, an Inventory Convention should also address conflicts with parties holding security interests in such receivables.<sup>10</sup>

### **5. Retention of title arrangements**

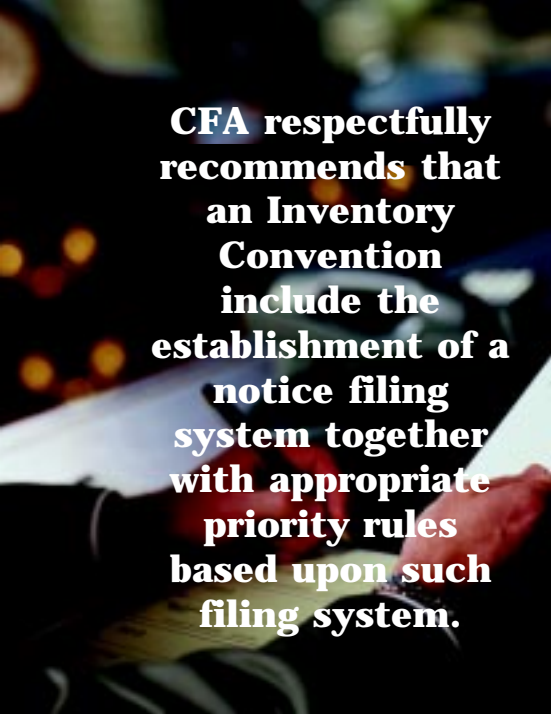
In many countries, it is customary for vendors of goods to retain title to the goods until the purchase price is paid in full. This is generally accomplished by a provision in the contract for the sale of the goods and, in some countries, can result from a unilateral declaration by the seller in a so-called "battle of forms." In these situations, a lender's security interest in inventory subject to such retention of title claims may be a nullity, inasmuch as a company is not able to grant a security interest in inventory that it does not own.

Retention of title clauses generally provide that title to the goods will not pass to the buyer until the purchase price for the goods has been paid in full. In some situations, the retention of title clause is more extensive and provides that title will not pass until the purchase price for all goods sold to the borrower by that vendor has been paid in full.

Lenders wishing to make loans against a borrower's inventory in these countries must first engage in costly due diligence to determine if retention of title provisions exist, and then either obtain releases of such provisions from the appropriate vendors or eliminate such inventory from the pool of potential collateral.

Some countries have enacted laws recharacterizing title retention arrangements as security interests, and requiring holders of such security interests to comply with the notice filing and other requirements pertaining to other security interests. This approach has a number of advantages. First, to the extent public notice of the title retention arrangement is required, a subsequent inventory lender will not be required to engage in the costly due diligence referred to above. Second, if title retention arrangements are subjected to the same rules of compliance as other forms of inventory financing, the costs of establishing a title retention

*(Continued on page 46)*



**CFA respectfully recommends that an Inventory Convention include the establishment of a notice filing system together with appropriate priority rules based upon such filing system.**

arrangement will be more closely equivalent to the costs of establishing such other forms of inventory financing, thereby fostering competition among inventory financiers based on cost of credit alone. CFA respectfully recommends the consideration of this approach in connection with an Inventory Convention.<sup>11</sup>

inventory must be given and priority is based, with some exceptions, on the earliest filing.<sup>12</sup> However, in many countries there is no filing or registration system for inventory. As a result, there is no way to conduct a search to identify conflicting security interests in inventory. In such cases, a lender must either be content to rely on representations of the borrower as to the absence of conflicting security interests, to obtain meaningful third-party guarantees or to forgo making the loan. Moreover, in the absence of a notice filing system, lenders in close geographical proximity to the borrower, who are able to monitor the borrower's inventory at lower cost than more distant lenders, will have a competitive advantage, thereby reducing competition among lenders in extending credit based upon price alone.

The absence of a notice filing system in particular countries often presents a difficult psychological barrier for lenders accustomed to a notice filing system because of the resulting inability of such lenders to determine the priority of their security interests with certainty, and therefore poses a major impediment to cross-border inventory financing in those countries. While CFA recognizes that there are significant cultural issues (such as considerations of privacy) and logistical impediments to establishing a notice filing system, CFA also believes that the certainty provided by such a filing system would be an excellent way to encourage the growth of cross-border inventory financing. Moreover, technological advances are making the establishment of such a system more feasible than ever before.

Of equal importance to the establishment of such a system is the establishment of specific rules for determining the priority of conflicting security interests in inventory, which address issues such as (i) conflicting security interests in the same inventory, (ii) the relative priority of a security interest in receivables as Proceeds of inventory and a security interest in such receivables as primary collateral and (iii) the relative priority of a security interest in inventory and the rights created by warehouse receipts or other documents evidencing title to the same inventory.

CFA respectfully recommends that an Inventory Convention include the establishment of a notice filing system together with appropriate priority rules based upon such filing system.

### **2. Purchase-money security interests**

In order to encourage purchase-money inventory financing, the laws of various countries provide that a purchase-money security interest in inventory can, under certain circumstances, have priority over other security interests in the same inventory. These laws enable a lender to make purchase-money loans on inventory without having to negotiate a subordination agreement with its borrower's other secured creditors, who may have an otherwise prior

### **6. Nondiscrimination against foreign lenders**

Some jurisdictions already have laws that promote inventory financing, such as by providing for nonpossessory security interests in inventory, but do not extend the benefits of these laws to nondomestic lenders. As a result, many potential lenders are precluded from obtaining the benefits of such laws, a circumstance which deprives commercial enterprises located in such jurisdictions of exposure to a broad range of potential lenders. CFA respectfully suggests that the extension of the benefit of lending laws in a given jurisdiction to foreign and domestic lenders alike, on a nondiscriminatory basis, would significantly promote inventory financing in that jurisdiction by encouraging competition among lenders and thereby reducing the cost of borrowing.

### **B. Characteristics pertaining to priority of security interests**

In order for a lender to achieve the requisite level of certainty to induce it to engage in inventory financing, it is not sufficient that the lender be able merely to obtain a security interest in the inventory that is enforceable against the borrower as a matter of contract. The lender must also be able to determine that its security interest has priority over competing security interests, or at least that its security interest is subject only to other security interests which are quantifiable in an acceptable amount.

#### **1. Ascertaining the priority of the security interest**

In order for an inventory lender to be able to assess how much it would be able to realize on its inventory, the lender must be able to ascertain, with a high degree of certainty, the priority of its security interest in relation to the security interests of other creditors (including an insolvency administrator for the borrower). In some countries, the most important tool for making this analysis is the notice filing system, under which public notice of security interests in

*(Continued on page 48)*

security interest in the inventory, each time the purchase-money lender makes a loan. In order for purchase-money lenders to obtain this priming security interest, it is important to require such lenders to give notice to the borrower's other secured creditors so that such secured creditors do not make loans predicated on inventory subject to purchase-money security interests.

As discussed above,<sup>13</sup> purchase-money inventory financing provides a highly effective and useful form of financing for borrowers, and one which also encourages competition among lenders. Accordingly, CFA recommends that UNCITRAL consider provisions recognizing and implementing purchase-money security interests for inclusion in an Inventory Convention.

### 3. Priming claims

In many countries, there are various categories of preferred creditors whose security interests could rank ahead of those of an inventory lender (referred to, for convenience, as "Priming Claims"). These Priming Claims often relate to unpaid taxes and wage-related claims. Priming Claims may not be objectionable to an inventory lender if the laws establishing them are sufficiently clear so that the lender is able to calculate the amount of the Priming Claims and to reserve for such amount. In fact, in some countries, inventory lenders routinely require their borrowers to report periodically as to the amount of Priming Claims and often create reserves against borrowing availability to assure that there will always be sufficient funds to pay such claims. CFA urges that an Inventory Convention include clear rules for determining which claims, if any, may constitute Priming Claims. Ideally, an Inventory Convention would establish a notice filing system for Priming Claims so as to enable a lender to ascertain, with a high degree of certainty, the nature and amount of such claims.

Two types of Priming Claims frequently encountered by inventory lenders in many jurisdictions are (i) those accorded to third parties that own the leased facilities in which the inventory is located and (ii) those accorded to third parties engaged in the processing of inventory. In many jurisdictions, commercial landlords, warehousemen and processors receive, by operation of law or by agreement, a lien on the personal property (including inventory) located in their facilities to secure the rental and other obligations owing to them. However, because of the preva-

lence of inventory lending in some countries, landlords, warehousemen and processors in such countries are often willing to accommodate requests by their customers to enter into agreements waiving their claims or subordinating them to those of the inventory lender. These agreements will often include provisions giving the inventory lender access to the inventory, either to remove it or otherwise dispose of it, upon the occurrence of a default under the inventory loan agreement. On the other hand, landlords, warehousemen and processors in many other countries are often unwilling to entertain such requests, and inventory lenders are forced to seek alternative ways to reduce their risk, such as by limiting the amount they are willing to lend against the inventory. CFA recommends that UNCITRAL consider a provision subordinating such Priming Claims, and insuring inventory lenders access to their collateral, in appropriate circumstances.

### 4. Choice of law considerations

An extremely important element of an Inventory Convention would be the inclusion of choice of law rules, governing issues such as (i) the extent to which the inventory lender and the borrower would be free to designate the substantive law applicable to their financing arrangement, (ii) the applicable law which would govern in the absence of an appropriate express choice of law by the parties and (iii) the governing law for determining the existence and priority of Priming Claims affecting the inventory. CFA suggests that, consistent with long-established legal traditions in many countries, the situs of the inventory should be the controlling factor in determining the governing law with respect to

*(Continued on page 50)*





In order to be willing to make secured loans in a given country, lenders must be convinced that reliable and efficient procedures exist for enforcing their security interests.

the creation and enforcement of security interests in inventory, but CFA also suggests that different rules may be appropriate with respect to Proceeds of inventory.

### **C. Enforcement issues**

The value of a security interest is significantly impaired if the lender is unable to enforce it in a reasonably predictable way and within a reasonably acceptable time frame. There are a number of elements of a country's legal regime that bear directly on this, and these are discussed below. In CFA's view, the element discussed in paragraph 1 below — the existence of appropriate nonjudicial procedures for enforcing security interests in inventory — should be addressed in an Inventory Convention. On the other hand, CFA acknowledges that certain aspects of the elements discussed in paragraphs 2 through 4 below, while critically important to an inventory lender, may realistically fall beyond the scope of such a convention.

### **1. Appropriate nonjudicial procedures for enforcing security interests**

In order to be willing to make secured loans in a given country, lenders must be convinced that reliable and efficient procedures exist for enforcing their security interests. Although the laws of some countries provide for nonjudicial procedures for enforcing security interests in certain types of collateral, in many countries resort to a judicial proceeding is required, which often can be costly and time-consuming. In these countries, the establishment of nonjudicial enforcement procedures would provide an important incentive to secured lenders. CFA recommends that an Inventory Convention include self-help remedies such as the right to conduct a nonjudicial public or private sale or other disposition of inventory with appropriate safeguards for the borrower, such as a requirement that the lender exercise all non-judicial

remedies in a manner that is commercially reasonable.<sup>14</sup>

### **2. A reliable judicial system**

A country's judicial system must be subject to clear and well-established rules and procedures that lead to predictable and timely results. The system must be perceived as being fair and free of corruption. It is also important to secured lenders that the judicial system recognize and enforce judgments obtained in another jurisdiction, even if such recognition and enforcement are conditioned upon the court's finding that the foreign judgment satisfies certain fundamental standards of fairness.

### **3. A predictable and fair insolvency regime**

A critical component of a country's judicial system is its insolvency regime. It is not essential that the insolvency laws of a given country be completely favorable to inven-

*(Continued on page 52)*

tory lenders; however, it is important that the insolvency laws recognize the enforceability and priority of valid security interests, and that the laws are applied in a predictable and efficient manner. Also of great importance, in those situations where the debtor in an insolvency proceeding is permitted to use inventory which is subject to a lender's security interest, is an appropriate mechanism for compensating the lender for the diminution in the value of its collateral resulting from such use, such as by conditioning such use on providing the lender with appropriate payments or substitute collateral.

#### **4. Repatriation of funds**

Finally, the laws of many countries restrict the ability of foreign lenders to export domestic currency from the country. As a result, even if a nondomestic lender in such a country is able to realize on its inventory collateral, the lender may be unable to repatriate the proceeds of such realization to its own country. This situation is compounded by laws in many of the same countries which permit a borrower to satisfy a judgment on a loan obligation in its local currency, even if the loan is denominated in a different currency. Such laws can have a significant chilling effect upon secured lending by nondomestic lenders.

#### **IV. Conclusion**

CFA submits that an Inventory Convention which addresses the issues discussed above would significantly promote the growth of low-cost inventory financing in contracting States, and respectfully urges UNCITRAL to undertake the study of such a convention. ▲

---

#### **Endnotes**

- (1) This Memorandum is one of three separate papers being submitted by CFA concerning, respectively, (i) financing secured by inventory, (ii) financing secured by intellectual property and (iii) financing secured by investment securities.
- (2) The term "inventory" is used in this Memorandum to refer to goods that are held by an entity for sale or lease in the ordinary course of such entity's business. In several countries, particularly in Europe, inventory is also known as "stock."
- (3) In this Memorandum, the term "borrower" is used to refer to the party granting a security interest in inventory, regardless of whether such party is the actual borrower under the inventory financing arrangement or a guarantor or other party granting a security interest to secure a loan or extension of credit to the actual borrower.
- (4) In various jurisdictions, personal and real property are often referred to, respectively, as movable and immovable property.
- (5) The term "security interest" is used generally in this Memorandum to refer to a consensual security interest or charge granted by a borrower to a lender to secure a loan or

other extension of credit. In some countries, the term is used interchangeably with the term "lien," while in other jurisdictions the two terms have different meanings.

- (6) Additionally, certain important issues pertaining to the ability to realize on inventory that is subject to intellectual property licenses are discussed in the separate paper pertaining to intellectual property financing that CFA has submitted to UNCITRAL concurrently with this Memorandum.
- (7) The need for nonpossessory security interests to promote commercial finance has been recognized by both the European Bank for Reconstruction and Development in its 1994 Model Law on Secured Transactions (the "EBRD Model Law") and the Organization of American States' draft Model Inter-American Law on Secured Transactions (1998) (the "OAS Model Law"). Article 6 of the EBRD Model Law establishes a registered charge on movable property, without the need for possession, as one of its three principal charges. Likewise, Article 5 of the OAS Model Law allows for a nonpossessory security interest in movables (known as a "SIM").
- (8) Such an approach is similar to the approach taken in the current draft of the UNCITRAL Convention on Assignment of Receivables in International Trade, which provides that, unless otherwise agreed, a security interest in receivables extends to future receivables. See article 9, paragraph 2 of such draft.
- (9) Article 7 of the EBRD Model Law permits the instrument creating the security interest to include a specific or general identification of the charged property. Article 22 of the OAS Model Law provides for the same flexibility.
- (10) See discussion in Section B.1 below.
- (11) This approach is consistent with the approach taken in Articles 36, 77 and 78 of the OAS Model Law, and is similar to the approach taken in the EBRD Model Law.
- (12) A registration system is also a cornerstone of the current draft of the proposed UNIDROIT Convention on International Interests in Mobile Equipment. In addition, both the OAS and EBRD Model Laws either provide for, or recognize, public registration of security interests.
- (13) See discussion in Section II above.
- (14) The ability to efficiently enforce one's security interest in collateral through a nonjudicial procedure is fundamental to most current and proposed multilateral secured transactions projects. For example, see Article 8 of the current draft of the proposed UNIDROIT Convention on International Interests in Mobile Equipment and Articles 22, 23 and 24 of the EBRD Model Law. Under the EBRD Model Law, certain measures used to protect the chargeholder's property or provide for its disposition are available once the chargeholder delivers an enforcement notice pursuant to Article 22.2. This includes the right to take possession (Article 23.1) and, after 60 days have elapsed, take title to and sell the property (Article 24). Once a registry enforcement form is delivered and registered in accordance with Articles 110 and 111 of the OAS Model Law, the secured creditor can take possession of the property and arrange for its sale or lease (Articles 120 and 121).