

## Summary of Presentation by Boris Kozolchyk to the BID on Oct. 20, 2003.

### **I. The Lack of Credit for Commercial and Construction Activities in Central America.**

Commercial and construction credit are, by and large, unavailable to small and medium-sized merchants in Central America and when available, the rates of interest far exceed cost of living and inflationary indices. As proven by studies done in Central America by the speaker and others since the 1960's (and continuing to the present), the most significant factor in the high cost and unavailability of credit is the legal uncertainty that permeates it. Equally affected are the creation, perfection and realization of security interests in moveable property and immoveable property.

### **II. Uncertainties in the Creation, Perfection and Realization of the Security Interest.**

#### **A. Uncertainties in the Creation of the Security Interest.**

The difficulties in describing the assets that are used as collateral in the security agreement stem in large part from the formality and high cost associated with "public" and "private" deeds (*escrituras publicas y privadas*). Inspired by the description of real property by metes and bounds (*linderos, cabida, etc.*), moveable property collateral in Latin America continues to be described as if it were land or a building described in a registry folder for that piece of property (*folio real*). This means that voluminous and rapidly changing collateral such as inventory or accounts receivable simply can not be properly identified in the security agreement. It also means that the principle that the "accessory follows the principal" (accessory being moveable property and principal being real property) subordinates moveables and fixtures to an existing security interest in the real property. In addition, there are presently no mechanisms in Latin American law to extend the security interests or liens in original moveable property to their proceeds, which in the case of inventory could be other inventory, accounts receivable, equipment, bank deposits, royalties, dividends, contractual and intellectual property rights, among others. The concept of "products" (*productos*) used in some laws on industrial or agrarian pledges (*prendas industriales o agrarias*) is wholly inadequate to describe and affect proceeds. The term "products" usually restricts the extension of the lien only to the same type of collateral, i.e., "fruits" only extends to future "frutos" or equipment only extends to future "equipo" and so on, but not to accounts, inventory, etc.

#### **B. Uncertainties in the Publicity or Notice Given to the Created Security Interest.**

Presently, once a security agreement is created in Latin America it is the agreement itself, prolix though it may be, that is recorded in the commercial registry. Each time that new money is given or changes take place in the collateral described in the security agreement, a

new or a formal amendment thereto must be recorded. Thus, the commercial registries of Latin America are not capable of providing the required notice or publicity to third parties such as actual or potential creditors and purchasers of the goods used as collateral in the secured loans. Most of these registries were designed for the inscription and periodic updating (mostly yearly or semi-annually) of business association corporate or societal records. Approximately once a year, amendment to the by-laws of a corporation or the decree of a judicial lien against a company or partnership would be recorded. In the interim, if someone wanted to find out if, say, the inventory or the accounts receivable or the sales proceeds of the borrower had been pledged and if so to whom and for approximately how much, the existing registry could not supply such information. This information, incidentally, often changes daily or weekly. A much more agile, accurate and accessible registry is required to provide this type of information.

First, it must be a debtor's registry and not a registry that records information about collateral, unless the collateral is highly valuable and can be identified by serial number, as is the case with airplanes, ships or other highly valuable mobile equipment. Second, it must be an electronic registry that allows easy access by creditors, present and future, as well as by potential buyers of the collateral, anywhere in the trading and credit world. Third, it must be a registry that is part of a network of similar registries in the region, hemisphere and eventually the trading world. Fourth, it must be an inexpensive registry. Unlike the typical real estate registry, it cannot charge a tariff per transaction that in effect doubles as a direct or indirect tax on the transfer of wealth. The purpose of registration should be to provide the easiest and widest possible access to information relevant to the debtor and his commercial assets. For this reason, Canadian and United States registries, for example, charge as an average no more than \$25 per recording, regardless of the transactional amount. This encourages widespread recording and consultation. A high registration fee encourages resort to non-registry methods of perfection of the security interest, usually in the form of "simulations" of creditor ownership rights. In the final analysis, the secret lien (*gravamen occulto*) is the worst enemy not only of the proposed system but also of commercial credit.

### **C. Uncertainties in the Foreclosure of Security Interests.**

Presently, the foreclosure of a security interest in moveable property in Latin America takes, on average, from 18 months to 3 years. When one takes into account the perishable and highly depreciable nature of moveable property collateral, one must conclude that the existing judicially-based foreclosure systems are simply inoperative. To bring back certainty to the collection process, present law must allow for extrajudicial creditor repossession and foreclosure. This extrajudicial, self-help procedure should be subject to the constitutional protection of due process of law, but such protection should take place *a posteriori*, i.e., once the creditor is given an opportunity to salvage a significant part of the value of his collateral. Otherwise, as pointed out by a recent study by the Central Bank of Brazil, the risk-of-collection component in the rates of interest charged by Brazilian banks to their borrowers will continue to climb from one third to at least one half of the interest rate. At the time of that study, the interest rate was in excess of 40% per year, and the risk component was responsible for more than one third of that amount and was continually climbing.

### **III. The Proposed Reform.**

#### **A. Adoption of the OAS Model Law on Secured Transactions and its Electronic Commerce Appendix as the Applicable Substantive Law for Central America.**

The National Law Center for Inter American Free Trade (NLCIFT) in partnership with the Supreme Court of Costa Rica and its Judicial Training School propose to significantly reduce the above-described legal uncertainties in the Central American region by promoting the enactment of the OAS Model Law on Secured Transactions and its appendix on electronic documents and signatures (IAREDS) in Central America. This Model Law and IAREDS were unanimously recommended for adoption by the member states of the OAS at the end of the CIDIP-VI process in February 2002.

The adoption of this Model Law, drafted by the top secured lending law experts in Latin America, Canada and the United States, will ensure the creditors' ability to lend using as collateral any moveable property valued by the marketplace, including existing as well as future property and proceeds thereof. It will do this by eliminating the uncertainties of creating, publicizing and foreclosing on security interests in moveable and immovable property.

#### **B. Adoption of Statutes or Regulations to Modernize and Harmonize Existing Commercial and Land Registries.**

The modernization of the commercial registry entails a consolidation of the existing registries for business associations with a debtor-based registry and with registries for high cost moveable property identified by serial number including automobiles, tractors, airplanes, etc. In this consolidated commercial registry, the filing will consist of brief summaries of the transaction and its parties in an electronic layout capable of uniform use throughout the region and beyond. The registrar's examination of each filing is very limited and likely to be automated. The cost of filing will be low. Filing, searching and certification functions should be done, whenever possible, electronically from remote locations as well *in situ*, as is presently the case in Canada and the United States.

Modernization of the commercial registry also requires the modernization of the land registry, at least in certain areas of common interest. One of these involves fixtures (inmuebles por incorporacion o destino). Nowadays, these goods are often as valuable if not more so than the immovable to which they are attached or incorporated. Their suppliers and those who finance relying on them as collateral need the assurance of priority of their rights. The interaction between modernized commercial and land registries should provide such an assurance. Another area of modernization of the land registry pertains to the "securitization" ("bursatilizacion", "titularizacion") of packages or pools of real estate mortgages for their sale and pledge in secondary markets. Those who buy and sell these packages or their bonds or certificates of participation need to know that their paper in the form of "mortgage bonds" or "certificates" is backed up by up-to-the-minute recordings in

the land registry, and that the land registry also includes information on liens or *in rem* claims (for example, tax or agrarian claims) wherever filed. Conversely, the sale or pledge of rights in the “titulos” (mortgage bonds or certificates themselves) should be recorded in both registries, as these titulos are considered in some Latin American jurisdictions moveable and in others immovable property.

## **C. Implementation.**

### **1. Preliminary Training.**

The implementation of the above suggestions requires training of a cadre of legislators, judges, administrators, secured lenders (mostly bankers) and lawyers in the text of the OAS Model Law and the nature of the modernized registries. This step should be undertaken as soon as possible.

### **2. Monitoring the Effectiveness of the Implementation.**

At a worldwide meeting of notaries public that took place in Veracruz, Mexico three years ago, I was informed by then-President of the Hungarian notarial association that the volume of secured lending had jumped by 100% in one year since the enactment of a rudimentary version in Hungary of what eventually became the OAS Model law. Clearly, there should be some monitoring of the volume of credit as well as of the reasonableness of interest rates in Central America and other countries that adopt the OAS Model law. At the same time, criteria should be developed to measure the increased accuracy, speed and accessibility of the modernized registries in the Central American region. Finally, the volume and types of disputes generated by the new system of substantive, procedural and registry law should also be monitored.