# Secured Lending and Its Poverty Reduction Effect

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## I. THE ECONOMIC EFFECTS OF COMMERCIAL SECURED LENDING

Commercial loans (also known as secured loans or as secured transactions) are loans particularly suited to satisfy the credit needs of small- and medium-sized enterprises. While their key features will be described in detail in the following sections, their economic significance must be appreciated from the outset. Because secured lending reduces commercial risks, it increases the borrowers' access to credit and lowers the rates of interest. The role that the risk of non-payment plays as a component of the rates of interest is apparent in a 1999-2000 study by the Central Bank of Brazil:[1] One-third of the approximately forty percent per annum interest rate paid at that time by Brazilian commercial borrowers was attributable to the legal uncertainties of collection.[2]

On the other hand, World Bank studies demonstrate that in a competitive lending environment, the risk reduction that results from adopting an effective secured lending system can be passed on as savings to the borrower in the form of lower interest rates. For example, in Albania, adoption of a modern secured lending system in 2001 reduced risk premiums by half and lowered interest rates by five percentage points, while in Romania, the rate of interest dropped by twenty percent since the new system was introduced in 2000.[3] Similarly, Mexico's 2003 amendments to its secured transactions law, which reduced some of the risks of collection, helped its economy grow "at a 4% rate during 2004 and . . . all credit sectors are growing at an annual rate exceeding 20%."[4] Speaking to a bankers' meeting in 2005, Alfonso García Tames, then Mexico's Deputy Secretary of the Treasury, noted that:

> Commercial credit showed a favorable rate of growth during the last three trimesters of 2004. In fact, between 2003 and 2004, the increase in

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1. Departamento De Estudios E Pesquisa, Banco Central Do Brasil, *Juros e Spread Bancário no Brasil* (1999-2000) [hereinafter Central Bank of Brazil Study].

2. *Id.*

3. *See generally* Mehnaz Safavian, Heywood Fleisig & Jevgenijs Steinbuks, *Unlocking Dead Capital: How Reforming Collateral Laws Improves Access to Finance*, 307 WORLD BANK PUB. POL'Y J., Mar. 2006, *available at* http://rru.worldbank.org/documents/publicpolicyjournal/307Safavian_Fleisig_Steinbuks.pdf; *see also* Wade Channell, Presentation at the Annual Conference of the Economic Freedom of the World Network, Nov. 2-5, 2006, Costa Rica, *Freedom to Pledge: Expanding the Realm of Property Rights for Increased Access to Credit* (Nov. 3, 2006), *available at* http://www.inlap.org/efn/Papers/Wade%20Channell--paper.htm.

4. *Bancos prevén expansión sostenida del crédito en México*, REUTERS, Mar. 3, 2005. The article states:

> ACAPULCO, México (Reuters) - El crédito bancario volvería a crecer cerca de 25 por ciento en el 2005 en México, por encima de las expectativas iniciales de la banca y apoyado en la expansión de la economía local, estimó el jueves Manuel Medina Mora, presidente de la Asociación de Bancos de México (ABM). La economía mexicana creció 4.4 por ciento en el 2004 .... "Se sigue acelerando el crecimiento del crédito y creemos que dada la expansión económica de nuestro país, podemos esperar crecimientos importantes," dijo Medina Mora en rueda de prensa, durante la 68 Convención Bancaria en el balneario de Acapulco, que organiza la ABM. "Por primera vez en una década crecen todos los circuitos de crédito y todos por encima del 20 por ciento .... Cada mes, el crecimiento porcentual es mayor," añadió.

*Id.*

> this portfolio was 16.8% in real terms. In turn, the credit to consumers also showed great dynamism, with annual rates of growth of 38.6% in the last four years. In the last trimester of 2004, the percentage of real growth was 41 percent in relation to the growth during the same trimester in the preceding year.[5]

These findings were consistent with the studies by another World Bank economist who estimated that the absence of commercial credit amounts to a loss of three to nine percent of a Latin American country's GDP.[6]

The effects of a sound secured lending law are felt also in other economic sectors beyond those traditionally associated with small- and medium-sized commerce, such as in the securitization of the revenues derived from construction—and especially housing projects. This type of financing is made possible by the sale in secondary markets of low- and middle-income housing mortgages and deeds of trust. Hence, it contributes hundreds of billions of dollars of construction financing annually to the economies of the United States and other developed nations, especially in Europe. Directly or indirectly, securitization relies on the personal property security afforded by the possession of documents that incorporate creditors' (security holders') rights in the underlying properties.

## II. POVERTY, MICRO, CONSUMER AND COMMERCIAL CREDIT

From an economic development standpoint, poverty has been defined as a "lack of access to essential goods, services, assets and opportunities to which every human being is entitled."[7] Having lived among many who have experienced it firsthand, I would add despair and distrust for social institutions as predominant feelings among the poor. Unfortunately, those who experience such feelings have little impetus for self-improvement. What is even more unfortunate is that despair

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5. Alonso Garcia Tames, Mexico Deputy Secretary of the Treasury, Versión Estenográfica de la Mensaje del Act. Alonso García Tamés, Subsecretario de Hacienda y Crédito Público, Durante la Ceremonia de Clausura de la 68 Convención Bancaria, Efectuada en el Salón de Sesiones del Hotel Acapulco Princess (Mar. 4, 2005) (transcript available at http://www.natlaw.com/interam/mx/bk/sp/spmxbk12.pdf). The article states:

> El crédito comercial vigente mostró un crecimiento favorable durante los últimos tres trimestres de 2004. De hecho, entre 2003 y 2004 el incremento de esta cartera fue de 16.8 por ciento en términos reales. Por su parte, el crédito al consumo ha presentado un gran dinamismo, con crecimientos anuales en promedio del 38.6 por ciento en los últimos cuatro años. En el tercer trimestre de 2004, el crecimiento de esta cartera fue de 41 por ciento en términos reales con relación al mismo trimestre del año anterior. Por otra parte, el crédito hipotecario presentó al cierre de 2004 un crecimiento anual real de 4.8 y 24.5 por ciento sin considerar la cartera asociada a programas de reestructura.

*Id. at 4.*

6. *See* Heywood W. Fleisig, *Assessing the Economic Cost of Deficiencies in the Framework for Secured Transactions: Examinations of Argentina and Bolivia* (Center for Economic Analysis of Law, Working Paper, 1996) [hereinafter Fleisig, *Assessing the Economic Cost of Deficiencies*], *available at* http://www.ceal.org/ceal-org/working.asp; Heywood Fleisig, *Secured Transactions: The Power of Collateral*, FIN. & DEV., June 1996, at 44, *available at* http://www.imf.org/external/pubs/ft/fandd/1996/06/pdf/fleisig.pdf.

7. Asian Development Bank, *Enhancing the Fight Against Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank* 1 (2004), *available at* http://www.adb.org/Documents/Policies/Poverty_Reduction/2004/prs-2004.pdf.

and distrust need not prevail. Even if poverty may never be completely eradicated, it can be significantly alleviated by legal institutions that make it possible for micro-, small-, and medium-sized businesses to obtain commercial and consumer credit at reasonable rates of interest.

A cursory review of recent literature of economic development reveals hopeful signs. For example, a December 2004 study by the Asian Development Bank (ADB) identified rapid, broad-based economic growth as the single most important factor in attaining poverty reduction.[8] It showed that business growth, in particular, increases the demand for labour and the level of wages—further reducing poverty. Similarly, properly financed opportunities for self-employment have been proven to make an important contribution to poverty reduction.[9]

The above study is one among many serious economic and social science analyses conducted by various research institutions in the last two decades. They have confirmed that access to commercial and consumer credit is one of the essential elements of business and economic growth. Thus, it is becoming increasingly clear to economists and social scientists that the availability of commercial credit to small- and medium-sized merchants and their customers not only boosts overall economic growth (as reflected in significant gains in GDP), but it also reduces poverty.[10] Accordingly, a 2004 World Bank study, using a broad cross-country sample, concluded that: "Financial intermediary development reduces income inequality by disproportionately boosting the income of the poor and therefore reduces poverty."[11]

### *A. Micro-Credit and Its Non-Title Collateral*

Some of this intermediation is attributable to "micro-credit," a credit that enables individuals in the lowest income sectors of the economy to run very small businesses—micro-enterprises—that, in turn, increase household income and assets. Thus, micro-enterprise programs become effective fighters of poverty, and one of these programs has recently been rewarded with a Nobel Prize for its success in stemming despair and starvation in Bangladesh.[12] In a nutshell, these programs

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8. *Id.* at 6.

9. *See id.*

10. Fleisig, *Assessing the Economic Cost of Deficiencies*, *supra* note 6 (estimating the GDP improvement up to nine percent).

11. *See* Thorsten Beck, Asli Demirgüç-Kunt & Ross Levine, *Finance, Inequality and Poverty: Cross-Country Evidence* (World Bank Policy Research Working Paper No. 3338, June 2004), *available at* http://www.econ.worldbank.org (follow "Research Website" hyperlink; follow "Working Papers" hyperlink; and then search by paper no.). According to these authors, "a broad sample of 52 developing and developed countries, with data averaged over the period 1960 to 1999" establishes a direct relationship between "financial intermediary development and changes in income distribution." *Id.* at 3. They add that:

> This relationship is crucial in understanding the linkage between financial development and poverty alleviation since poverty reduction in any given country is determined by the growth of mean income and changes in income distribution. Given that there is already significant evidence that financial development is pro-growth, we seek to determine whether financial development is also pro-poor. By pro-poor, we mean does financial development significantly improve income distribution by disproportionately boosting the incomes of the poor?

*Id.*

12. *See* U.S. Agency for International Development (USAID), Accelerated Microenterprise

make "'cashew shellers in Senegal, avocado growers in Kenya, makers of hand-made paper in Bangladesh, and street vendors in Mexico less vulnerable to devastating crises.'"[13]

Micro-credit does not rely on the borrower's title to his or (more frequently) her assets as collateral or as a source of repayment to the lender. It relies on the borrower's appreciation of the importance of the loan and corresponding willingness to repay it. Appreciation and willingness are such that many borrowers are often willing to cover for each other's liabilities.[14] Yet, micro-entrepreneurs operating in the large informal economy—including many businesses owned by women—lack adequate financing to grow once their enterprise can start employing more than a handful employees. As a result, micro-enterprises "have less of an impact on economic growth than they might otherwise have."[15]

Significantly, where commercial credit is available to small- and medium-sized enterprises, micro-enterprises can also become its beneficiaries and poverty is thereby further alleviated. As shown by the above-referenced World Bank Study, "the income of the poorest quintile grows faster than average GDP per capita in countries with better-developed financial intermediaries" (i.e., commercial or "mainstream" lenders).[16] What is more, "income inequality . . . falls more rapidly in countries with higher levels of financial intermediary" lending.[17] Not surprisingly, then, countries with developed financial intermediaries experience larger reductions in infant mortality and lesser reliance on child labor.[18] Hence, as concluded by another World Bank economist, microfinance and finance of small- and medium-sized businesses are complementary, rather than competing, alternatives, especially when addressing the problem of poverty.[19]

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Advancement Project (AMAP), Poverty Assessment Tools, http://www.povertytools.org (last visited Apr. 18, 2007); *see also* Grameen Website, www.grameen-info.org (last visited Apr. 18, 2007) (on the work of the 2006 Bangladeshi Nobel Prize-winning economics professor and banker Mohammed Yunnus who won the Nobel Peace Prize and whose methods have been used in fifty-eight countries).

13. IRIS Center, *IRIS Helps Ensure that Microenterprise Funds Reach the Very Poor* (2005) (quoting Dr. Thierry van Bastelaer, Director, IRIS Center's Enterprise Development Group), *available at* http://www.iris.umd.edu/Reader.aspx?TYPE=HTML_ARTICLE&ID=b7fd059e-9651-4696-accb-070fa88969f8.

14. *See* Rania El Gamal, *Microfinance: Fighting World's Poverty Through Investment*, KUWAIT TIMES, June 12, 2006, *available at* http://www.businessdayonline.com/?c=44&a=7017.

15. *Removing Obstacles for African Entrepreneurs Before the Subcommittee on Africa, Global Human Rights and International Operations of the Committee on International Relations*, 109th Cong. 3 (2006) (prepared statement of Christopher H. Smith, Chairman, House Subcommittee on Africa, Global Human Rights and International Operations), *available at* http://www.internationalrelations.house.gov/archives/109/27989.pdf.

16. Beck, Demirgüç-Kunt & Levine, *supra* note 11, at 4.

17. *Id.*

18. *Id.* at 12 (concerning infant mortality); *id.* at 4 (concerning child labor, which refers to the World Bank's recent work that analyzes the link between financial development and child labor).

> In a cross-country sample, Dehejia and Gatti (2002) find that the incidence of child labor is lower in countries with greater financial depth and that financial deepening dampens the impact of income volatility on child labor. Similarly, using a panel dataset of Tanzanian households, Beegle, Dehejia and Gatti (2003) find that child labor is used to buffer transitory income shocks less when households have access to credit.

*Id.* at 5.

19. Patrick Honohan, *Financial Sector Policy and the Poor: Selected Findings and Issues* 30-33, 43-44

### B. *Commercial Lending and the Self-Liquidating Loan*

Unlike micro-credit, commercial lending enables the "mobilization" of the debtor's assets as collateral and thereby facilitates repayment. This method of lending—institutionalized in eighteenth century England[20] and fully developed in the twentieth century United States—stands in sharp contrast to the lending methods that prevail in most developing nations.[21] In these nations, the debtors' assets are pledged and immobilized either by the creditors' possession or by their "safe" storage with third parties. Once immobilized, the release of these assets for resale, re-pledge, or transformation is only possible upon full repayment of the debt. In contrast, the Anglo-American commercial lending practice relies upon the mobilization of the assets by allowing the debtor to remain in possession of these assets and authorizing their use, transformation, exchange, or sale, thereby enabling the "self-liquidation" of the loan. As stated by the NLCIFT's First Principle of Secured Transactions Law in the Americas, and as implicit in the OAS Model Law and the Latin American statutes and legislative drafts inspired by these principles:

> Secured commercial and consumer credit is an effective tool for economic development because it allows the debtor's use, transformation, sale or barter of collateral (mobilization). The mobilization of these assets leading to their sale or disposition makes possible the payment or self-liquidation of the loan . . . .[22]

#### 1. Key Features of Commercial Collateral and the Immateriality of Its Title

Because of the self-liquidating nature of the commercial loan, its collateral has peculiar features. Firstly—and in contrast with the collateral in a home mortgage,

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(World Bank, Working Paper No. 43, 2004), *available at* http://www1.worldbank.org/finance/assets/images/0821359673_Financial_Sector_Policy_and_the_Poor.pdf#search=%22%22Financial%20Sector%20Policy%20and%20the%20Poor%22%22.

20. The view of commercial loans (extended to "able" men) as self-liquidating, and of retail trade and consumption loans as dependent upon the honesty of "good" men, which became part of the Bank of England's credit policies, was articulated in the following excerpt:

> There are Two sorts of Credit; the one, is Grounded upon the Ability of the Buyer; the other, upon the Honesty: The first is called a Good Man, which implys an Able Man; he generally buys upon short Time; to pay in a Month, which is accounted as ready Mony, and the Price is made accordingly. The other is accounted an Honest Man; He may be poor; he Generally buys for three and Six Months or longer, so as to pay the Merchant by the Return of his own Goods; and therefore, the Seller relys more upon the Honesty of the Buyer, than his Ability: Most of the Retail Traders buy upon this Sort of Credit, and are usually Trusted for more than double they are worth.

NICHOLAS BARBON, A DISCOURSE OF TRADE 19 (Jacob H. Hollander ed., Lord Baltimore Press 1905) (1690).

21. *See generally* Boris Kozolchyk & Dale B. Furnish, *The OAS Model Law on Secured Transactions: A Comparative Analysis*, 12 SW. J. L. & TRADE AM. 235 (2006). For an analysis of the status of law and lending practice in Latin America, and for surveys of the law and practice in other regions, see Safavian, Fleisig & Steinbuks, *supra* note 3. *See also* Channell, *supra* note 3.

22. *See* National Law Center for Inter-American Free Trade, *12 Principles of Secured Transactions Law in the Americas*, princs. 1 (2006) [hereinafter NLCIFT *Principles*], *available at* http://www.natlaw.com/bci9.pdf.

which is immobile, long-lasting, and retains or increases its value during the life of the loan—the collateral of a commercial loan is mobile, perishable, and usually depreciates quickly in value. Consequently, and secondly, any moveable (tangible or intangible) object with sufficient market value to facilitate quick repayment of a commercial loan by its transformation, exchange, or resale can be collateral. Contrast this open number (*numerus apertus)* feature of commercial lending with the prevailing restrictive or closed number (*numerus clausus*) approach to collateral that prevails in developing countries.[23] Thus, as pointed out by Safavian and Fleisig, Nigeria (among many other developing nations) recognizes only ten percent of the types of assets used in the United States as acceptable security for a loan.[24]

Thirdly, this open-numbered collateral can secure the loan of not one but many possible creditors simultaneously and successively. Consider, for example, the case of a retail merchant who seeks credit to purchase inventory goods such as shirts. These shirts, and the proceeds from their resale to the public, could be the collateral or part of the collateral that will secure the credit extended to him by a wholesaler or manufacturer, or by his bank. The proceeds of the sale of the shirts could also be collateral. These proceeds could be either moneys deposited in the retail merchant's cash register after each sale, or they could be purchase orders, invoices, checks, promissory notes, or credit card receipts deposited in his creditors' bank accounts, all as a result of daily, weekly, or monthly sales. Alternatively, they could be other inventory or other goods acquired as replacements for the originally-financed shirts.

This revolving (including future-acquired) inventory and proceeds can serve as collateral for many creditors, with rights in them that can exist at the same time or be subsequently acquired. This "sharing" of present and future collateral by present and future creditors is possible because, from a legal standpoint, the ownership of the collection of goods that comprise the inventory and of their proceeds is fragmented into diverse possessory rights of specified scope or inclusiveness and duration. The enforcement of these rights requires that information be provided on the perfection of the possessory rights and their priorities to creditors or purchasers who may have an interest in relying on the same assets as collateral or in purchasing them. For this information to serve as effective and functional notice it must be a summary of the lien that is reliable, timely, and as public or widely accessible and as transparent as possible. Commercial and secured lending has no worse enemy than hidden or secret liens—i.e., rights that are either unrecorded or whose possession for security purposes is not apparent to a potential creditor or purchaser. Finally, enforcement of these possessory rights requires a quick, inexpensive, and extrajudicial procedure of repossession and resale.

Let us now observe the interaction between the fragmentation of ownership of the collateral and the possessory and malleable nature of the creditors' rights in a typical U.S. financing scheme. Assume that the goods that will be manufactured will be the above-mentioned shirts. For ease of explanation (and contrary to what has become the U.S. commercial practice of outsourcing of most manual labor), let us

23. In the Central American region, see, for example, the Código Civil and the Código de Comercio. *See, e.g.*, CÓD. CIV. [Civil Code] art. 441 (Costa Rica) (the "traditional" or possessory pledge (*prenda con tenencia*)); CÓD. COM. [Commercial Code] art. 442 (Costa Rica) (the "pledge of a credit" (prenda de un crédito)); *id.* arts. 530, 533 (the "commercial pledge" (*prenda comercial*)); *id.* art. 537 ("pledge with dispossession" (*prenda sin tenencia*)); CÓD.CIV. arts. 880-903 (Guatemala) (the pledge (*prenda*)).

24. Safavian, Fleisig & Steinbuks, *supra* note 3.

assume that the shirts are manufactured in the United States. The manufacturer will need credit with which to purchase his raw materials and equipment. Accordingly, he will seek a loan from a bank and will grant this bank as a secured creditor a security interest. The security interest will typically include not only the raw materials and equipment but also the present and future inventory of shirts and their proceeds. Similarly, the wholesaler and retailers who will purchase the manufactured shirts from the manufacturer will need credit for their respective acquisitions.

In each acquisition, present and future inventories as well as their proceeds will serve as collateral. Yet, during the time the manufacturer's shirts are being shipped by the manufacturer to the wholesalers or retailers, the bank that issued a letter of credit to pay for the shipped shirts on behalf of the wholesaler or retailer will also acquire a possessory right in these shirts. This security interest will be perfected by the manufacturer-shipper's endorsement of a negotiable bill of lading, which attests to shipment of the goods, to the bank that issued or confirmed the letter of credit. This negotiable bill of lading will be issued to the shipper by the ocean carrier in charge of transporting the shirts to the wholesale or retailer. In endorsing the negotiable bill of lading, the manufacturer-shipper is not only creating the bank's security interest, but is also providing notice of the existence of the security interest to the world at large. The reason for this notice is that by transmitting possession of a document that provides an exclusive right to claim the shirts from the carrier to the person holding the bill of lading, no one else can make such a claim. Hence, the bank's possession of this bill of lading will entitle it to claim the delivery of the shirts from the carrier with a higher priority than that enjoyed by most other claimants of the shirts.

Among the claimants whose possessory rights or security interests are inferior to those of the bank that issued the letter of credit are: a) the sellers of the raw materials or equipment to the manufacturer of the shirts who are still owed part or all of their purchase prices, or the financiers for the manufacturer's acquisition of the raw materials or equipment who are still owed all or a portion of their loans; b) the manufacturer who is still owed the purchase price of the shirts by the wholesale buyer of the shirts; c) the wholesaler who is owed the purchase price of the shirts sold to the retailer or the wholesaler's bank, who has not been paid the amount lent to the wholesaler or retail merchant for their respective purchases of shirts; and d) the retail merchant who has paid part of the purchase price of the shirts to the manufacturer or wholesaler. These creditors or purchasers could not seek possession of the shirts or of the proceeds of their sale until the bank in possession of the bill of lading has been paid what it is owed for its issuance of the letter of credit.

On the other hand, there are two claimants whose possessory right to the shirts is superior to that of the bank. One of these claimants is the ocean carrier who has not been paid his freight charges and who is still in possession of the transported shirts. The other claimant is the consumer-buyer of the shirts who bought them from the retail or wholesale merchant in the ordinary course of their respective businesses. Where such a buyer exists, none of the pre-existing unpaid secured lenders or commercial purchasers can repossess or recover the shirts from him. The creditors' secured claims could only be made effective against the proceeds obtained by the retailers, wholesalers, or manufacturers from the sales of the shirts to the consumers.

The above rights to the possession of the collateral are more malleable (if not ephemeral) than those of a typical home-mortgagee. Moreover, the only party

whose right to the possession of the shirt approximates the right of ownership of a home-mortgagor is that of the consumer-buyer in the ordinary course of business. Yet, unlike the home owner, the possessory right of the consumer is not the product of a "historical" or linear chain of transactions or being the holder of a Hernando de Soto's talismanic ownership document.[25] The consumer-purchaser's possessory right is a product of the lawmakers' decision to protect a third party who is a stranger to the preceding chain of transactions. Without such a protection (which means providing the stranger with immunity against pre-existing possessory rights), the viability of a marketplace whose participants are predominantly strangers would be undermined as they would fear buying, borrowing, exchanging, or otherwise participating in the marketplace.[26]

What matters in the law of commercial lending, then, is not who is the "historical" owner of the shirts or who is the creditor with the best chain of title to the shirts, but who has the best right to their possession or to their market value at a given point during the transactional and useful life of the shirts or of their proceeds. Accordingly, the "being" of rights in a collateral such as the original inventory shirts, which can become cash or commercial paper and reappear as tangible goods (such as new shirts or other inventory) or be transformed into intangible goods (such as accounts or wire transfers), resembles that of the river described by the Greek philosopher Heraclites as: "You cannot step twice into the same river, for other waters and yet others go ever flowing on."[27] Accordingly, when a merchant pledges his inventory, title to this collateral is, in the words of the Uniform Commercial Code, "immaterial."[28] In the final analysis, then, the meaning of collateral in commercial lending is not a "thing" or group of things but the right to the possession of what becomes a stream of income generated by the use, transformation, sale, or exchange of commercial assets. And by assets we mean any object, tangible or intangible, deemed valuable in the marketplace by those who participate in it.

The economic and legal policies that determine who has the best right to the possession of that stream of income are, in the final analysis, those that make the river of commerce flow best by encouraging contributions to its stream. These contributions could be by sellers of raw materials, financiers of equipment, providers of services, or providers of financing with which to acquire any or all of the above

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25. *See* Boris Kozolchyk, *A Roadmap to Economic Development Through Law: Third Parties and Comparative Legal Culture*, 23 ARIZ. J. INT'L & COMP. L. 1 (2006) [hereinafter Kozolchyk, *A Roadmap*].

26. *See* Boris Kozolchyk, *The Transfer of Personal Property by a Nonowner: Its Future in Light of its Past*, 61 TUL. L. REV. 1453, 1455 (1987).

> The need to protect the bona fide purchaser who acquired from an entrusted intermediary is justified by market economics. Unless buyers are assured that they will not be deprived by an unknown owner or creditor of what they honestly acquired in the open market, they will be afraid to buy. On the other hand, unless the entrusting owners' expectations of recovering the value of entrusted property are protected, they will hesitate to entrust their property. These economic realities explain the apparent coexistence of the ancient Roman law maxim *'Nemo dat quod non habet'* with the mercantilistic *Bourjon* principle of [possession is considered equivalent to a title, as found first among civil codes in] article 2279 of the French Civil Code of 1800.

*Id.* at 1455, 1455 n.4.

27. *See* GREEK PHILOSOPHY AND HERACLITUS (William Harris trans., 2005) (360 BC), *available at* http://community.middlebury.edu/~harris/Philosophy/Heraclitus.html.

28. *See* U.C.C. § 9-202 (2000).

items of value. The value of their contribution can be determined or ascribed by the lawmaker or by the parties to the loan on a quantitative or a qualitative basis, or as a combination thereof. It is now time to discuss the legal components of an effective system of secured lending.

### C. *Commercial Lending and Debtor and Creditor Protection*

Fairness in the treatment of debtors and creditors is one of the most important components of an effective law of secured transactions. Poor debtors lack the bargaining power of most of their creditors and, hence, become vulnerable to exploitive and abusive lending practices. A lack of protection against these practices often leads to the debtors' insolvency and to their inability to function as productive members of society. Where ordinary or bona fide debtors are treated as criminals, the result is not only inhumane but also counterproductive—the availability of credit does not improve, and the cost of credit continues to climb.[29] For these reasons, debtor protection—particularly of those who are most vulnerable—contributes to the availability of credit for micro-, small-, and medium-sized businesses.

On the other hand, since credit is only extended when lenders are willing to lend, adequate creditor protection is key to the availability of finance for small- and medium-sized businesses as well as for micro finance. In the words of Chilean Central Bank economic researchers who studied the effect of inadequate monitoring of bank loans on poorer debtors: "[I]nefficient [creditor] legal protections, disproportionately increase financial restrictions for creditors that have less wealth."[30] The main reason for this restriction is the fixed cost of monitoring debtor performance by the lending banks. Because these costs are fixed and larger loans are more profitable, lending banks do not monitor the performance of smaller borrowers as carefully as they do that of their larger borrowers. Inadequate monitoring of small borrowers makes it easier for these borrowers to adopt riskier business and repayment practices. These practices, in turn, lead to a higher probability of insolvency.

Likewise, inefficiencies in bankruptcy procedures have a greater effect on small businesses than on large ones. Using a survey of practices in sixty-two countries, the same Chilean researchers explored the impact of creditor protection on the availability of bank credit to small- and medium-sized enterprises. They found that better protection of all creditors reduced the financing gap between

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29. *See* Ley de Jurisdicción Constitucional No. 7135, La Gaceta No. 198, art. 113 (1989) (amended in La Gaceta No. 212 on Nov. 9, 1989), *available at* http://www.asamblea.go.cr/ley/leyes/7000/7135.doc (stating the reasons in favor of the abolition of Costa Rica's Civil Code's *apremio corporal*).

30. Arturo Galindo & Alejandro Micco, *Bank Credit to Small and Medium Sized Enterprises: The Role of Creditor Protection* 1 (Banco Central de Chile, Working Paper No. 347, 2005), *available at* http://www.bcentral.cl/eng/stdpub/studies/workingpaper/htm/347.htm. Galindo and Micco add:

> The degree to which smaller firms are constrained depends on the quality of the regulatory framework, suggesting that in countries where creditor rights are protected (and enforced), smaller firms have greater access to bank credit to finance investment. In our sample this effect is large. In common law countries (where creditor protection is high), the difference in the share of investment financed with bank credit between large and small firms is approximately 9 percentage points. In non-common law countries this difference is 25 percentage points.

*Id.* at 15.

small and large firms.[31] In light of the above findings, we need to examine the role of legal and cultural factors in making commercial and consumer credit available at reasonable rates of interest in developing nations.

## III. CULTURAL AND LEGAL FACTORS

### *A. The Relative Importance of Legal Title*

The importance of culture in bringing about economic development has been questioned—if not discarded—in the influential writings of the Peruvian economist Hernando de Soto.[32] He points to the negative effect of legal uncertainty, especially with respect to land titles and other "property document[s]."[33] In his opinion, "the suggestion that it is culture that explains the success of such diverse places as Japan, Switzerland and California and culture again that explains the relative poverty of such equally diverse places as China, Estonia, and Baja California, is worse than inhumane; it is unconvincing."[34]

De Soto focuses instead on "representational systems," meaning the things or languages that embody legal certainty for the holder of rights, either to property or contractual rights, as contrasted with the culture that creates such things or languages. In de Soto's words:

> In the West, by contrast, every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. . . . The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house.[35]

The preceding examination of the meaning of collateral in micro and commercial lending showed that title was immaterial for both loans. In the case of micro lending the likelihood of repayment was caused mostly by the debtors' appreciation of what he received and his strong desire to continue to receive this credit. With commercial lending, the above-quoted statement and especially "every piece of equipment, or store of inventories is represented in a property document" is equally untrue.[36] Furthermore, what prompts the lender's willingness to loan is not the borrower's title to the collateral, but the self-liquidating nature of the collateral and his right to its possession as protected by a system of public notice—regardless of who is or was the historical owner of the collateral. Even with respect to lending secured by land or real estate in Latin America and elsewhere, the role of title is not

31. *Id.* at 2.

32. *See generally* HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (2000); Kozolchyk, *A Roadmap*, *supra* note 25 (discussing some of Hernando de Soto's writings).

33. DE SOTO, *supra* note 32, at 6.

34. *Id.* at 4.

35. *Id.*

36. DE SOTO, *supra* note 32, at 6.

as necessary and sufficient as may be inferred from de Soto's writings. As concluded by Erica Field and Maximo Torero in their Harvard University study:

> Detailed data collected on loans from different financial institutions also enables us to compare the impact of title acquisition among banks with alternative lending strategies. We find that land titling [in Peru's land titling program inspired by Hernando de Soto's studies] is associated with a 9-10 percentage point increase in loan approval rates from the public sector bank for housing construction materials, *while there appears to be no effect on the loan approval rate of private sector lenders . . . .*[37]

Similar studies were conducted in Argentina by Professors Sebastian Galiani and Ernesto Schardgrodsky.[38] These scholars found that while secure land rights encourage the poor to build their homes,

> even in a relatively advanced country such as Argentina, title is not enough in itself to animate the dead capital interred in land and property. . . . [T]he titled households enjoyed no better access to bank loans, credit cards or bank accounts, and only 4% of them managed to acquire a mortgage.[39]

Finally, an April 2006 study, The Effects on Property Titling in Langa Township South Africa, conducted by Karol Boudreaux of George Mason University, confirmed the findings of the studies conducted in Peru and Argentina, where commercial lending was concerned:

> Today, most homes—though not shacks—have titles. . . . Has this government policy led to economic growth and poverty alleviation for Langa's residents? The answer is a qualified yes. By creating secure property rights in houses, the South African government has created incentives for owners to improve their homes and to use them for home-based businesses, thus creating jobs and income in poor communities. However, more needs to be done. *Few Langa residents use their titles as collateral for commercial loans, still preferring to rely on personal savings and savings clubs. Titling is not enough.* Institutional weaknesses make the use of title as collateral too risky for many Langa residents . . . and regulatory burdens make it costly to grow and expand small businesses.[40]

Even if graphic representations of the rights of ownership to land carried with them talismanic effects causing credit and investment certainty to prevail, such effects were inseparable from the culture that attributed certainty to the

37. ERICA FIELD & MAXIMO TORERO, DO PROPERTY TITLES INCREASE CREDIT ACCESS AMONG THE URBAN POOR? EVIDENCE FROM A NATIONWIDE TITLING PROGRAM 1 (2003) (emphasis added), *available at* http://econ.ucsd.edu/seminars/seven_ssrc/Field_Torero914.pdf.

38. *The Mystery of Capital Deepens*, THE ECONOMIST, Aug. 26, 2006, at 62, *available at* http://defeatpoverty.com/articles/Economist%20Mystery%20Deepens.pdf.

39. *Id.*

40. KAROL BOUDREAUX, THE EFFECTS OF PROPERTY TITLING IN LANGA TOWNSHIP, SOUTH AFRICA (Mercatus Policy Series Policy Comment No. 4, 2006) (emphasis added) (stated in the executive summary).

representation in question. Consequently, cultural-legal factors must be taken into account. Considering that commercial credit takes place mostly among strangers, it is especially important to focus on the cultural values that shape the debtors' duties toward creditors who are neither the debtors' family nor friends.

### *B. Duties Toward Family, Friends, and Strangers*

The 1999 study of the Central Bank of Brazil estimated that one-third of the approximately forty percent per annum interest rate paid by Brazilian commercial borrowers was attributable to the difficulties and risks of loan collection and non-repayment.[41] This is neither an unusual finding nor a recent phenomenon, either in Brazil or in other Latin American countries. For example, my 1967 RAND Corporation study Law and the Credit Structure in Latin America showed that the percentages of discounted bills of exchange or drafts protested for lack of payment in Chile from 1958 to 1962 were, respectively, 31.5%, 26%, 34.4%, 37%, and 39.1%.[42] This meant that out of, say, one hundred negotiable and credit instruments in circulation in Chile in 1962, almost forty had not been paid at maturity. While during the same period, the protests of negotiable instruments by Argentine banks fluctuated between one-third and one-half of the Chilean figures, the percentages of the aggregate uncollected secured and unsecured loans and discounted negotiable instruments in Argentina (gathered under the rubric of "quasi money") were, respectively, 2.5%, 2.7%, 6%, 9.5%, and 22.9%.[43] In other words, of the total number of bank loans, direct or indirect extensions of credit, and negotiable instruments, as many as twenty-two percent during a peak year were in default.

Neither creditors nor debtors are well-served by a legal culture that makes collection so difficult and risky for creditors and so expensive for debtors. In fairness, however, the fault does not lie entirely with the legal culture. Underlying the legal culture, there is a business culture of "winner take all, loser take none" and a commerce practiced as a "tricky" or "picaresque" occupation.[44] Such an attitude toward business has much to do with the cost of credit. The tricky or picaresque aspects of dealing with checks, drafts, and promissory notes as credit instruments were reflected in responses given to this writer by Argentine bankers and merchants as part of the same study.

My first question was: "Why, if protests of negotiable instruments are so common and their collection so difficult, are you still willing to take checks, drafts, or notes in payment of what is owed to you?" In response, several of my businessmen-respondents referred to what they described as the "false-money psychology." This "psychology" encouraged taking these instruments in payment with the understanding that as with other "false" money, they would be passed on to someone else in payment of what the taker owed to them. The next, inevitable

41. *See* Central Bank of Brazil Study, *supra* note 1.

42. BORIS KOZOLCHYK, LAW AND THE CREDIT STRUCTURE IN LATIN AMERICA (RAND Memorandum 4918, 1966). For a somewhat shortened version of the RAND study, see Boris Kozolchyk, *Law and the Credit Structure in Latin America*, 7 VA. J. INT'L L. 1, tbl. 6 (1967) [hereinafter Kozolchyk, *Law and the Credit Structure in Latin America*] (shortened version).

43. Kozolchyk, *Law and the Credit Structure in Latin America* (shortened version), *supra* note 42.

44. Kozolchyk, *A Roadmap*, *supra* note 25, at 4.

question was: "Yet, what if that someone else is equally aware of the falseness of the money, why would he or she take it?" The answer was: "Because the falsity is factored into the prices everyone charges for their goods or services." In other words, a merchant would be willing to take a likely "false" check after he had charged his customer a much higher price than he would for a cash sale. He would demand a sufficiently large cash down payment to cover a substantial part of his cost; he would then gamble on the likelihood of collecting the remainder of the check by negotiating it to someone else, who would, in all likelihood, engage in the same picaresque calculation. I recall the interest that these answers evoked among my RAND Corporation economist-colleagues: picaresque or tricky commercial behavior acquired an unforeseen economic importance as an explanation for the ever-increasing levels of prices in Argentina's hyperinflation.

The business culture of "winner take all, loser take none" is not peculiar to Latin America; it is present in those developing nations that continue to be guided by standards of fairness particular to agricultural survival-tribal societies.[45] In these societies, only the members of one's tribe, clan, family, or circle of friends are considered insiders, and are legally entitled to duties of fair dealing by their fellow insiders. In contrast, those who belong to other tribes, clans, families, or circles of friends are deemed outsiders ("strangers") and, as such, are not entitled to the duties of fair dealing owed to insiders.[46]

This is not to say that creditors-strangers are totally without protection in developing nations. They are usually allowed to "purchase" a temporary protected status by paying a bribe. Yet this status is only temporary because it only applies to a specific transaction or event. It is also temporary because it lasts until the same or a better protection is made available to another (often competing) stranger willing to pay a similar or higher bribe. At this point, the stranger's protection either disappears or becomes subject to a bidding war.

The effects of a business and legal culture in which only the most minimal business duties are owed to strangers, and the widespread feeling of distrust it inspires in market participants, were apparent in the responses provided by middle class Costa Ricans in a 1968 questionnaire on their investment practices. When asked why the respondent, as a potential investor, preferred to invest in real estate mortgages that offered a smaller return on invested capital than that yielded by the dividends of stock issued year after year by an industrial company, many respondents provided variants of the same answer: if the industrial company's dividend return is such a good deal, why would it be offered to me, neither a member of the family nor a friend of those who run this company?

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45. *See* Kozolchyk, *A Roadmap*, *supra* note 25, at 4; Boris Kozolchyk, *Fairness in Anglo and Latin American Commercial Adjudication*, 2 B.C. INT'L & COMP. L. REV. 219, 257 (1979).

46. The first time I discussed the findings in my study, Boris Kozolchyk, *Toward a Theory on Law in Economic Development: The Costa Rican USAID-ROCAP Law Reform Project*, 1971 LAW & SOC. ORDER 681, with the late and lamented father of legal anthropology, E. Adamson Hoebel, he recalled an incident he witnessed that illustrates the predicament of the stranger in a tribal environment. Hoebel was watching a ritual snake dance that involved an actual snake in the hands of a Native American ritual dancer. This took place at a Native American reservation located near a U.S. national park in the western United States. At one point, the park ranger asked the tribal dancer to stop his dance so that he could have the visitors move back from one of the nearby cliffs, lest the snake dart out and scare a visitor who could then easily fall off the cliff. Somewhat annoyed at the interruption, the dancer asked the ranger: "Why are you so concerned, are these your family, or are they your friends, do you even know these people?"

### C. *The Legal Protection of Strangers or Third Parties and the Credit Marketplace*

The present-day commercial marketplace is comprised of countless strangers or contracting parties who are most often unknown to each other, and who also lack any connection to transactions entered into by their contracting parties with their contractual predecessors. These strangers could be investors, lenders, borrowers, sellers, buyers, carriers, shippers, consignees, insurers, insureds, brokers, credit card issuers or holders, and so on. As different forms of trade and credit emerge, the list grows almost endlessly.

These contractual strangers would not be willing to provide or acquire goods or services, lend, borrow, exchange, or pay, unless they were protected from the claims, defenses, and equities derived from transactions in which they had not participated in or been given adequate notice. Many of these strangers are referred to by the applicable law as protected third parties. In our day, the economic importance of these third parties is such that no viable commercial or financial marketplace can exist without providing these third parties adequate legal protection.

#### 1. The Wrong Choice of Protected Third Parties

The provision of adequate legal protection to third parties is not as easy as it appears. The choice of the wrong party for protection purposes as well as the excessive or deficient protection of those chosen can be quite costly to society and its economy. First, the law must determine who—among the many competitors for the status—qualifies as a third party that is entitled to protection. Second, the law must establish a form of protection that is deemed fair by the participants in the various transactions. Case statutory law is not explicit as to who qualifies as a third party entitled to protection; courts or legal commentators must fill this gap.

Unless courts or commentators are familiar with the transaction or legal institution in question, their choice of a wrong party may carry serious negative consequences. Consider, for example, a Costa Rican provincial court decision that assumed that a given holder of a negotiable draft qualified for the status of holder in due course entitled to sue a party whose name appeared in the drawee-acceptor's column of the draft.[47] The party whose name appeared on the face of a draft had never signed or otherwise accepted such a draft. By allowing such a cause of action, this decision conferred upon the holder of a draft the right to sue practically anyone

47. Case of the Nonsigned Bill of Exchange by the Accepting-Drawee of Cartago, Costa Rica, Oct. 10, 1966, Juzgado Contencioso Administrativo of the City of Cartago (Costa Rica). *See* Boris Kozolchyk, Jurisprudencia Mercantil, Separata Revista de Ciencias Jurídicas, Universidad de Costa Rica. In January 1968, while preparing summaries of all the reported commercial court decisions by Costa Rican courts from 1900-1966, Lic. Rodrigo Oreamuno of the San Jose Bar (and much later Vice-President of Costa Rica), at that time one of the Costa Rican researchers, alerted the Author to a decision by a lower court in the city of Cartago dated October 10, 1966, which had worried commercial lawyers in San Jose. A few days later the Author visited with the judge and clerk responsible for this decision. The description of facts and reasoning that appears in the principal text is part of the notes taken by the Author during these interviews. These notes are available at http://www.natlaw.com/intlcases.htm (an electronic archive of the National Law Center for Inter-American Free Trade, "significant comparative commercial law cases and comments").

whose name appeared in the drawee-acceptor's column, even though that party had not assumed such a liability.

As it turned out, the draft in dispute was the first draft the judge had ever seen. Hence, he did not understand how this three-party instrument functioned or why it was necessary when most of the merchants he knew used a two-party instrument such as a promissory note. The cost of such an unjustified over-protection of creditors-holders of drafts was quickly apparent. Very few merchants or their customers were willing to become parties to such a dangerous instrument. Consequently, a very useful three-party credit instrument such as the draft stopped being used in one of Costa Rica's principal credit markets for a good number of years.

Conversely, underprotection of deserving third parties may reduce the number of willing potential market participants. A group of decisions by the Mexican Supreme Court accomplished this result, drastically reducing the number of protected third party creditors and purchasers of land.[48] These decisions noted that a purchaser or creditor who acquired land or rights in rem could only be protected as a third party if he acted in good faith by doing a diligent search of the land registry records.[49] However, to do a diligent search, the third party had to examine the entire chain of title, from the first to the very last recording of the parcel, and the chain or "successive tract" had to be unbroken. Given the serious difficulties of searching most land records at the time of these decisions, very few purchasers or creditors could have qualified as protected third parties—especially with respect to properties with long or complicated title chains. Similarly, many developing nations still deny protection to contracting parties and to parties who acquired rights based upon their contracts, if those contracts did not fulfill certain *ad solemnitatem* (solemn) requirements. This is true regardless of whether one of or both of the parties performed their part of the bargain, or acted in reliance on the other party's promise of performance.[50]

### 2. The Wrong Choice of Protection

Similar difficulties and negative consequences are apparent with the manner in which the law or its adjudicators have protected creditors. Consider, for example, the creditor remedy known as "apremio corporal"[51] popular in Costa Rica during a good part of the twentieth century until it was abrogated as unconstitutional.[52] This remedy entailed the imprisonment of defaulting debtors, with its purpose to bring about certainty to its commercial and consumer credit market. The reasoning behind this remedy was callous but straightforward: if many debtors ordinarily

48. For a translation and discussion of these decisions, see Boris Kozolchyk, *The Mexican Land Registry: A Critical Evaluation*, 12 ARIZ. L. REV. 308, 336-38 (1970).

49. *Id.* at 336.

50. *See* BORIS KOZOLCHYK, LA CONTRATACIÓN COMERCIAL EN EL DERECHO COMPARADO 214-52 (2006).

51. *See* CÓD. COM. art. 568 (1964) (now abrogated); CÓD. CIV. arts. 1002-1003 (1888) (now abrogated).

52. Ley de Jurisdicción Constitucional No. 7135, La Gaceta No. 198, art. 113 (1989) (amended in La Gaceta No. 212 on Nov. 9, 1989), *available at* http://www.asamblea.go.cr/ley/leyes/7000/7135.doc. For a discussion of the *apremio corporal* prior to its abrogation in Costa Rica, see Kozolchyk, *supra* note 21, at 259-60.

default in their credit obligations and most of them fear imprisonment, why not legislate the defaulting debtors' imprisonment? Thus, the Costa Rican legislature authorized an action that resulted in debtors' imprisonment for a period of two months to two years, unless the debtor complied with a court order to pay the debt or return the collateral.

Contrary to the belief among legislators and judges that if this remedy were deemed unconstitutional Costa Rica's credit system would collapse,[53] no collapse occurred even though the sanction was rarely enforced. What happened instead was that creditors continued to extend credit, albeit at ever-increasing rates of interest. When a researcher asked one of the bailiffs—who roamed the city of San Jose looking for defaulting debtors— why he reported that no debtors were found after the most perfunctory of searches, his answer was revealing: if this sanction were enforced, most Costa Ricans, including the politicians who enacted it and the judges in charge of applying it, would all wind up in jail.[54]

### 3. Factors in the Choice of the Right Third Parties and Their Protection

As illustrated by the wrong choices of protected third parties, for the legal choice to be effected properly, the lawmaker or adjudicator must fully understand the transaction in question—especially its purpose, its mechanics, and the reasonable expectations of participants. Only with this understanding is the lawmaker or adjudicator in a position accurately to assess the good faith standards used to measure the parties' performance and their qualifications for protection.

The same is true with respect to the determination of the proper protection of third parties. As discussed earlier, it is not enough to invoke the truism of legal certainty and simply assume either that credit will necessarily be granted to those merchants who can exhibit a legally enforceable title, or that a penal enforcement of contract rights will generate larger volumes of consumer or micro-credit. Even if title is an important component of real estate-based credit, how effective a component will it be if courts adopt a standard of good faith that disqualifies most purchasers or creditors from the protection of the registry? A successful protection of creditors and debtors depends upon the manner in which the lawmakers and adjudicators handle the legal and socioeconomic facts that surround commercial and consumer lending.

53. In a conversation with the Author during October 1968, the late Justice Ulises Odio of the Costa Rican Supreme Court expressed his constitutional misgivings but pointed to data that indicated that more than one thousand debtors in the city of San Jose (whose population was then approximately 250,000) were imprisoned for *apremio corporal*. Interview with Ulises Odio, Costa Rica Supreme Court, in San Jose, Costa Rica (Oct. 1968). Yet a field study of actual arrests conducted by team members of the Law Reform Project, under the Author's direction, showed that no more than four debtors were actually in jail for this action. The remainder in the Justice's printout were reported by the respective bailiffs as "not found" in their residences or places of business.

54. Kozolchyk, *Toward a Theory*, *supra* note 46, at 731 n.183.

## IV. LEGAL FACTS OF SECURED LENDING AND THEIR GUIDING PRINCIPLES

### *A. The Universality of Effective Secured Lending Practice and Its Principles*

Secured lending has proven its effectiveness in improving a country's GDP as well as in reducing its poverty. By now, the secured lending practices that lead to commercial and consumer credit at reasonable rates of interest have been sufficiently tested in many of the world financial marketplaces, thus enabling the distillation of their guiding legal principles and formulas for creditor and debtor protection. Moreover, as with other commercial transactions, some key practices and legal principles of secured lending have gained universality.

The universality of some of its practices results from the inherently limited methods that can be used by lenders when extending secured credit to strangers. The inherent limitation of effective practices is caused by the cooperative nature of commerce in general and of lending in particular. Accordingly, "winner take all, loser take none" as well as bad faith practices are incompatible with secured lending, as is the lack of transparency vis-à-vis third party creditors or purchasers. Since the advent of the contemporary financial marketplace, any commercial activity conducted with strangers requires as much reliable, timely, and easily accessible information as possible on the market participants. In the case of secured lending, if borrowers wish to rely on certain assets as the collateral that will help repay their borrowings, they must assure both known and unknown lenders of the availability of a desirable minimum, or cushion, of such assets.

In secured lending practice it is thus indispensable to provide actual or potential lenders with a public, transparent, and accurate record of the borrowers' encumbered and unencumbered collateral. Any practice that results in hiding collateral or secured loans from the public eye is similarly incompatible with this transparency. Where the collateral is quickly perishable or depreciable in value, as is the case with most commercial assets, the creditor's ability to repossess and foreclose on these assets must also remain unimpeded, and cannot be tied up in lengthy court proceedings. Unless this is done, the creditor will lose the reassurance of his collateral cushion and will simply refuse to become a secured lender.

It is for this reason that when I was asked by a Mexican NAFTA negotiator why Mexico's law of secured transactions had to resemble that of the United States and Canada, my reply was that the proper question was not what law Mexico had to emulate, but whether Mexico in fact desired secured lending. If it did, its law had to be based on principles that reflected those tried and tested practices in active financial marketplaces, and were thus capable of universal usage. Where some of these practices are not followed—such as the practice of recording the security interest in a public registry—it is because lenders have their own system of private notice that is available to a small number of participants, but is unsuitable for markets with a larger number of participating strangers.[55]

55. For example, bankers in some markets resort to private informal organizations referred to in some Latin American countries as "risk clearing" offices (*centrales de riesgo*) which allow them to exchange information on individual debtors' loans and payment or performance records. Such organizations do not create rights with regard to non-participating third parties such as other creditors or purchasers of debtors' assets. Neither can they assure the participants that all the rights in the debtors' collateral have been taken

### B. *The NLCIFT Principles*

The principles discussed hereafter informed the drafting of the Model Law on Secured Transactions adopted by the Organization of American States (OAS) in 2002[56] and by member nations in different versions, such as by Mexico[57] and Peru.[58] Local versions of this Model Law are currently being considered for adoption by Guatemala,[59] El Salvador,[60] Honduras, Costa Rica, and Chile.[61] As drafted by the National Law Center for Inter-American Free Trade (NLCIFT), these principles cover the creation, perfection, priority, and enforcement of security interests *(garantías mobiliarias)* in personal or moveable property.

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into account by the compilers of risk information. *Mutatis mutandis*, some countries resort to the conveyance of proprietary-fiduciary rights to certain creditors, or to their "retention of title rights," which are not recorded. This information is unavailable to other creditors or to potential creditors, considerably reducing the number of willing lenders.

56. MODEL INTER-AMERICAN LAW ON SECURED TRANSACTIONS (2002) (adopted by the Sixth Inter-American Specialized Conference on Private International Law (known as CIDIP-VI, for its Spanish acronym) on February 8, 2002 (Final Act, 3(F), CIDIP-VI) [hereinafter *Model Law*]. Its name in Spanish is *Ley Modelo Interamericana sobre Garantías Mobiliarias.*

57. Decreto por el que se reforman, adicionan y derogan diversas disposiciones de la Ley General de Títulos y Operaciones de Crédito, del Código de Comercio y de la Ley de Instituciones de Crédito [Decree Reforming, Amending, or Derogating Various Dispositions of the General Law on Negotiable Instruments and Credit Transactions, the Commercial Code, and the Law on Credit Institutions], Diario Oficial de la Federación [D.O.], 23 de mayo de 2000 (Mex.) [*Reform Law of 2000*], and Decreto por el que se reforman, adicionan y derogan diversas disposiciones de la Ley General de Títulos y Operaciones de Crédito, del Código de Comercio, de la Ley de Instituciones de Crédito, de la Ley del Mercado de Valores, de la Ley General de Instituciones y Sociedades Mutualistas de Seguros, de la Ley Federal de Instituciones de Fianzas y de la Ley General de Organizaciones y Actividades Auxiliares del Crédito [Decree Reforming, Amending, or Derogating Various Dispositions of the General Law on Negotiable Instruments and Credit Transactions, the Commercial Code, the Law on Credit Institutions, the Securities Market Law, the General Amending, or Derogating Various Dispositions of the General Law on Negotiable Instruments and Credit Transactions, the Commercial Code, the Law on Credit Institutions, the Securities Market Law, the General Law on Insurance Companies, the Federal Law on Bonding Institutions, and of the General Law of Organizations and Activities Ancillary to Credit], Diario Oficial de la Federación [D.O.], 13 de junio de 2003 (Mex.). While these decrees adopt some of the NLCIFT principles, others were disregarded much to the detriment of these important reforms.

58. Ley de la Garantía Mobiliaria, Ley 28677 (2006) (Peru). This law, however, does disregard important NLCIFT principles.

59. *See* Vinicio Sic, *Controlarán más a cooperativas y ONG*, May 2, 2006, *available at* http://www.sigloxxi.com/index.php?link=noticias&noticiaid=982.

60. Professor Dale B. Furnish, a senior researcher at the NLCIFT, has been acting as an advisor to the government of El Salvador in its enactment of an OAS Model Law-inspired statute and expects enactment of it in the near future. The draft of this law is still in a preliminary stage and is not available for public discussion.

61. The process of adoption of laws inspired in the OAS Model Law is, as of this writing, on its way in Honduras, Costa Rica, and Chile although at different stages of consideration. During October 2006, a drafting group was convened at the NLCIFT to prepare a revised draft of a Honduran decree-law to be submitted to the Honduran Congress during November 2006. In December 2006, members of the Honduran Supreme Court of Chamber of Commerce will also meet at the NLCIFT to discuss this draft and plan the drafting of regulations for a commercial-electronic registry. In the case of Costa Rica, during August 2006, President Oscar Arias appointed Ing. Jorge Woodbridge, Vice Minister of the Economy, to head a drafting commission of a Costa Rican law of secured transactions and a commercial electronic registry. Minister Woodbridge, in turn, appointed the legal advisors to the drafting commission; drafting is expected to commence in the immediate future. Chile's Ministry of the Treasury has approached the Chilean International Legal Center and the NLCIFT (its counterpart in the United States) for advice in the drafting of a law of secured transactions for submission to the Chilean Congress in the near future.

The NLCIFT principles define commercial credit as an effective tool for economic development based upon the self-liquidating nature of its collateral.[62] They describe a security interest as a "preferential right to possession or control of personal property [which] does not require that the debtor . . . have title to the personal property collateral . . . ."[63] As discussed earlier, since this right is not of ownership, it can coexist with other possessory rights. In addition, the personal or moveable property that can be collateral must be open in number and can be present or future, tangible or intangible.[64]

According to the principles, "[s]ecurity interests may be created by contract or by law."[65] However, to perfect a security interest vis-à-vis third parties, other requirements must be met, especially the requirement of giving functional notice to these parties.[66] The concept of functional notice includes either the creditor's possession in the case of the possessory pledge or a public notice system one of whose purposes is to eliminate secret liens.[67]

The principles strongly recommend the adoption of a registry system, in which all known or future security devices become part of a unitary security interest, thereby facilitating the ranking of priorities mostly based upon the rule of first to file, first in right.[68] Registration should be inexpensive, and should take place in a public registry that is easily accessible to third parties, regardless of nationality or economic sector (if at all possible by electronic means). In standardized fashion, the filing should contain only the essential data to identify the parties and the amount of the loan or line of credit and collateral—consistent with the needs of actual and potential third parties to discover all recorded liens against the debtor's assets. Generic descriptions of collateral such as inventory or accounts receivable should suffice. The registry should be indexed generally by the debtor's name and, only exceptionally, by the serial number of the goods.

"A 'purchase money', or 'acquisition' security interest should take priority, to the extent that the credit provided is used directly to acquire the collateral, over prior existing perfected security interests in the same kind of collateral, as an incentive to those wishing to provide timely, valuable and needed loans and as a safeguard against the monopolization and immobilization of the collateral available by one or more secured creditors."[69] Perfection of a purchase money security interest should require—in addition to the appropriate filing—a special notice to pre-existing security interests.

Taking into account the importance of consumer purchases as the originators of the stream of income that underlies commercial lending, a buyer in the ordinary course of business takes free of a perfected security interest created by his seller, even when the buyer may know of that security interest. However, "if the sale occurs outside the ordinary course of business, then the buyer takes subject to the security interest even if he pays a fair purchase price."[70]

62. *See* NLCIFT *Principles*, *supra* note 22, princ. 1.
63. *Id.* princ. 2.
64. *Id.* princ. 3.
65. *Id.* princ. 4.
66. *Id.* princs. 5, 6, 7.
67. *Id.*
68. NLCIFT *Principles*, *supra* note 22.
69. *Id.* princ. 8.
70. *Id.* princ. 9.

Self-liquidation of the security interests requires that repossession of the collateral and foreclosure take place by means of contractual and extrajudicial enforcement. The principles strongly suggest adoption of an enforcement mechanism that "confers upon the creditor or agreed-upon fiduciary the power to repossess or retain and foreclose on the collateral privately or by means of a highly expeditious judicial foreclosure."[71]

Extrajudicial enforcement without breach of peace and subject to subsequent judicial review is gaining increasing acceptance by legislators and legal commentators throughout the developing world.[72] The Supreme Court of Mexico, for example, has upheld the constitutionality of an extrajudicial remedy associated with the *Fideicomiso de Garantía*, the Mexican version of the United States deed of trust.[73] In addition, the Costa Rican Supreme Court has validated the legality of a *Fideicomiso de Garantía* much along the lines of its Mexican counterpart.[74] Highly respected constitutional law scholars, including one of the drafters of the Guatemalan constitution, concur on the constitutionality of the extrajudicial remedies of the proposed draft of the Guatemalan law of secured transactions.[75]

Because bankruptcy laws are often used as devices to evade debt collection in many developing nations—except where the bankruptcy law in question reflects contemporary creditor and debtor protection legislative trends—the principles recommend the exclusion of perfected security interests from the bankruptcy estate.[76] This is also a World Bank recommendation.[77] Exceptionally, where the

71. *Id.* princ. 10.

72. *See, e.g.*, Law Amending the Civil Code, Notarial Law, and Other Laws art. 151j (Jan. 1, 2003) (Slovk.) (amending the Civil Code of 1964) (providing that creditor may not agree with debtor on the appropriation of the collateral *prior to default*). By contrast, no prohibition of the *Pactum Commissorium* exists *after the default*. *Id.*; *accord* UNMIK Regulation No. 2001/5, art. 19.12 (Kosovo). For Eastern European doctrinal opinions on the legality of the *Pactum*, see Ganka Ivanova, *Bulgaria*, *in* CTR. FOR INT'L LEG. STUD., INTERNATIONAL SECURED TRANSACTIONS 35 (2003) (stating that "acceptance of encumbered assets in satisfaction of the secured obligation is provided by the Civil Procedure Code in favor of the mortgagee or the pledgee under court foreclosure"). *See also* Chrysta Bán, *Hungary*, *in* INTERNATIONAL SECURED TRANSACTIONS, *supra*, at 29. She writes that "following default, the secured creditor may propose to accept the encumbered assets in full or in partial satisfaction of the secured obligation. A pre-default agreement that automatically vests ownership of the encumbered assets in the secured creditor on default is null and void and unenforceable." The Author is indebted to NLCIFT staff member Marek Dubovec for supplying the above sources.

73. For a discussion of this decision, see Dale Beck Furnish, *El Debido Proceso y Derecho de Audiencia en la Ejecución Contra de los Bienes del Deudor en los Estados Unidos Mexicanos y los Estados Unidos de América: Un Análisis Comparado*, 17 EL FORO 119 (Barra Mexicana, Colegio de Abogados, México, 2004).

74. Vistamarina, Vimasa S.A., Banco BCT Panamá, y Banco de San José S.A., 00005-F-2003, 02-000086-0004-CI, 15:10, Sala Primera Civil Costa Rica (Jan. 15, 2003). I am grateful to Lic. Joaquin Picado, staff member of the NLCIFT, for the text of this important opinion.

75. E-mail from Lic. Carlos Molina Mencos, Doctor en Derecho, Molina Mencos, Pineda y Asociados to Boris Kozolchyk, Director, National Law Center for Inter-American Free Trade (Jan. 6, 2005) (on file with author).

76. *See* NLCIFT *Principles*, *supra* note 22, princ. 11.

77. WORLD BANK & INT'L FIN. CORP., DOING BUSINESS IN 2006, at 67, *available at* http://www.doingbusiness.org/documents/DoingBusines2006_fullreport.pdf ("Reformers in poor countries would do better to focus on improving foreclosure of secured debt outside of bankruptcy, thus reducing reliance on the courts"); *see also* Kenneth W. Dam, *Credit Markets, Creditors' Rights and Economic Development* 26 (John M. Olin L. & Econ. Working Paper No. 281, 2006), *available at* http://www.law.uchicago.edu/Lawecon/WkngPprs_251-300/287.pdf.

bankruptcy takes the form of a business reorganization, collateral may become part of the bankruptcy estate—subject to the exclusive jurisdiction of the bankruptcy court to confirm the perfection of the security interest and establish its priority against the claims of other creditors—to determine the extent and value of the security interest, and ultimately also to decide whether the collateral is essential to a feasible reorganization that will protect valid security interests.

## V. CONCLUSIONS AND A CORRECTIVE STRATEGY

The proposition that the financial plight of the poor in developing nations is hopeless deserves reconsideration in light of the repeated findings on the impact of commercial and consumer credit at reasonable rates of interest upon economic growth and reduction of poverty. Similarly, the conclusion that the massive distribution of legal titles to real or personal property is a necessary and sufficient condition to economic development also deserves reconsideration. At best, it may be a necessary but not a sufficient condition for certain—mostly real estate secured—loans. The transition from a micro to a commercial loan requires from either real or personal property collateral more than simple ownership or title: it requires self-liquidation and everything associated with this essential feature of the commercial loan.

However, a corrective strategy for making commercial and consumer credit available at reasonable rates of interest in developing nations by adopting an open system of secured lending is still a work in progress. Much depends upon special features of the business and legal cultures of the country in question and upon the answers to critical legal and socioeconomic questions, such as: how valuable are its goods and services in local and international markets; how large is its consumer and borrowers' class; how skilled and educated are its craftsmen acting as small- and medium-sized businesses; how picaresque or tricky are the business practices associated with credit sales or with purchase money loans; how picaresque or tricky, or honest and reliable are its accounting practices (can lenders truly rely on what appears on financial statements?); how reliable are its collateral value appraisals or commercial insurance; how corrupt is its administration of justice; are there knowledgeable and honest bankruptcy trustees; are creditors' committees truly representative and trustworthy; how developed and reliable are its means of communication; and how dependable and costly are its transportation, warehousing and communications systems? These, and other variables, can become responsible for the viability of an OAS Model Law-inspired statute and the rapidity of its success.

The experience with commercial lending in Latin America suggests some common normative problems whose solution deserves consideration as part of a successful strategy. These are:

1. A secured lending law ought not be treated as an isolated legal enactment. Its success depends upon the enactment of equally effective and market-sensitive laws of bankruptcy, insolvency, electronic commerce (including an electronic registry of security interests in personal and real property) and more functional (and less formalistic) laws of contracts, negotiable instruments, and documents of title. Otherwise, whatever legal protection of third party creditors is obtained through the law of secured transactions will be lost by a "loose" or otherwise non-existing bankruptcy or e-commerce law. Similarly, whatever transactional speed and lower

cost of operation is achieved by the law of secured transactions will be lost by imposition of costly formalities by the law of contracts, negotiable instruments, documents of title, or by the laws that govern the notarial or governmental formalities of these and other transactions.

2. As was done in the case of Guatemala and Honduras[78]—and will hopefully be done in Costa Rica and Chile—a careful evaluation of the most valuable and liquid collateral in the marketplace should precede the drafting of the provisions on perfection, priority and enforcement of security interest. For example, assuming the agricultural nature of such collateral in Guatemala and Honduras, perfection, priority, and enforcement rules should take into account the ad hoc type of documents or electronic records, ones that could convey rights to the collateral in question to bankers and purchasers in major spot and futures markets for the goods in question.[79]

3. Best practice guides should be developed and their use carefully monitored. Training and regular monitoring of performance should apply not only to secured lenders and borrowers, but also to the financial statement and reporting practices of accountants, appraisers, and business inspectors—whether they are acting as the parties' staff or independent contractors. The importance of reliable financial statements and certifications of value—particularly with regard to the required amount of collateral—cannot be overstated, especially in a picaresque business culture.

4. Lawyers, judges, registrars, mediators, and arbitrators should be trained in the market and third party protection-sensitive interpretation and administration of the secured transactions, bankruptcy, e-commerce, contracts, and registry laws.

78. *See* Draft Guatemalan Law arts. 27-29; Draft Honduran Law arts. 36-38.

79. *See, e.g.*, Marek Dubovec, *Commodity Contracts as Hedging and Security Tools* (NLCIFT Occasional Paper, 2006) (on file with author and the NLCIFT).