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Secured Lending and its Poverty Reduction Effect

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I. Socio-Economic Factors.

A. Poverty, Micro and Mainstream Credit.

The Asian Development Bank (ADB) defines poverty as a “lack of access to essential goods, services, assets and opportunities to which every human being is entitled.”¹ Having lived among many who have experienced it firsthand, I would add two feelings to this predicament: hopelessness and distrust for society and its institutions. Unfortunately, those who experience such feelings have little impetus for self-improvement. What is even more unfortunate is that hopelessness and distrust need not prevail. For even if poverty may never be completely eradicated, it can be significantly alleviated through the economic growth brought about, *inter alia*, by the legal institutions that allow for commercial and consumer credit at reasonable rates of interest.

The recent literature of economic development is replete with hopeful signs. A study completed by the Asian Development Bank (ADB) in December 2004 identified rapid, broad-based economic growth as the single most important factor in attaining poverty reduction.² It showed that business growth, in particular, increases the demand for labor and the level of wages - further reducing poverty. Similarly, properly financed

¹ Asian Development Bank, *Enhancing the Fight Against Poverty in Asia and the Pacific – The Poverty Reduction Strategy of the Asian Development Bank* (December 2004) at http://www.adb.org/Documents/Policies/Poverty_Reduction/2004/prs-2004.pdf (last accessed July 13, 2006).

² Asian Development Bank, *Enhancing the Fight Against Poverty in Asia and the Pacific – The Poverty Reduction Strategy of the Asian Development Bank* (December 2004) at http://www.adb.org/Documents/Policies/Poverty_Reduction/2004/prs-2004.pdf (last accessed July 13, 2006).

opportunities for self-employment have been proven to make an important contribution to poverty reduction.³

The above-mentioned study is one among many serious economic and social science studies 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 has become increasingly clear to economists and social scientists that the availability of commercial credit to small and medium-sized merchants not only boosts overall economic growth (as reflected in significant gains in gross domestic product)⁴ but it also reduces poverty. Accordingly, a 2004 World Bank study, using a broad cross-country sample, concludes that:

Financial intermediary development reduces income inequality by disproportionately boosting the income of the poor and therefore reduces poverty.⁵

Some of this financial intermediation is attributable to “micro-credit”: 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 poverty⁶; and as found by the IRIS Center of the Department of Economics at the University of Maryland, these programs

³ *Id.* at 6.

⁴ Heywood W. Fleisig, *Secured Transactions: The Power of Collateral*, Center for the Economic Analysis of the Law (June 1996), at <http://www.worldbank.org/fandd/english/0696/articles/0150696.htm> (last accessed July 13, 2006). This study estimates the GDP improvement up to 9%. See also *Assessing the Economic Cost of Deficiencies in the Framework for Secured Transactions: Examinations of Argentina and Bolivia*, at <http://www.ceal.org/ceal-org/working.asp> (last accessed July 13, 2006).

⁵ THORSTEN BECK, ASLI DEMIRGÜÇ-KUNT, AND ROSS LEVINE, FINANCE, INEQUALITY AND POVERTY: CROSS-COUNTRY EVIDENCE, (World Bank Policy Research, Working Paper No. 3338, June 2004) at <http://econ.worldbank.org>. 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. 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? (p.3).

⁶ See further USAID, *Accelerated Microenterprise Advancement Project (AMAP) – Poverty Assessment Tools*, at <http://www.povertytools.org/> (last accessed July 13, 2006).

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.”⁷

Yet, micro-entrepreneurs operating in the large informal economy — including many businesses owned by women — often lack access to adequate financing from banks. As a result, micro-enterprises have less of an impact on economic growth than they might otherwise have.⁸ Nevertheless, this is not a hopeless situation because an improvement in the access to commercial credit by small and medium enterprises also helps micro-enterprises and alleviates poverty. As shown by the above referred to World Bank Study, the income of the poorest quintile grows faster than average GDP per capita in countries with better-developed financial intermediaries.⁹ What is more, income inequality falls more rapidly in countries with higher levels of financial intermediary development. Similarly, countries with developed financial intermediaries experience larger reductions in infant mortality and lesser reliance on child labor.¹⁰ 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 tackling the problem of poverty.¹¹

⁷ Dr. Thierry van Bastelaer, Director of the IRIS Center’s Enterprise Development Group, *quoted in IRIS Helps Ensure that Microenterprise Funds Reach the Very Poor* (September 2005), at http://www.iris.umd.edu/Reader.aspx?TYPE=HTML_ARTICLE&ID=b7fd059e-9651-4696-accb-070fa88969f8 (last accessed July 13, 2006).

⁸ Excerpt of a presentation by Chairman Christopher H. Smith, House Subcommittee on Africa, Global Human Rights and International Operations, entitled *Removing Obstacles for African Entrepreneurs* (June 8, 2006), at http://www.house.gov/international_relations/109/smith060806.pdf (last accessed July 13, 2006).

⁹ THORSTEN BECK ET AL., *supra* note 5 at 4 *also* at 11, 17-19.

¹⁰ *Id.* at 12 concerning infant mortality and 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.

¹¹ PATRICK HONOHAN, FINANCIAL SECTOR POLICY AND THE POOR, SELECTED FINDINGS AND ISSUES (The World Bank, Working Paper No. 43, pp. 30-33, 43-44 Washington, D.C. 2004) 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.

B. Poverty and Debtor and Creditor Protection.

Because of the importance of access to credit as a tool for the alleviation of poverty, it is necessary to ascertain the impact of debtor and creditor protection upon the availability of credit. It can hardly be disputed that, generally speaking, 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. It is for this reason that debtor protection, particularly of those who are most vulnerable, contributes to the availability of credit for micro, small and medium-sized businesses.

However, 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 (also referred to as "mainstream" finance), 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: "inefficient (creditor) legal protections disproportionately increase financial restrictions for creditors that have less wealth."¹² (Parenthesis added). The main reason for this restriction is the fixed cost of monitoring debtor performance by the lending banks. Because these costs are fixed and because 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 the bankruptcy procedures have a greater effect on small firms than on large ones. Using a survey of practices in 62 countries, the 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 small and large firms.¹³ In light of the above findings, it is time to examine the role of legal and cultural factors in making commercial and consumer credit available at reasonable rates of interest in developing nations.

¹² ARTURO GALINDO AND ALEJANDRO MICCO, BANK CREDIT TO SMALL AND MEDIUM SIZED ENTERPRISES: THE ROLE OF CREDITOR PROTECTION (Banco Central de Chile Working Paper No. 347, December 2005) at <http://www.bcentral.cl/eng/stdpub/studies/workingpaper/htm/347.htm>.

¹³ *Id.* at 15, which adds:

... 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.

II. Cultural and Legal Factors.

A. Duties toward Family, Friends and Strangers.

A 1999 study of the Central Bank of Brazil estimated that fully one third of the approximately 40% per annum interest rate paid by Brazilian commercial borrowers was attributable to the difficulties and risks of loan collection and non-repayment.¹⁴ This is neither an unusual finding nor a recent phenomenon - either in Brazil or other Latin American countries. For example, my 1967 RAND Corporation study “Law and the Credit Structure in Latin America”¹⁵ 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%.¹⁶ This meant that out of, say, one hundred negotiable and credit instruments in circulation in Chile in 1962 almost 40 had not been paid at maturity. And 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%.¹⁷ In other words, of the total number of bank loans or direct or indirect extensions of credit and negotiable instruments, as many as 22% during a peak year were in default.

Clearly, neither creditors nor debtors are well served by a legal system 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 system. A business culture of “winner take all, loser take none” and a commerce practiced as a “tricky” or “picaresque” occupation have 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 questions were: “Why, if protests are so common and collection of negotiable instruments 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 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 question was: “Yet, what if that someone else is equally aware of the falseness of the

¹⁴ Departamento De Estudios E Pesquisa, Banco Central Do Brasil, *Juros E Spread Bancário no Brasil* (1999).

¹⁵ Boris Kozolchyk, *Law and the Credit Structure of Latin America*, RAND MEMORANDUM 4918 RC, March 1966). For a somewhat shortened version of the RAND study, see *Law and the Credit Structure in Latin America*, 7 VA. J. INT’L L. 1 (1967) Table 6.

¹⁶ *Id.*

¹⁷ *Id.* at 20, 21, Table 4.

money, why would he 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 "false" check after he had charged his customer a much higher price than he would for a cash sale. He would demand a "cash down payment" which would cover a substantial part of his cost, and 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.

As I have stated elsewhere, 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 peculiar to agricultural survival-tribal societies.¹⁸ In these societies, only the members of one's tribe, clan, family or circle of friends are considered insiders and factually or 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 outsiders or "strangers" and as such are not entitled to the duties of fair dealing owed to insiders.¹⁹

This is not to say that strangers are totally without protection in developing nations. They are usually allowed to "purchase" a temporary protected status by paying the notorious 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 disappears or becomes subject to a bidding war.

The effects of a culture in which only the most minimal business duties are owed to strangers and the widespread feeling of distrust it inspires in market participants was

¹⁸ See generally Boris Kozolchyk, *A Roadmap to Economic Development Through Law: Third Parties and Comparative Legal Culture*, 23 ARIZ. J. INT'L & COMP. L. 1 (2005). See also *Fairness in Anglo American and Latin American Commercial Adjudication*, 2 B.C. INT'L & COMP. L. 257 (1979).

¹⁹ The first time I discussed the findings in my study, Boris Kozolchyk, *Toward a Theory of Law in Economic Development, the Costa Rican USAID ROCAP*, 4 ARIZ. L. REV. 681 (1971), 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 US 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?"

apparent in the responses provided by middle class Costa Ricans to 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 much 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 it (the industrial company's dividend return) is such a good deal, why would it be offered it to me, neither a member of the family nor a friend of those who run this company?

B. 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 have no 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. And as different forms of trade and credit emerge, the list grows, virtually *ad infinitum*.

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 they had not participated in or had not been given adequate notice of. 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 with 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. Accordingly, the law must, first of all, determine who, among the many competitors for the status, qualifies as a third party entitled to protection. Secondly, the law must establish a form of protection that is deemed fair by the participants in the various transactions. And in case statutory law is not explicit as to who qualifies as a third party entitled to protection, courts or legal commentators must fill the gap.

Yet, 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.²⁰ The party

²⁰ Unreported October 10, 1966 decision by the Juzgado Contencioso Administrativo of the City of Cartago (nearby San Jose, Costa Rica) See Boris Kozolchyk, *Jurisprudencia Mercantil, Separata Revista de Ciencias Juridicas*, Universidad de Costa Rica. In

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 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, under-protection of deserving third parties could equally reduce the number of willing potential market participants. A group of decisions by the Mexican Supreme Court accomplished this result by drastically reducing the number of protected third-party creditors and purchasers of land.²¹ These decisions required 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.²² However, to do a "diligent search", the third party had to examine the entire chain of title, from the last to the first recording of the parcel, and this 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 those who acquired rights based upon their contracts if these contracts failed to fulfill certain "*ad solemnitatem*" (solemn) requirements. And this is true, regardless of whether one of or

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 this 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 this 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 this author during these interviews. These notes are available at www.natlaw.com (an electronic archive of the National Law Center for Inter American Trade, "significant comparative commercial law cases and comments").

²¹ For a translation and discussion of these decisions, see Boris Kozolchyk, *The Mexican Land Registry, A Critical Evaluation*, 12 ARIZ. L. REV. 265, 336-338 (1970).

²² *Id.*

both of the parties had performed their part of the bargain or had acted in reliance of the other party's promise of performance.²³

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*”²⁴ popular in Costa Rica during a good part of the 20th century until it was abrogated as unconstitutional.²⁵ This “remedy” entailed the imprisonment of defaulting debtors, and its purpose was to bring about certainty to its commercial and consumer credit market. The reasoning behind this remedy was callous but straightforward: if many debtors ordinarily 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 collapse²⁶, 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. And 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.²⁷

²³ See BORIS KOZOLCHYK, *LA CONTRATACIÓN COMERCIAL EN EL DERECHO COMPARADO*, 214-252 (Madrid, Universidad Carlos III, EDICIP and National Law Center for Inter-American Free Trade, 2006); see also www.natlaw.com.

²⁴ See Article 568 of the Costa Rican Commercial Code of 1964 and Articles 1002 & 1003 of the Civil Code of 1888 (now abrogated).

²⁵ See LEY DE JURISDICCION CONSTITUCIONAL No. 7135 of October 11, 1989 published in the Gazette No. 198 of October 19, 1989 and 212 of Nov. 9, 1989 with corrections. See www.poder-judicial.go.cr/salaconstitucional/jc.html (for a discussion of the *apremio corporal* prior to its abrogation in Costa Rica). See Boris Kozolchyk, *The Mexican Land Registry, A Critical Evaluation* 12 ARIZ. L. REV. 265, 336-338 (1970).

²⁶ In a conversation with this author during the month of 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*. Yet, a field study of actual arrests conducted by team members of the Law Reform Project under this author's direction showed that no more than 4 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.

²⁷ Kozolchyk, *supra* note 19 at 731 n.183.

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, it is necessary that the lawmaker or adjudicator 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 to assess what are the most realistic good faith standards with which 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. It is not enough to invoke the truism of legal certainty and assume that credit will necessarily be granted to those merchants who can exhibit a legally enforceable title to their property any more than it follows that a strict-penal enforcement of contract rights will generate larger volumes of consumer or micro-credit. To begin with, as will be discussed shortly, the requirement of legal title in asset based lending or personal property secured transactions is often irrelevant, if not damaging. And even assuming that title is an important component of another type of credit such as the real estate-based credit, how effective a component will good title be if the country's courts adopt a standard of good faith that disqualifies most purchasers or creditors from qualifying as third parties in good faith entitled to the protection of the registry? In the final analysis, a successful protection of creditors and debtors depends upon the manner in which the lawmakers and adjudicators alike handle the requisite legal and socio economic-facts.

III. The Requisite Legal Facts of Secured Lending and their Guiding Principles.

A. The Universality of Good Secured Lending Practice and its Principles.

As noted earlier, secured lending has by now proven its effectiveness in improving a country's GDP as well as in reducing its poverty. By now also, 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 to enable the distillation of their guiding legal principles and formulas for creditor and debtor protection. Moreover, as with some other commercial transactions, there is a certain degree of universality in the key practices and principles.

This universality is caused by the very limited range of practices that can qualify as effective in carrying out the purpose of the credit transaction. For example, if borrowers wish to rely on their assets as the collateral that will need to assure both known and unknown lenders of their ability to repay loans out of the available "cushion" of collateral. Consequently, it is indispensable to provide these third parties with a public, transparent and accurate record of the borrowers' encumbered and unencumbered collateral. A practice or principle that results in hiding collateral or secured loans from the public eye is incompatible with the indispensable transparency and prevents secured lending. Similarly, where the collateral is quickly perishable or depreciable in value, as is the case with most moveable or personal property, the creditor's ability to repossess and foreclose on such property 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 it was that Mexico's law of secured transactions had to resemble that of the United States and Canada, my reply was that the question Mexico had to ask itself was not what law it had to emulate but whether it wanted to have a law that encouraged secured lending. If it did, the practices that were tried and tested in very active financial marketplaces and the principles derived from them could not be ignored, for these practices and principles embodied what was, in fact and in law, contemporary secured lending.

B. The NLCIFT Principles.

The principles discussed hereafter informed the drafting of the Organization of American States (OAS) Model Law on Secured Transactions as adopted by the OAS in 2002²⁸ and by member nations in different versions, such as by Mexico²⁹ and Peru³⁰, and as being considered for adoption by Guatemala³¹ and El Salvador.³² As drafted by the National

²⁸ 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*.

²⁹ 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.) [hereinafter *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.

³⁰ Ley de la Garantía Mobiliaria, Ley 28677, March 1, 2006. This law, however, does disregard important NLCIFT principles.

³¹ See *Ley de Garantías Mobiliaria*, at <http://www.sigloxxi.com/index.php?link=noticias-iciaid=982>, May 13, 2006.

Law Center for Inter American Free Trade (NLCIFT), these principles can be summarized as follows:³³

1. Secured commercial and consumer credit is an important tool for economic development because it relies on the self-liquidating nature of the transaction and collateral involved — *i.e.*, the collateral and its proceeds will repay the loan.

This principle reflects a banking practice first introduced by the Bank of England when it distinguished between the real estate loan and the commercial loan. Unlike the former, the purpose of the latter was to facilitate repayment during a period of months and not years. It relied for repayment on the sale by the borrower of his “liquid” commercial assets, *i.e.*, marketable goods or staples whose acquisition had been made possible by the loan. The proceeds of these sales were the principal source of the repayment, and for this reason the loan was considered as “self-liquidating.”

2. A security interest is a preferential right to possession or control of personal property. As such, it does not require that the debtor who grants the interest have title to the personal property collateral; his right to its possession, even though co-existent with other possessory rights in the same property, will allow the creation of the security interest.

Unlike with real property, the most important right with respect to moveable or personal property is possessory. It is very difficult and expensive to document the ownership of personal property, and especially its “historical” ownership. This legal fact was reflected in a famous provision in the French Civil Code of 1804 which proclaimed that “with respect to movables, possession is the equivalent of title.” In addition, ever since the extensive use of negotiable documents of title such as negotiable ocean bills of lading and warehouse receipts in 19th century commerce, title to personal property became fragmented. Therefore, title to the same personal property could be lawfully claimed by many merchants and consumers, including installment sellers, buyers, creditors, carriers, consignees, warehousemen, depositors or bailors, etc. This legal fact of contemporary secured lending is contrary to many a 19th and 20th century code provision that require that an object only be pledged or conveyed by its owner or agent of the owner.

3. The security interest may be created in any personal property susceptible to monetary valuation whether present or future, tangible or intangible including rights to the same, as well as in the proceeds of this collateral, whether in their first or future generations. Thus, personal property

³² 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.

³³ See the NLCIFT 12 Principles of Secured Transactions Law in the Americas, at <http://www.natlaw.com/bci9.pdf> (last accessed July 13, 2006). Because of limitations of space, the order and number of these principles has been slightly altered.

collateral as well as security interests in them are open in number (*numerus apertus*) and are not limited to the pledge with or without dispossession of the debtor or to chattel mortgages, retention of title or conditional sales, etc.

One of the least desirable legacies of Roman law (and there were many highly desirable ones that are still used in our contemporary marketplace) was the “typification” of contracts. This meant that only those contracts that were recognized by the Roman civil law as giving rise to certain actions were enforceable. Where this tradition prevails, as it does in a good number of “civil law” contracts, only those secured transactions found in codified or statutory law are enforceable, regardless of their currency in the marketplace. Such a “*numerus clausus*” approach is extended to the objects that can be used as collateral, thereby depriving “untypified” business assets such as a merchant’s inventory, good will, contract rights, accounts receivable and proceeds of their value as collateral.

4. Security interests may be created by contract or by law. The effectiveness of a security interest between the secured creditor and debtor arises from their contract, without any additional formality. Nevertheless, third party rights including the rights of judgment creditors and trustees in bankruptcy will not be affected by the security interest unless proper notice of it is provided (perfection).
5. Registration should be inexpensive and should take place in a public registry easily accessible to third parties regardless of nationality or sector, and, if at all possible, by electronic means. The filing, in standardized fashion, should contain only the essential data to identify the parties, the type of security interest, the amount of the loan or line of credit and collateral consistent with the needs of actual and potential third parties. The indexing in this registry should be organized generally by the debtor’s name and, exceptionally, by the serial number or other special description of personal property of high value.
6. A principal goal of a secured transactions public notice system is to eliminate secret liens. Public notice (perfection) can either be attained by the creditor’s possession or control of the collateral, or by registration. A perfected security interest can merge with a negotiable instrument, in which case it will become a negotiable security interest and, thus, an abstract undertaking, independent from the underlying transaction, thereby allowing its “true sale” or negotiation to a *bona fide* purchaser.
7. Public notice by the specialized registry can best be provided when all types of security interests are treated as a unitary security interest whose effect, including priority, upon third parties such as other secured creditors and purchasers commences from the time of its filing, irrespective of the time of its creation.

8. Registration can be effected by a generic description of the collateral such as “inventory,” “accounts receivable” or “equipment,” so long as the description makes it possible to accurately determine exactly what collateral is subject to the perfected security interest; or — if so required by specific laws or treaties — it can be effected by a detailed description of highly valuable goods, in which case they may be identified by a serial number or other marks or features.

The preceding principles are self-explanatory. As noted earlier, a system of commercial credit which is open to all lenders and borrowers who can qualify as third parties entitled to legal protection and which involves all sorts of transactions and collateral cannot exist without a transparent notice of its transactions to the world at large. Such a system stands in sharp contrast with a closed system in which no public notice of the transaction is given to third parties and whose lending is done by very few entities on an exclusive or quasi-exclusive basis. In such a system, the information about debtors and their assets is shared on an exclusive basis by the few lenders.

The incipient and weak nature of developing nations’ credit markets requires, for the sake of the debtors, the widest possible opening of the sources of credit and, for the sake of the creditors, an ability to rely on the most transparent and accurate information on debtors and their assets. Consequently, a closed system of notice is the least suitable for developing countries.

9. An exception to a priority in the case of a purchase money or acquisition security interest can be effectuated by providing, in addition to the appropriate filing, a special notice to pre-existing security interests; this exception operates also as a limitation to the monopolization of the collateral available by one or more secured creditors.

The allowance of a purchase money security interest is one of the best tools to prevent the monopolization of commercial credit through “omnibus” clauses that subject all of the assets of the secured debtor to a security interest for an unreasonably long period of time and regardless of the ratio of loaned amount to collateral. This purchase money security interest also acts as a safety valve when very desirable or necessary loans can only be obtained if the purchase money secured creditor is allowed an exceptional priority.

10. Self-liquidation of the security interests requires that repossession of the collateral and foreclosure be effected by means of a contractual, rescissory and extrajudicial enforcement 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, at the behest of the creditor.
11. Whenever possible, the perfected security interest should not become part of bankruptcy proceedings and the law of bankruptcy or any other branch of the law should not become a tool to avoid and evade secured

obligations owed to local or foreign creditors. Exceptionally, if collateral becomes part of the bankruptcy estate, it should be subject to the exclusive jurisdiction of the bankruptcy court for purposes of determining the extent and value of the security interest and confirming its perfection and priority against the claims of other creditors alleging possible defects in perfection, fraud and unlawful preference.

The above two principles are remedial corollaries of the practice of self-liquidating loans. 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.³⁴ 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. In addition, the Costa Rican Supreme Court has validated the legality of a *Fideicomiso de Garantía* much along the lines of its Mexican counterpart.³⁵; and highly respected constitutional law scholars, including the drafter of the Guatemalan constitution, concur on the constitutionality of the extrajudicial remedies of the proposed draft of the Guatemalan law of secured transactions.³⁶

The exclusion of perfected security interests from the bankruptcy estate reflects not only a World Bank recommendation³⁷, but it also embodies the best legal practice in nations

³⁴ See, e.g., The Slovakian law amending the Civil Code of 1964 of 9 August 2002 in force on 1 January 2003, Art. 151-j which provides that creditor may not agree with debtor on the appropriation of the collateral prior to default. In contrast, no prohibition of the *Commissorium* exists after the default. *Similarly see* Kosovo, Regulation No. 2001/5 at Art. 19.12. See GANKA IVANOVA, INTERNATIONAL SECURED TRANSACTIONS: BULGARIA 35 (Oceana Publications 2004) (for Eastern European doctrinal opinions on the legality of the *Pactum*), who states: “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, INTERNATIONAL SECURED TRANSACTIONS: HUNGARY 29 (Oceana Publications 2003). She writes: “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 him with the above sources.

³⁵ Sentencia 00005, 15/01/2003, hora 15:10, Sala Primera de la Corte Suprema. I am grateful to Lic. Joaquin Picardo, Staff member of the NLCIFT for the text of this important opinion.

³⁶ E-mail from Carlos Molina Mencos (January 6, 2005) (on file with author).

³⁷ World Bank, Doing Business in 2006, at p. 67.: “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, JOHN M. OLIN LAW & ECONOMICS (Working Paper No. 281 (2d series), p. 26, February 2006).

where bankruptcy procedures are easily abused by defaulting debtors and where the policing of automatic stays as well as preservation of the collateral while in bankruptcy are utopian remedies.

IV. 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 concerning the impact of commercial and consumer credit at reasonable rates of interest upon economic growth and reduction of poverty. The conclusion that the massive distribution of legal titles to real or personal property and the certain enforcement of contract rights is the necessary and sufficient condition to economic development similarly deserves reconsideration.

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 socio-economic questions. For example, 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 craftspersons acting as small and medium-sized businesses, how picaresque or tricky is its commerce, how corrupt is its administration of justice, how developed is its institutional infrastructure, how reliable its accounting, insurance and appraisal systems, how easy and reliable are its transportation, warehousing and communications systems, etc.? 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 winning strategy. These are the following:

1. A secured lending law should not be treated as an isolated legal enactment; its success depends upon the enactment of equally effective and market sensitive laws of bankruptcy and 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 non-existing bankruptcy law. Similarly, whatever transactional speed and lower cost of operation is obtained 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 formalities of these and other transactions.

2. Best practice guides should be developed and their use carefully monitored not only for secured lenders and borrowers but also for accountants, appraisers and business inspectors, whether acting as bank employees or as independent contractors. The importance of reliable financial statements and certifications of value or presence of the

required amount of collateral cannot be overemphasized, especially in a picaresque environment.

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