An Approach to Legal Reform in Central and Eastern Europe: The European Bank's Model Law on Secured Transactions

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It is certainly most appropriate to throw some light onto the legal transition process in Central and Eastern Europe in the opening issue of this legal journal which is dedicated to important developments in the law of the 20th century. The legal reforms across this region form one of the outstanding legal events of the second half of this century. The transition from state-planned central economies to market-oriented economies involves reforms of the legal systems. The extent of these reforms is well-documented in a number of collections which discuss the various Central and Eastern European laws on a region-wide basis.[1] It is impressive how many laws in the areas of commercial, company, banking, competition or insolvency law, to name but a few areas, were passed in the years since the Berlin wall came down in 1989. There may still be implementation problems with some of these laws, some may also need further refinements or corrections but the sheer effort which has gone into the transformation of whole legal systems is admirable.

For the purpose of this article I want to concentrate on one specific example of how legal reforms in Central and Eastern Europe were, and are, approached: the Model Law on Secured Transactions prepared by the European Bank for Reconstruction and Development.[2] However, before discussing this Model Law it worth looking briefly at the link between development and legal reform.

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1 *See* Parker School of Foreign and Comparative Law at Columbia University (ed.), *Central & Eastern European Legal Materials* (Yonkers/NewYork, release 42, June 1997) (cited as CEEL); Stephan Breidenbach (ed.), *Handbuch Wirtschaft und Recht in Osteuropa* (Munich, 1997); *see* review by Jan-Hendrik Röver (winter/spring 1995), *Law in Transition*, at p. 30; Stephan Breidenbach, Christian Campbell and EBRD (eds.), *Business Transactions in Eastern Europe*, 2 Vols. (New York, 1997).

2 European Bank for Reconstruction and Development, Model Law on Secured Transactions (London, 1994). Stephan Breidenbach, Christian Campbell and EBRD (eds.), *Business Transactions in Eastern Europe*, Vol. 2 (New York, 1997), Appendix 1; *Sudebnik*, Vol. 1 (1996), at pp. 587–672 (English version and Russian translation); Jan-Hendrik Röver, 'Vergleichende Prinzipien dinglicher Sicherheiten. Eine Studie zur Methode der Rechtsvergleichung' (PhD Thesis, Munich, 1997), Appendix (German translation). Further translations are available from the European Bank for Reconstruction and Development.

European Journal of Law Reform, Vol. 1, No. 1/2

A. The History of Legal Reform

The history of the relationship between law reform and the development of economic systems is largely a desiderate of the future.[3] It is possible, however, to mention a few pertinent aspects.

The direct link between law and economic development is not a new discovery. It was the founder of modern economic thinking, Adam Smith,[4] who clearly formulated the need for an adequate legal framework for a prosperous economic development. For him the relationship was natural. He taught not only economics but also ethics[5] and law[6] at the University of Edinburgh. In this century Max Weber and Walter Eucken, in particular, discussed the relationship between law and economics. Max Weber devoted a whole chapter in his monumental work *Economy and Society*[7] to the sociology of law. He underlined how important the foreseeability of law is for economic activity.[8] Walter Eucken, member of the Freiburg School and one of the most important economic thinkers for the West German post-war economic system,[9] formulated the relationship even more explicitly: he recognized several legal institutions such as property and liability as constitutive elements of a market economy.[10]

At the end of the last and the beginning of this century there were a few important examples of what I tend to call the 'adoption model of legal reform': reforming countries which adopted foreign laws more or less wholesale. In Japan the 1868 Meiji Restoration began a period of 20 years of institutional modernization. It resulted in the adoption of a number of foreign codes, initially French influenced. At a later stage the French models were replaced by German laws, notably the German commercial and penal codes. Kemal Atatürk's Turkey also attempted to support economic progress by adopting foreign laws, for example the Swiss Civil Code.

The use of legal reform as an active and deliberate tool for economic development re-emerged as part of the 'law and development programmes' in the 1960s. The

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3 *See* for early developments Douglass C. North and Robert Paul Thomas, *The Rise of the Western World. A New Economic History* (Cambridge, 1973).

4 *See* John Kenneth Galbraith, *Economics in Perspective. A Critical History, Boston* (1987); Robert Heilbronner, *Worldly Philosophers. The Lives, Times and Ideas of the Great Economic Thinkers* (London, 1991, 6th ed.).

5 *See* Adam Smith, *Theory of Moral Sentiments* (D.D. Raphael and A.L. Macfie (eds.)) (Oxford, 1979).

6 *See* Adam Smith, *Lectures on Jurisprudence* (R.L. Meek D.D. Raphael and P.G. Stein (eds.)) (Oxford, 1978).

7 Max Weber, *Wirtschaft und Gesellschaft. Grundriß der verstehenden Soziologie*, (Tübingen, 1972, 5th ed.).

8 *Supra*, at pp. 184, 195–198.

9 *See* David J. Gerber, 'Constitutionalizing the Economy: German Neo-Liberalism, Competition Law and the New Europe' in (1994) XLII *AJCL*, at pp. 25–84; Andreas Heinemann, *Die Freiburger Schule und ihre geistigen Wurzeln* (Munich, 1989).

10 Walter Eucken, *Grundsätze der Wirtschaftspolitik* (Tübingen, 1990, 6th ed.).

whole concept of development of so-called 'developing' countries had appeared in the 1950s and came to be seen as an important task for the so-called 'developed' countries,[11] many of which were former colonial powers. The 'law and development programmes' went through various phases each of which was characterized by a different emphasis. A first phase lasted from the early 1960s to the mid-1970s. During this phase aid agencies financed many legal technical assistance projects in Africa, Asia and Latin-America. For example, foreign legal advisors were sent to developing countries and assisted governments with economic law reforms. It was assumed that legal change would lead to legal systems in developing countries largely similar to those in Western developed countries. This assumption seemed to be rational because many legal systems in the now developing countries were based upon civilian or common law systems inherited from the colonial era. However, progress was slow and results often remained intangible because legal reforms were pursued in countries not committed to market economy and pluralistic political systems. As a consequence, by the mid-1970s, funding for many legal assistance projects had almost ceased.

The 'law and development movement' received a new impetus in the 1970s by what a USAID study[12] has called the 'New Directions Mandate'. During this second phase donors focused on the specific needs of the poor. It sought to alleviate poverty and comprised such diverse efforts as improving access to justice and legal literacy as well as activities in the area of human rights. In the 1980s a third phase of the law and development movement was geared towards issues of administration of justice. Various projects attempted to strengthen court procedures, i.e. the enforcement of rights. Both the activities of the second and the third phase of the law and development movement remained largely invisible.

The break-up of the former communist bloc marked a significant change. Legal technical assistance increased dramatically since, in Central and Eastern Europe, wholesale revamping of legal systems was seen as part and parcel of the transition from state-planned central economies to market-oriented economies. Hence, in the 1990s legal reform became an integral part of the policy advice, not only of the technical assistance programmes run by many individual countries but also, of international organizations. Legal and economic transition in Central and Eastern Europe coincided with a growing recognition of the private sector as an active player notably in the area of infrastructure investments; it was acknowledged that private sector activity necessarily requires a predictable legal framework.

In the 1990s legal reform as a tool for economic reform is, however, not restricted to countries of the former communist bloc but has become a global phenomenon.

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[11] *See* Guy Feuer and Hervé Cassan, *Droit international du développement* (Paris 1991, 2nd ed.).

[12] 'Weighing in on the Scales of Justice: Strategic Approaches for Donor-Supported Rule of Law Programs', Washington, DC, 1994.

The World Bank[13] and the Asian Development Bank particularly run comprehensive legal reform programmes in their respective member countries. In recent years there seems also to have taken place a shift in the reform tools. It now seems to be recognized that there are no universalist solutions to the improvement of legal frameworks; the transplantation of Western legal models without regard to local circumstances is seen as counter-productive. The 'adoption model of legal reform' has been supplanted by a 'choice model of legal reform' in which the ultimate choices are made by national decision makers.

B. Transition, the European Bank and Secured Transactions

The European Bank for Reconstruction and Development (EBRD) is an international organization providing financing for projects in the transitional economies of Central and Eastern Europe. Its mandate is to 'foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative'.[14] Its charter puts special emphasis on the Bank's private sector activities because it requires the Bank to lend and invest at least 60 per cent of its capital in the private sector.[15] In this respect the Bank is, however, able to invest in projects which are state sector projects initially and become private sector projects subsequently by way of privatization of the project company.[16]

The Bank's activities are not limited to project financing; it also assists in legal reforms across the region.[17] Involvement in legal reforms complements its investment activities because the transformation process will only be successful in the long term if it is based on adequate institutions.[18] The replacement of command systems by market-oriented economies, and of one party controlled regimes by

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[13] *See* World Bank Legal Department, 'The World Bank and Legal Technical Assistance. Initial Lessons', Policy Research Working Paper 1414, Washington, DC, 1995; Andrew N. Vorkink, *The World Bank and Legal Technical Assistance. Current Issues* (Washington, DC, 1997).

[14] Art. 1 of the Agreement Establishing the European Bank for Reconstruction and Development, signed in Paris on 29 May 1990 by 40 countries.

[15] Art. 11(3)(i), (ii) of the Agreement Establishing the Bank.

[16] The whole project is qualified as a private sector project; *see* Art. 11(3)(iii) of the Agreement Establishing the Bank.

[17] *See generally* Andre Newburg, 'Some Reflections on the Role of Law in the Transition Process' (August 1995) *International Practitioner's Notebook*, Nos. 58 and 59, at pp. 22–24.

[18] *See European Bank for Reconstruction and Development*, Transition Report 1994 (London, 1994), Transition Report 1995 (London, 1995) and Transition Report 1996 (London, 1996); Douglas C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge, 1990).

democratic institutions governed by the rule of law, requires a complete overhaul of the laws and institutions of the former communist countries.

As part of its legal reform efforts the Bank developed a Model Law on Secured Transactions. A secured transactions law is needed in a market economy because it strongly influences how investors assess their investment risk. It may influence their decision whether to invest or not; it may also change the terms on which they are prepared to invest (typically by lowering the interest on a loan, by extending the time for which money is given and by extending the scope for debt financing as opposed to equity financing).[19]

C. History of the Model Law on Secured Transactions[20]

In April 1992 the European Bank held a Round Table discussion at its First Annual Meeting in Budapest. It dealt with 'Creditor's Rights and Secured Transactions in Central and Eastern Europe'. There was a lack of adequate security rights across the region. Stanislaw Soltysinski and Petar Sarcevic made the suggestion at this Round Table that the need for modern secured transactions laws may best be addressed by way of developing a Model Law.

The idea of a Model Law on secured transactions (albeit limited to movable property) had already been pursued in the 1970s and early 1980s by the United Nations Conference on International Trade Law (UNCITRAL). The most significant result at the time was a comparative report produced by Ulrich Drobnig.[21] The project was, however, halted because the differences between various security regimes around the world were deemed to be too great to draft a Model Law which would bridge differences particularly between common and civil law jurisdictions. When the European Bank started its work there was, therefore, no international Model Law to draw upon.[22]

From the very beginning the Bank involved in the project lawyers from Central and Eastern Europe. They were invited to an international Advisory Board. This Board comprised of 20 members, all of them respected security experts from around the world. A set of draft provisions was prepared which was presented and discussed with the Advisory Board and a general audience at the Bank's Third Annual

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[19] Jan-Hendrik Röver, *Vergleichende Prinzipien dinglicher Sicherheiten. Eine Studie zur Methode der Rechtsvergleichung* (PhD thesis, Munich, 1997) (hereafter cited as: Röver, *Vergleichende Prinzipien*), s. 7 III 3.

[20] *See* in more detail Röver, *Vergleichende Prinzipien*, s. 5 II.

[21] Ulrich Drobnig, 'Legal principles governing security interests' (document A/CN.9/131 and annex) (1977) VIII *UNCITRAL Yearbook*, Part 2, II, A, at pp. 171–221.

[22] For an overview of the various efforts to reform secured transactions law by way of international or supranational instruments *see* Röver, *Vergleichende Prinzipien*, s. 4 II.

Meeting 1994 in St Petersburg[23] after consultations with both the members of the Advisory Board and also a large number of other interested parties.

D. Model Law as a Technique for Legal Reform

Model laws are themselves not applicable laws; they serve as examples which have to be implemented as national laws. However, they often intend to harmonize areas of law. Their aim is to be adopted by a number of countries more or less wholesale. Examples are the UNCITRAL Model Law on International Commercial Arbitration which has by now been adopted by about 100 countries or the UNCITRAL Model Law on International Credit Transfers. The American Uniform Commercial Code offers an example for an intra-state Model Law intending to harmonize an area of law within one country.

There is a second type of Model Law which pursues a more modest purpose: it wants to be of assistance to national legislation. The EBRD Model Rules belong to this category of Model Laws. Their primary function is not a harmonization of the law, nor are they intended as a complete law for turn-key incorporation into local law. This is the result of a number of factors. The area of secured transactions does not lend itself to international unification. It is very much dependent on many areas of national law such as contract, property, civil procedure and insolvency law. Not surprisingly the variety of solutions in the area of secured transations is enormous as the Drobnig study[24] demonstrated. In addition, an international consensus about the fundamentals of secured transactions is only about to emerge. This is in stark contrast to the field of international sales of goods, for example, where after 50 years of successive attempts the Vienna Convention on the International Sale of Goods finally provided a successful instrument. The lack of an existing Model Law for secured transactions served as a healthy warning not to be too ambitious.

The first aim of the Model is to raise awareness about the importance of secured transactions in a market economy. As proper security is one of the most important concerns of an investor when considering a project it seemed appropriate to emphasize the need for adequate security legislation by providing a sample text. The World Bank illustrated this aspect by embarking on a number of Secured Transactions Projects for Central and South American and Asian countries in the process of which it has made available the European Bank's work.[25]

Another aim is to provide a starting point for the drafting of security legislation. It is no more than a starting point. The Bank has recognized that Central and

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[23] *See* 'European Bank for Reconstruction and Development, Model Law on Secured Transactions', speeches given at the Presentation of the Model Law during the Third Annual Meeting of the EBRD on 16 April 1994 in St Petersburg (London, 1994).

[24] *See supra* note 21.

[25] *See* Röver, *Vergleichende Prinzipien*, s. 4 I 2, 3.

Eastern European countries have developed legal systems where a new security law has to be integrated carefully. However, the Model Law may be a valuable reference point in the drafting process.

The drafting of a Model Law particularly for the transition economies in Central and Eastern Europe was encouraged by two factors. Although far from being a region with a common legal tradition, the laws of Central and Eastern European countries are on the one hand influenced by the Continental legal tradition and on the other they all lacked adequate rules on secured transactions at the beginning of the transition process.

It is too early to make predictions about any harmonization of secured transactions laws in Central and Eastern Europe which may come about because of the influence of the Model Law on the drafting of security laws in transition economies. Any convergence of principles of security laws in the region resulting from the Model Law would be welcomed but such harmonization is not actively sought at this moment.

E. Structure of the Model Law

The text of the Model Law is divided into five main parts. Part 1[26] contains general provisions which determine who can give a charge and who can receive a charge, as well as general rules concerning the secured debt and the charged property. Part 2[27] deals with rules on the creation of charges and introduces the general distinction between registered charges which have to be registered in a charges' register, possessory charges for which registration is not required but where the charge holder takes, and must retain, possession of the charged property and unpaid vendor's charges which protect suppliers of goods who seek a retention of title. Part 2 also contains rules about the defences of a charger against a charge and the rights and obligations of charger and charge holder, and introduces the idea of a charge manager who is designed to stand in the place of the charge holder for most dealings concerning the charge. Part 3[28] provides for the cases where third parties are involved, in particular the priorities between different charge holders, the transfer of a secured debt (and a charge), the licence of the charger to deal in charged property and the acquisition by third parties of things or rights which are subject to a charge. Part 4[29] sets out a system of enforcement proceedings. The rules of enforcement will have to be adapted to local procedural rules. The Model Law has to interface with local insolvency laws; it was thought, however, that the scope of the Model Law

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[26] Arts. 1–5.
[27] Arts. 6–16.
[28] Arts. 17–21.
[29] Arts. 22–32.

should be limited to secured transactions law proper and, therefore, Article 31 contains only a few general principles to be taken into account by local insolvency legislation. Part 4 is completed by a definition of the different events which cause a charge to terminate. Lastly, Part 5[30] sets out rules for registration at a separate charges' register. These will need to be supplemented according to the needs of each country.

F. Some Typical Provisions of the Model Law

Although it is impossible to explain the details of the Model Law within the confines of this article a few typical provisions can demonstrate the general approach and style of the text.[31]

I. Single security right

The Model Law is based on the idea of a single security right for all types of things and rights.[32] The single security right is called a 'charge'. This name may seem unfortunate because it could lead to the misunderstanding that the security right under the Model Law is based on the notion of the English security interest 'charge'. The term 'charge' is, however, only a linguistic borrowing from the English language. The security established by the Model Law is subject to the rules of the Model and has little in common with the English charge. The word 'security', on the other hand, was not used for the right created by the Model because it can be, and often is, confused with 'securities' in the sense of 'negotiable instruments'.

Calling the charge a 'single security right' provides a comfortable label. It does, however, not say in which sense the right is a unitary one. One has to distinguish several aspects in order to understand the concept of a single security right. First, the Model is applicable to all types of property. Article 5.2 of the Model emphasizes this wide scope of application. Secondly, the general provisions of the Model in Articles 1 to 5 apply to all charges. Thirdly, the provisions on the involvement of third parties in Articles 17 to 21 apply equally to all charges. The same can be said about the provisions on enforcement in Articles 22 to 32 and the insolvency principles of the Model Law.[33] The Model does not, however, create a single right as far as the creation of the charge is concerned. It distinguishes three different ways of creating a charge.[34]

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[30] *See* Arts. 33–35.

[31] For a restatement of the main concepts of the Model Law in the form of principles, *see* John Simpson and Jan-Hendrik Röver, 'General Principles of a Modern Secured Transactions Law' in (1997) III *NAFTA Law Review*, at pp. 73–81.

[32] Art. 1.1; for a comparative overview *see* Röver, *Vergleichende Prinzipien*, ss. 11, 12.

[33] Art. 31.

[34] *See* V. *infra* text to notes 51–53.

Hence, the concept of a single security right is to create in principle a single charge, regardless of the nature of the property, the character of the debt, or the attributes of the person giving or receiving the charge. The Model does, however, not go as far as the so-called functional approach of Article 9 of the Uniform Commercial Code of the United States which covers 'any transaction which is intended to create a security interest'.[35]

II. Right in property[36]

The charge is a limited right in property[37] and not a mere contractual obligation. The liability of the charger is limited to a right to sell the charged property in enforcement proceedings.[38] Proprietary qualities of the charge are also demonstrated by the fact that charged property can in principle not be acquired by third parties free from the charge[39] albeit there are exceptions to this rule.[40] The Model Law also indicates that the charge must give priority in the insolvency of the charger over unsecured creditors.[41] However, this is only formulated as a principle. Issues of insolvency law were generally left to national law.

III. Securing business credits[42]

An important limitation of the scope of the Model Law must be highlighted which also emphasizes its nature as a mere model.[43] The Model is limited to securing business credits. A natural person can only give security in relation to business transactions and not for consumer transactions. The reason for this restriction is that the Bank did not want to enter the difficult and highly political field of consumer protection. The Bank also saw the more immediate need in improving the business environment. However, the Model can be extended to also cover consumer transactions. This will require the addition of adequate rules on consumer protection. The basic elements for secured transactions in a business context and in a consumer context are the same. It is, therefore, possible to build from the Model Law a more comprehensive system encompassing consumer transactions.

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[35] Section 9–102(1)(a) of the Uniform Commercial Code; *see* Röver, *Vergleichende Prinzipien*, s. 11 II 4.
[36] Arts. 1.1, 26.1, 21.1, 21.2, 31.3; for a comparative overview *see* Röver, *Vergleichende Prinzipien*, s. 9.
[37] *See* wording in Art. 1.1: 'encumbered'.
[38] Art. 26.1.
[39] Art. 21.1.
[40] Art. 21.2.
[41] Art. 31.3.
[42] Art. 2 first sentence.
[43] *See supra* text to notes 24, 25.

IV. Flexible definition of secured debt and charged property[44]

There is a great flexibility in the way in which the parties can describe the debt which is secured and the things and rights which are given as security. The secured debt can be a single debt or more debts, the charged property can be one or more things or rights.[45] In both cases they can be described specifically or generally.[46] They can be present or future and can change during the life of the charge, as long as they are identified at the outset.[47] The Model even allows the charged property to be described as all assets of an enterprise and thereby introduces the concept of an enterprise charge.[48] These principles allow a similar flexibility in describing and identifying secured debt and charged property as can be found under American floating liens[49] or English floating charges.[50]

V. Public registration of charges [51]

The Model works on the principle that charges are a matter for public knowledge. Since Roman law there has been scepticism about the idea that a person may create secret rights in its assets. A person who gives assets as security but does not indicate this to his potential creditors creates an impression of 'false wealth'. The Model achieves publicity mainly by relying on registration of charges at a separate charges' registry. It does not put its emphasis on possession as a means of achieving publicity because efficient business finance requires chargers to be left in possession of charged assets to work with them. The Model Law's registered charge provides a legal framework to achieve this objective. Unlike common law systems which regard registration as a requirement for perfection of a security interest which has previously attached, the consequences which flow from the registered charge depend on a registration statement being presented to the registry.

This system obviously requires the existence of a registry for charges. The registry should possess the information necessary for third parties to become aware of charges and to make informed investment decisions. The information required to be registered should be minimal. The Model Law aims at making the procedure as simple and as cost-efficient as possible for the parties while still providing sufficient information on the register for third parties to be adequately informed.

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[44] Arts. 4.1, 5.1; 4.3.2, 7.3.2; 5.5, 7.3.4, 8.4.4; 4.3.4, 4.4, 5.8, 6.8; 5.6.
[45] Arts. 4.1, 5.1.
[46] Arts. 4.3.2, 7.3.2; 5.5, 7.3.4, 8.4.4.
[47] Arts. 4.3.4, 4.4, 5.8, 6.8.
[48] Art. 5.6.
[49] Barkley Clark, *The Law of Secured Transactions under the Uniform Commercial Code* (Boston Mass., 1993), chapter 10.
[50] Roy Goode, *Commercial Law* (London, 1995, 2nd ed.), chapter 28.
[51] Arts. 6.1.1, 6.2.2, 8, 33–35.

However, the Model Law recognizes possessory charges which do not require any registration but the taking of possession.[52] Another exception from the requirement is the unpaid vendor's charge.[53] Its purpose is to avoid registration for short-term credits in the context of the sale of goods.

VI. Broad rights of enforcement[54]

Part 4 of the Model Law regulates the end of the life of a charge which can occur by virtue of enforcement or other events of termination. Enforcement aspects are essential for the proper working of security. The Model, therefore, contains detailed rules on enforcement. It must, however, be seen on a jurisdiction-by-jurisdiction basis how these rules can be adapted to an individual legal system and can be tied in with the existing court procedures. The central aim of the enforcement mechanism is to provide, as much as possible, for a cost-effective and speedy self-help regime for the charge holder without the need to rely on recourse to a court.

The beginning of this process depends on the charge becoming immediately enforceable[55] which by definition requires that there is a failure to pay the secured debt.[56] There is no requirement of a separate court order to enable the person taking security to enforce his charge but he must deliver an enforcement notice to the charger in order to inform the charger about the beginning of enforcement proceedings. The remainder of Part 4 of the Model Law sets out rules for the procedure which applies when a charge holder seeks to enforce his charge.

Articles 23 and 24 govern the next step in the quest of the charge holder for satisfation of the secured debt. Article 23 sets out measures for the protection of the charged property. These measures relate, for example, to taking possession of movable things[57] and the maintenance of charged property's value.[58] The charge holder is also empowered to apply to the court for orders in relation to protecting the charged property.[59]

Once protection is assured the charge holder may rely on the measures for realising the charged property.[60] The person holding the charge is being given broad, but clearly defined, rights to sell the charged property in whichever way he considers most appropriate. The means of transfer by way of sale is therefore flexible[61] while

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[52] Arts. 6.1.3, 6.4, 10.
[53] Arts. 6.1.2, 6.3, 9.
[54] Arts. 22–30.
[55] Art. 22.2.
[56] Art. 22.1.
[57] Art. 23.1.
[58] Art. 23.4.
[59] Art. 23.5.
[60] Art. 24.
[61] Art. 24.4.

the charge holder is obliged to endeavour to realize a fair price.[62] Purchasers of charged property from either a charge holder or an enterprise administrator are protected by Article 26 and acquire title to charged property under this provision.

Any interested party may apply for court protection[63] and claim damages for loss suffered as a result of wrongful or abusive enforcement.[64] Persons who may be entitled to the proceeds of sale are further protected by the requirement that distribution be made through a depositary of the proceeds.

VII. Enterprise charge[65]

The Model Law opens the way for taking a charge over all the assets of an enterprise.[66] In addition, if the charge is an 'enterprise charge' the charge holder may choose an alternative way of enforcing the charge by appointing an 'enterprise administrator' and by selling the enterprise as a going concern.[67] The Model, therefore, provides an additional procedure for cases in which a charge has been taken over all the assets of an enterprise. The main purpose of this procedure is to prevent liquidation and to keep the enterprise alive as a going concern. Thus, it allows for an enterprise in financial distress to be rehabilitated while potentially increasing the amount recovered by creditors. Under the provisions relating to enterprise administration, the enterprise administrator is in the position of carrying on the business of the enterprise and finally selling it as a going concern. Such a remedy would necessarily have to be applied in a manner consistent with local insolvency law.

VIII. Minimum restrictions

Traditionally, property law in civil law countries consists predominantly of mandatory provisions. In many respects this is also true for the Model Law. Nevertheless, the parties to the charge are given maximum flexibility to arrange their relationship as best suits their needs. Mandatory requirements and restrictions on what the parties can agree have been kept to a minimum. The flexibility resulting from this policy is best seen in the wide freedom of the parties to determine the secured debt and the charged property.[68]

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[62] Art. 24.3.1.
[63] Art. 29.
[64] Art. 30.
[65] Arts. 5.6, 8.4.5, 22.7, 25.
[66] Art. 5.6.
[67] Art. 25.
[68] *See* IV. *supra* text to notes 44–50.

G. Use of the Model Law [69]

The fundamental objective of the Model Law has been to encourage the countries of Central and Eastern Europe to improve their legal frameworks for secured lending for the benefit of creditors and borrowers, thereby assisting these countries in the transition process. In this respect it must be recognized that the drafting of legislation is only one of the initial steps in putting into place a complex system in which many parts interact with each other. Institutions and rules for the registration and publication of charges, for their enforcement and for their recognition in insolvency proceedings, have to be established and put into practice. The Bank's role in this process, in which the Model Law has served as a valuable reference point, consists of initiating discussion about a workable secured transactions environment and in defining achievable objectives, proposing revisions to existing laws or draft laws, exchanging views with policy and law makers on the rationale for such revisions and providing training to all those who have to apply a secured transactions system.

When the European Bank presented its Model Law on Secured Transactions in 1994 there were many questions about the practical value of this effort. The *Financial Times'* Eastern European Business Law put it most bluntly: 'A Model Law with nowhere to go?'[70] Three years later there are tangible results of the EBRD's work and it is now also possible to put criticism into perspective. The Model Law project has indeed been of benefit in that it has helped to stimulate practical legal reforms in many of the Bank's countries of operations. Particularly prominent has been the example of Hungary. Work on a new Hungarian draft security law was furthered by the Model Law and there was an exchange of information during the drafting of both laws. This co-operation was facilitated by Attila Harmathy being both a member of the Bank's Advisory Board and the Chairman of the Hungarian Security Law Reform Commission. The draft law has been passed by the Hungarian Parliament in April 1996 and the Bank has also assisted in the subsequent implementation of a computerized registration system.[71] Although the new Hungarian security law has been drafted quite independently of the Model Law,

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[69] *See* for more details John Simpson and Jan-Hendrik Röver, 'The EBRD's Secured Transactions Project: a progress report' (spring 1996) *Law in Transition*, at pp. 20–24; Carsten Dageförde, 'Five Years of the Secured Transactions Project – A Survey' (spring 1997) *Law in Transition*, at pp. 12–13.

[70] May 1994, at pp. 2–5.

[71] *See* for first reports: Istvan Gardos, 'New Hungarian legislation on security interests: an improvement in the Hungarian secured lending environment' (summer 1996) *Law in Transition*, at pp. 1–6; Judith Bokai and Orsolya Erdös Szeibert eds.), 'Die Mobiliarhypothek und deren Register', *in Bundesnotarkammer Festschrift für Helmut Schippel zum 65. Geburtstag* (München, 1996), at pp. 843–868; John L. Simpson, 'New System for the registration of charges in Hungary' (summer 1996) *Law in Transition*, at pp. 7–10.

there are a number of parallels between the principles underlying both texts. Foremost of these is that both texts are based on the concept of a single security right for all types of property.[72] As far as the creation of charges is concerned, the Hungarian Civil Code distinguishes mainly between mortgages over land which have to be registered in the land register,[73] registered charges over other types of property[74] which have to be registered in a charges' register held by the Hungarian Chamber of Notaries and pledges[75] which require a transfer of possession. The Hungarian law also allows great flexibility as to the ways in which the parties can describe and identify the secured debt and the charged property. Furthermore, it introduces public registration as the rule for the creation of charges.[76] In addition, enforcement does not necessarily require a court decision but can be initiated on the basis of a notarized document.[77] The law even introduces an enterprise charge and allows to charge all the assets of an enterprise;[78] in contrast to the Model Law it does not, however, provide for the remedy of a sale of an enterprise as a going concern. It should be noted that the enterprise charge is an institution which was already known to Hungarian law as early as in the 1920s.

Most recently the Moldovan Parliament passed a Security Act incorporating many principles of the Model Law.[79] Consultation and co-operation with national officials in connection with the preparation of new secured transactions legislation has also taken place in a number of other countries, including Azerbaijan, Bulgaria, Kyrgyzstan, Latvia, Poland, Romania, the Russian Federation and Slovakia. In November 1994 the Model Law was used alongside Article 9 of the United States' Uniform Commercial Code and the pledge provisions of Part 1 of the new Russian Civil Code, as a framework for discussion of secured commercial lending in the CIS at a conference in Moscow.[80] The conference stimulated the drafting of a new Russian Mortgage Act, the draft of which the Bank commented on extensively.

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[72] *See* s. 251(1) of the Hungarian Civil Code.
[73] Section 260(1).
[74] Section 260(2).
[75] Section 261(1).
[76] Section 260.
[77] Section 262(2).
[78] Section 254.
[79] Act No. 601 'Lege cu privire la gaj' (20 September 1996) *Monitorul Oficial al Republicii Moldova,* Nos. 61–62, at pp. 28–33.
[80] *See* Jonathan Bates *et al.* (eds.), International Conference on Secured Commercial Lending in the Commonwealth of Independent States, Conference Proceedings, London, Maryland 1995.

H. Critique of the Model Law

Critical comments on the Model Law have focused on three questions:[81]

(a) whether or not the inclusion of immovable property and thereby the creation of a charge encompassing all types of security was adequate;
(b) whether or not the unpaid vendor's charge concept creates a regime which is too favourable to credit sellers; and
(c) whether or not the enforcement provisions are too protective and therefore too much in favour of the charger.

I. The inclusion of immovable property

The Model Law has indeed, from its earliest stages of development, been designed to include immovable property; both the Hungarian and the Modovan security laws have embraced this approach. This inclusion is not an essential element, but a rigid exclusion of immovable property would have been against the underlying philosophy of establishing a facilitative legal framework for all types of secured transactions. At the same time it has always been acknowledged that security laws often make a distinction between security in land and security in movables. This may also be a convenient approach for many countries in Central and Eastern Europe, particularly where the concept of a separate land mortgage is practised and where a working land registry is in place. However, the Model Law is intended to represent a starting position and, for a country which has no existing regime for security over immovable property, there is no reason why in substance the legal nature of a charge as a property right should not be the same for both movable and immovable property. All security rights can be reduced to the same conceptual foundations.[82]

In many jurisdictions title to land will be shown in a separate register. In that case, under the Model Law, registration of a charge also in the separate register would be required under Article 11. If the charge over land is not registered in the charges' register but only in the land register the value to potential creditors of a search at the charges' registry is reduced. The position of other types of property with title

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[81] *See* John A. Spanogle, *EBRD Model Law on Secured Transactions* (Washington, DC, 1994); John Simpson and Jan-Hendrik Röver, *EBRD Model Law on Secured Transactions, A Response to Comments by John A. Spanogle* (Washington, DC, 1995); John A. Spanogle, *A Functional Analysis of the EBRD Model Law on Secured Transactions in Emerging Financial Markets and Secured Transactions* (London, The Hague, Boston, forthcoming); Karl Kreuzer, *The Model Law on Secured Transactions of the EBRD from a German Point of View in Emerging Financial Markets and Secured Transactions* (London, The Hague, Boston, forthcoming).

[82] *See* F.H. Lawson and Bernard Rudden, *The Law of Property* (Oxford, 1982, 2nd ed.) at pp. vi, 78, 146, 225–226; *see also* English Property Act 1925 whose title is: 'An Act to Assimilate the Law of Real and Personal Estate.'

registered in a separate register (for example, ships) is similar. At a later stage it will be possible to introduce registration systems with automatic computerized linkage between different registers. In the meantime the inconvenience of dual registration has to be weighed against the advantage of easily accessible information.

II. The tale of two creditors: lender and credit seller

Early consultations during the drafting process of the Model Law indicated a strong desire to include the credit seller in the scope of the Model and this led to the inclusion of the concept of an unpaid vendor's charge. Retention of title has become an accepted practice in much of Europe and it was felt that if the Model avoided the issue uncertainty would arise for lenders as to whether title to property had passed to a borrower, or had been retained by the supplier, as well as on questions of priority. The unpaid vendor's charge transforms the security of the unpaid vendor for a limited period of six months into substantially the same right as that of the registered charge holder. In addition, the Model envisages a very simple means of converting an unpaid vendor's charge into a registered charge.[83]

The relative priorities of lender and credit seller are essentially an economic question. In any market economy the supply of goods on credit and the lending of money are both important components. If a supplier has no security over the goods he has supplied he is less likely to agree to credit. If the supplier is given security then a lender is less likely to grant credit on the basis of security over the same goods. Two parties cannot be expected each to grant credit on the basis of the same security unless they are persuaded that it is adequate to cover both of them. Somewhere a balance has to be struck and the Model seeks to do this in the context of jurisdictions where secured lending is new and many businesses may rely on the credit that is given to them by their suppliers. The attraction of inventory financing has to be set against the dangers of businesses raising money against the security of assets that they have not paid for and the lender taking priority over the unsuspecting supplier.

The idea of requiring registration for all unpaid vendor's charges (and thereby adhering to the principle of publicity) was rejected since it would favour the major sophisticated supplier and the lender over the small supplier who would find registration more of a burden, both psychologically and administratively. The absence of registration makes it more difficult for potential lenders to determine with any certainty whether a charge exists over recently acquired assets. No system of registration can produce perfect transparency which reveals all limitations on a person's right to the property he appears to own. In practice lenders may have to assume that any property of a borrower that has been acquired within the preceeding six months is subject to a charge unless the borrower demonstrates that the vendor has been paid or that no charge has been created.

The system provided in the Model does not preclude lending secured on

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[83] Art. 8.2.

inventory. However, the lender who relies on security over the inventory has to ensure that the same inventory has not been supplied by a vendor in reliance on an unpaid vendor's charge. This is similar to the position in many jurisdictions where retention of title provisions is commonly included in sale contracts. There are many ways in which the lender can protect himself by contract (such as by ensuring that the vendor is paid, by ensuring that no vendor's charge is created in the first place or by supplementing his security).

III. Enforcement provisions of the Model Law

It has always been recognized that the enforcement provisions will have to be adapted to existing civil procedural laws of a country even more than other parts of the Model Law. They can, therefore, only give a first idea of what a workable enforcement system for secured transactions might look like. It is, however, important to realize that the Model Law does not try to promote single-sidedly the interests of the charge holder. It seeks to strike a balance between interests of both charger and charge holder. As the charger faces the danger of losing his rights in the charged property he must have a way of challenging improper acts of the charge holder. Also the interests of other parties with rights in charged property cannot be ignored. Where protections lead to a loss of efficiency in the security regime this is counter-balanced by a gain in social peace.

I. Conclusion

The Model Law has demonstrated that it can serve as a basis from which national laws can be developed. It is an example for law reform assistance which does not rest on a ready-made solution taken from a specific national law. The basis from which the Model Law was built is rather a set of principles derived primarily from comparative research.[84] Therefore, the Model Law enables an application of what was earlier called the 'choice model of legal reform'. Both the method of using a Model Law for the purpose of law reform and the principles of secured transactions law underlying the Model (if not its actual text) may stimulate future reform work. It may well be that this exercise of developing modern legislation for secured transactions in Central and Eastern Europe will even provide useful lessons for other parts of the world.

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[84] For a discussion of general principles of secured transactions law *see* John Simpson and Jan-Hendrik Röver, 'General Principles of a Modern Secured Transactions Law' in (1997) III *NAFTA Law Review*, at pp. 73–81; for a discussion of the principles method of comparative law which can facilitate law reform *see* Röver, *Vergleichende Prinzipien*, s. 6.