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Secured Credit for Jobs and Economic Growth

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Introduction

This report briefly reviews the opportunity Bangladesh may find for increased business credit through improved legal and institutional support. The report examines the weaknesses of substantive law in Bangladesh relating to movable property financing. The report outlines concrete policies that would improve the legal climate for movable property financing law. The report's appendix contains a draft proposal that might be used to develop a legislative expression of the policies necessary to bring Bangladesh law from its 19th century approaches to 21st century commercial realities.

There is no effort here to pretend that deficient law is the only obstacle to business credit in Bangladesh. Macroeconomic conditions are crucial. Quality performance by courts is necessary for enforcement of property rights. In fact, creditors often assert that enforcement is the problem, not the law. This report disagrees with that assertion. Substantive law is a problem. It is true that the best law will be of little use to creditors if it is not enforced or if it is improperly enforced. But it is equally true that perfect enforcement machinery would be useless to creditors if policy toward movable property financing remains opposed to the needs of modern commerce, expressed in anachronistic rules interpreted by those whose hands are tied by misguided and inconsistent rulings of the past.

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In modern commerce, access to credit often requires the effective use of movable property to secure payment of obligations. Creditors generally desire some form of security beyond a mere promise to pay, in exchange for business credit. Creditors often prefer land and buildings (immovable property) as security, even though other property (manufactured goods, stock in trade, or accounts receivable) may be more valuable. In developing countries, this is often because the law on movable property as security is weaker than the law on mortgage of land and buildings.

Unfortunately, large and small businesses in rich and poor countries generally have insufficient land and buildings to secure business loans. If a business has immovable property, the property is often mortgaged to creditors whose funds have made the purchase possible.

Over the past forty years in the U.S., and over the past decade or so in Canada, the law on movable property as collateral has developed markedly from 19^{th} century law and tradition. The result has been an explosion of credit for everyone – consumers, and businesses of all sizes. The focus of the reformed law has been:

- To simplify, unify, & codify the rules by which movable property is claimed as collateral,
- To guarantee prospective creditors access to quick, inexpensive, and reliable information about the status of encumbrances upon a prospective debtor's movable assets,
- To assure creditors of their respective priority in the debtor's assets, in the event that the debtor disposes of the collateral, or in the event that competing creditors stake claims to it,
- To assure creditors, upon the debtor's default, speedy and inexpensive access to the collateral to help satisfy the debt.

Some of the benefits of secured credit are the following.

Equipment financing. New equipment revitalizes industry, lifts operations to today's standards, and creates jobs.

Agriculture inputs. Increased credit for crop and livestock production improves productivity, adds value to domestic production, and reduces reliance on imports.

Consumer goods financing. Consumers have easier access to credit for automobiles and appliances. Consumer purchasing power promotes businesses that produce, sell, repair and maintain consumer goods.

Building improvements. Movable property is often used to improve immovable property. New electrical generators, water tanks, wells, pumps, and elevators are easier to obtain under modern law.

Public facilities. The state may use movable property more effectively as collateral to purchase equipment for road building and maintenance, dock construction, and for the improvement of other important state facilities.

Inventory financing. Sellers of computers, automobiles, tractors, office machinery, and other necessary business equipment frequently need easy access to credit to buy the goods that they sell in their stores.

Cash flow financing. Sellers of goods often want to provide credit to customers. Seller financing promotes sales and provides an alternative to bank financing. Under modern law, sellers can easily sell their customer accounts to factors, or get cash flow financing using the accounts as collateral.

Importing, exporting, & transportation. Bangladeshi businesses can borrow more securely and at lower cost for import, export, and transportation of goods, using documents of title, letters of credit, warehouse and shipping receipts as collateral.

Stronger banking. Banks must persuade regulators that loan portfolios are secure. Modern law provides much greater security to banks and regulators, building a stronger banking system.

1. The legal formalities of movable property financing.

Movable property is used to secure loans under all legal systems. A secured loan should create two rights in favor of the creditor. The first arises from the monetary obligation. The creditor's right to payment is known under the law as an *in personam* right – a right against a person. The second is a property right, not against a person but against the collateral. The creditor's right in the property is known as an *in rem* right – a right in “the thing.” Distinctions between rights *in rem* and rights *in personam* have been recognized since the age of the Roman Empire. They later became part of the British legal system, and consequently a part of the legal heritage of Bangladesh and the United States.

Whenever movable property is taken as security, the law requires some theory by which the creditor claims, and by which the creditor may enforce, an *in rem* right in movable property – the collateral. Without property rights in the collateral, the creditor is left entirely to the resources of the debtor to pay the monetary obligation on the strength of rights against the debtor personally. Without property rights in collateral, a secured loan is no better than an unsecured loan, until the creditor obtains a court judgment granting the creditor rights in the debtor’s property. Dozens of forms of transactions have been invented in many countries, in an attempt to provide creditors with the property rights in collateral they need. Bangladesh law attempts to adopt a few. Pledge, hypothecation, and the financial leases are the forms of transaction most commonly used by Bangladesh creditors. A trust receipt system is occasionally used for inventory financing purposes.

a. Pledge

The pledge is perhaps the oldest transaction by which movable property is taken to secure an obligation, having been codified as early as in Roman times. The law of Bangladesh on pledge is found in the Contract Act of 1872, sections 172 to 181.

In short, a debtor (the pledgor, or pawner) may give a pledge to a creditor (the pledgee, or pawnee) in movable property for the purpose of securing on obligation. The creditor is obligated to take possession of the pledged property while claiming it as security. Upon default, the creditor may dispose of the property and the proceeds will be applied to the secured debt. The debtor is liable for any deficiency. The creditor must provide the debtor with reasonable advance notice of the disposition of collateral.

Creditors in Bangladesh find use for the pledge. For example, creditors may require importers to pledge imported goods in exchange for credit to purchase the goods. Upon arrival in Bangladesh, the creditor takes possession of the goods and releases them to the debtor as the debtor pays for them. The arrangement is not ideal. It is inflexible for the importer – the pay-as-you-go restriction prevents the importer from selling the goods on credit. And the creditor, of course, is saddled with the burden of maintaining control of the goods, the cost of which is passed, of course, to the debtor.

The pledge is unsuitable for most common commercial transactions. Suppose a producer desires a loan to purchase equipment, and would like to pledge the equipment as collateral. The producer needs possession of the equipment to produce goods for sale that enable payment of the obligation. The possession requirement is an anti-commercial obstacle. Suppose a dealer of goods desires cash flow financing to purchase inventory (sometimes called "stock in trade"). The dealer must have possession of the goods to sell them. The formal requirements of the pledge are unforgiving.

Upon the debtor's default, the creditor has the right to sell the pledged property after reasonable notice to the debtor.

b. Hypothecation

Hypothecation is the creative lawyer's attempt to avoid the anti-commercial restrictions of the pledge. Eventually, debtors and creditors had become painfully aware of the inadequacy of the pledge. They persuaded some judges that possession did not necessarily mean actual, physical possession. Possession could be "symbolic," or "constructive." A pledge without possession by the creditor, however, requires a new term. The term "hypothecation" came to be applied to pledges where the creditor's possession is constructive.

Hypothecation, in Bangladesh, is essentially an attempt to create a non-possessory pledge. In the hypothecation agreement, the debtor grants the creditor a "charge" on movable property, and the creditor grants the debtor the right to hold and use the charged property.

The law of hypothecation is not found in any act of parliament. In Bangladesh, it exists in the ether created by court decisions and legal commentators dating at least to the early decades of the 20th century. (See, for example, commentary to section 4 in *Mulla on the Sale of Goods Act* by Harshendu S. Pathak [1992]).

According to local practice, however, the creditor's right to the property does not arise until the creditor obtains an execution order to enforce the charge. If the creditor's property right does not vest until enforcement action is taken, one wonders if Bangladesh law really recognizes an *in rem* right under hypothecation agreements. Without an *in rem* right, the hypothecation agreement gives the creditor no meaningful security. If another creditor should obtain a lien on the property prior to the debtor's default, presumably, the creditor's rights would be subordinate to the lien.

If it is doubtful that hypothecation actually creates an *in rem* right in collateral, the doubt is even stronger to the extent hypothecation agreements are used in inventory financing. Inventory financing arrangements contemplate that most of the charged property will be acquired in the future. Scholarly commentary on the Sales Act is clear that an agreement to sell goods in the future does not create any *in rem* rights because there is nothing in which to create an *in rem* right. Logically, this unfortunate principle should be equally applicable to credit sales, suggesting strongly that hypothecating debtors give precious little of value to the creditor.

Whatever the creditor's right is, it is weak, and it is no wonder that creditors report that hypothecation is general taken only if immovable property is mortgaged first.

In the event that the hypothecation agreement is "registered" (see the discussion of the joint stock company registry, below), the creditor's rights may be safer, based on a Supreme Court decision that upholds a registered hypothecation over subsequently created liens.

Upon default, the creditor has no right to take possession and dispose of the hypothecated property. The creditor must resort to dismal judicial sale procedures.

c. Financial lease

From the U.S. and Canada to many developing countries in Eastern Europe, leasing law has been codified in excruciating detail. But leasing (like hypothecation) remains a creature of court decisions in Bangladesh, abstracted from the general 1872 law on contracts.

In countries where secured credit is weak, some argue that financial leasing is not really secured credit. Therefore, it is important to discuss underlying principles briefly and in very general terms. Under <u>traditional leases</u>, the lessor and lessee agree to terms under which the lessee has the right to possess and use the leased property. The lessee's right is a leasehold right, an *in rem* right in the property. The legal title to the property, ownership, remains in the lessor. Generally, the parties expect the property will have residual value at the end of the lease, and the lessor will re-assume the right to possession and use. Then, the lessor may re-lease the property to the lessee or another person, or use or dispose of the property in any manner deemed desirable. By contrast, under <u>financial leases</u> the parties generally expect the property will have little or no residual value at the end of the lease. The lessor expects that lease payments will be equal to the purchase price of the goods (plus interest) just as if the goods were sold to the lessee. In general, the lessor somehow becomes obligated to transfer title to the lessee completion of the terms of the lease. The "lessor" is really not a lessor at all. The lessor is a credit seller of goods, who is retaining title to the goods (an *in rem* right) to secure the obligation. If the lessor fails to make the prescribed installment payments, the lessor will reclaim the right of use and possession on the basis of the legal title to the goods and the breach of contract by the debtor. Financial leases are sales disguised as leases, and are often called "phony leases" or "leases for security."

In countries where secured credit is undeveloped or underdeveloped, the financial lease is seen as preferable to all other forms of secured credit. It is even seen as distinct from secured credit (e.g., not subject to registration requirements, as in Bangladesh). The perceived strength lies in the creditor's retention of the strongest *in rem* right under local law – legal title. In fact, the financial lease is viewed more as real lease, rather than a disguised sale. Nothing prohibits this tendency in Bangladesh while leasing law remains an amorphous creature of a weak judiciary. In the United States and Canada, by contrast, the law erases all distinctions between financial leasing and other forms of securing obligations using movable property. All sellers are treated equally.

Anti-commercial consequences flow from Bangladesh's treatment of financial leases as other than security arrangements like the pledge and hypothecation. For example, since the financial lease is not treated as a secured obligation, it is not subject to registration at the Registry of Joint Stock Companies (RJSC). Consequently, if a debtor offers all equipment or inventory as collateral, the creditor's search of RJSC records will not reveal equipment on purchase under phony leases. The creditor will only see pledged or hypothecated property. The financial lessor is free to deceive prospective creditors. This is ironic because the "leased" property is the property the prospective creditor most urgently needs to know about since the legal title held by the lessor/seller is the strongest security Bangladesh law offers. Creditors report that financial leasing is the most common transaction among the big three – pledge, hypothecation, and financial lease. Thus, for the purpose of searchers at the RJSC, the fruits of the search are frequently of little value. The search adds little to the creditor's sense of security. The debtor gets no value for having offered collateral. Everybody loses.

In one sense, Bangladesh succeeds in erasing the distinction between financial leases and other secured credit transactions. Upon default, a creditor's right to possession cannot effectively be enforced. Judicial process rarely results in repossession. The lessor/seller may try to force an expensive, inefficient, and slow judicial sale of the collateral. As the collateral depreciates in value, the system assures that the creditor will see only a fraction of the secured debt.

d. Assignment

Assignment of accounts and other rights to payment is also uncodified law in Bangladesh. Formal rules for creating and enforcing assignments are hidden in court decisions spanning decades. The decisions are difficult to discover, sometimes inconsistent in result, and risky to rely upon.

With proper legal foundations, many businesses could obtain credit based on accounts as collateral. Upon default, the creditor gets access to payments owed to the debtor by the debtor's customers. If the creditor takes the accounts only as security, the creditor may still collect any deficiency from the debtor if proceeds from the accounts fail to satisfy the secured debt. If the accounts are purchased outright, the creditor generally assumes the business risks of collection, and has no recourse against the debtor if collection yields less than the purchase price of the accounts.

Authorities disagree over whether a general assignment of accounts is recognized as a valid transaction under Bangladesh law. Certainly it is possible to assign a single account for the purpose of paying a debt, but the ability to assign a single account is of little value to most creditors. Furthermore, the assignment is valid only if the debtor receives actual notice of the assignment. If general assignment of accounts were possible, the notice requirement would add enormous and unnecessary expense to the transaction.

Authorities agree that any assignment of a right to payment is subject to the stamp duty law. This law effectively taxes credit by requiring the creditor to pay a percentage of the assigned claim to the state. Of course, creditors collect the tax from the debtor in advance, effectively reducing the amount of credit.

The notice requirement and the tax burden effectively eliminate the opportunity for modern receivables financing. To avoid the restrictions and expense imposed by Bangladesh's common law, some creditors risk use of the hypothecation agreement instead of the assignment. It is uncertain whether, or for how long, courts will tolerate an attempt to accomplish indirectly what the courts and ill-conceived tax policy have discouraged directly.

e. Trust Receipt

It is reported that in rare cases a trust agreement serves to finance inventory, or the stock in trade of a seller of goods. The debtor and creditor agree that the debtor holds the inventory in trust, for the benefit of the creditor in case of default. The creditor does not retain title to the inventory.

Again, the trust scheme is not statutory. Rather, it relies on judicial case law construction. Those knowledgeable of the scheme do not claim that the law recognizes *in rem* rights in the inventory, as a result of the trust relationship. No other details could be secured on this technique.

Summary – Legal formalities of secured credit in Bangladesh

Commerce should be burdened with few legal formalities. Modern commerce requires simplicity and uniformity in creating security in movables. Transaction costs – in the form of staff time, professional time, government fees – must be minimal. But often the law is replete with rules and regulations.

Equipment, inventory, and receivables financing should be commonplace in Bangladesh commerce. Equipment financing is most frequent, especially where the financial lease can be employed. Inventory financing is not common, as the hypothecation agreement offers very weak security from a legal point of view. Receivables financing is virtually non-existent except among the very best customers of the most progressive financial institutions.

Legal formalities are a problem in Bangladesh. Rules for creating security are uncertain, often complicated, and more often opposed to commercial needs. Except for the pledge, there is no statutory basis for the forms of transactions in use in Bangladesh. Only in the case of the pledge and the financial lease does the creditor clearly enjoy *in rem* rights in the collateral. In cases where the creditor does not have legal rights in the property, it can hardly be said the transactions are secure at all.

Transaction costs are high. The aggressive bankers report that lawyers are involved in nearly every loan agreement, no matter how small.

The issues ignored by the legal formalities are as important as the issues they confuse and complicate. For example, there appears to be no case law (and there is certainly no statutory law) on the taking of future movable property as collateral. The ability to take future property as collateral is crucial to all modern inventory loan requirements, and in many general loans based on equipment as collateral. Future collateral is closely related to the issue of proceeds of collateral, which is also ignored under Bangladesh law. In most cases, anything received by the debtor in exchange for collateral should secure a loan to the same extent as the collateral itself. If collateral is sold on credit, the accounts should be viewed as proceeds that automatically secure the debt as well. Cash received on the accounts should be viewed as collateral proceeds. If insurance policies pay claims on lost or damaged collateral, the insurance proceeds should secure the debt. Bangladesh law has not contemplated these issues to the satisfaction of creditors, if it has contemplated them at all.

2. Notice to prior creditors and priority among competing claims.

a. The need for notice of claims to movable property, and clear priority rules.

Creditors generally want their interests in collateral to have priority over the interests of other creditors. Creditors face many predators in the world of secured credit. The debtor might sell or exchange the collateral, setting up a contest with the transferee. The debtor may give a second charge in the property to a second creditor, or may have given a prior charge to a prior creditor, setting up a contest between creditors with conflicting interests in the same collateral. Other persons may obtain liens (*in rem* rights) in the collateral, before or after the creditor takes the collateral as security. Failure to pay taxes may result in a tax lien. Court action against the debtor by a third party may result in execution against the debtor's movable property. The debtor, or other creditors, may initiate bankruptcy proceedings entitling the bankruptcy trustee to take control of the debtor's movable property.

Creditors need to know where they stand against all potential predators. They need notice of <u>all</u> prior claims to the debtor's collateral <u>before</u> the loan is made. This warning system must work fast, it must be accurate, and it must cost very little. Creditors also need to know exactly where they stand against the predators. They must know what their legal rights in advance and to a certainty. Only with this information in hand can the creditor make intelligent decisions about how much to lend, how much collateral to demand, and what interest rate to charge.

b. The Registry of the Joint Stock Company

Bangladesh law attempts to provide a notice system for the secured creditor – the Registry of the Joint Stock Companies. Under section 159 of the company law, certain mortgages and charges on movable property are void unless registered. They are:

- A mortgage or charge that secures any issue of debenture
- A mortgage or charge on uncalled share capital of the company
- A mortgage or charge on any book debts of the company
- A mortgage or charge, other than a pledge, on movable property except stock in trade
- A floating charge on the business undertaking

The focus of the registry is narrow. This registry effectively covers hypothecation, assignment, and trust receipts. It explicitly excludes pledges and it is interpreted to exclude financial leases. Consequently, it does not provide a searcher with warning of all interests in the prospective debtor's movable property.

The scope of the registry is limited. The registration requirement applies only to limited companies. According to some estimates, only ten percent of all Bangladesh businesses are limited companies. Virtually all SMEs are proprietorships or partnerships, not limited companies.

The narrow focus and limited scope of the registry render it of little use to modern secured credit needs. The RJSC covers only some of Bangladesh's encumbered movable property, and it gathers information from a small minority of debtors. Creditors need a registry that collects information on all charges on movable property, with respect to all debtors. But the problems with the RJSC do not end there.

According to the limited company act, the charges subject to registration are invalid if not registered. This requirement is dangerous and leads to abuse. The provision effectively places the Government of Bangladesh between every limited company and its creditor. No charge is valid until the Government is persuaded to act. Persuading the

Government to act comes at a price. While the official fee for registration of a mortgage or charge is nominal (see Schedule II, Company Act), "unofficial" fees begin at 7,500 taka and go up dramatically with the size of the secured debt.

How, one might ask, does the Government know the amount of the secured debt? The law requires the creditor to produce a copy of the credit agreement. Also, application forms require extensive disclosure of the terms and conditions of the agreement between the parties. In addition to enabling abuse, these requirements add paperwork, cost, and delay to the process.

Searching the registry is complicated. In general, lawyers perform searches that should only amount to clerical work. Banks may pay as much as $1,000 per month in retainers to lawyers for searching purposes. A search may take days to complete. In the meantime, the law grants creditors 21 days to register a charge. This presents the danger of secret liens that cannot be discovered by searchers.

The formal requirements of registration, and its exorbitant unofficial cost, can only serve to depress secured credit to limited companies while the registry fails to serve the purpose of notice of prior interests.

As for priority among competing claims, no statute sets forth any rules. Again, creditors are left to the case law to determine, or guess their fate. Barristers give conflicting opinions as to the standing a registered limited company has against any of the natural predators with respect to collateral: buyers, third party creditors, the tax authority, judgment creditors, and bankruptcy trustees. As for the priority of creditors whose debtors are not limited companies (perhaps 90% of Bangladesh businesses), there is fair consensus that the creditor enjoys little protection at all, except perhaps against subsequent creditors who enter into hypothecation agreements, or another of the non-statutory forms of transaction.

c. Modern registries of security interests in movable property

Modern movable property financing laws rely on registries to serve two, <u>and only two</u>, key functions. First, the registry warns creditors that there may already be a security interest in favor of a prior creditor. Second, the registry establishes the creditor's date of priority with respect to the collateral.

Registration requirements are simple and inexpensive. A creditor files a simple notice containing identification of the creditor and debtor, and a description of the collateral. There is no need to produce a loan agreement, no need for authentication by notaries or other officials. Often registration is by internet without intervention by any human being. The average filing fee in the United States and Canada is approximately $10.00. The filing fee in Ukraine is approximately $6.00.

The registry official notes the date of registration, assigns a registration number, and indexes the registration by the name of the debtor. In the U.S., the registration is valid for five years, and can be amended, continued, or terminated.

The registry is never permitted to see the loan agreement. No terms of the agreement are disclosed to the registry. No financial information about the transaction reaches the registry.

3. Enforcement of the secured debt.

a. In Bangladesh, the advantage goes to the debtor

When the time comes to enforce a secured loan, Bangladesh law and procedure favor the debtor. Various studies have documented the tactics debtors may use to delay, add expense to, frustrate, and nearly certainly deny the creditor's ability to get value from collateral. No effort is made here to re-confirm these facts, or to suggest remedial reform measures in judicial procedures. It will suffice to observe that the high risks and costs of enforcement are a significant deterrent to credit. The potential risk and cost must be factored into every loan decision, including those decisions about borrowers who eventually pay their debts in full and on time. Everyone pays the price, not only the defaulters. Less money is lent, more collateral is demanded, and higher interest rates are charged.

The scope here will merely be to propose rules specific to the secured credit regime which, if enforced, would improve the climate for secured credit.

Upon default, the creditor must have the right to take possession or control of the collateral. No such right exists today. Many are quick to point out that the transfer of property act guarantees a creditor the right to take possession of collateral upon the debtor's default, but the transfer of property act applies to immovable property, not movable property. The fact is, as every Bangladeshi creditor will confirm, there is no effective way for the creditor to take possession or control of movable collateral upon default. Even when the creditor holds legal title to the goods, such as under a financial lease where the creditor's rights are presumably the strongest, the creditor is rarely able to take possession of the goods.

With no effective right to possess the goods, enforcement against movable property ends in judicial sale of the asset, in those rare cases in which there is enforcement at all. Judicial sale, of course, is the most expensive and time consuming of all available procedures, usually yielding a disappointing price, at best.

b. Best practice.

Under modern secured credit laws, the creditor has the right to possession of the collateral upon default. Further, the creditor has the right to dispose of the collateral in any manner that is commercially reasonable, public or private, to get value from the collateral to apply toward the secured debt. If the debtor does not contest, the creditor may take the collateral without judicial process, saving time and expense. If the creditor does not agree to the transfer, the creditor has a right to a speedy and relatively inexpensive court order, under which the authorities are to remove the collateral from the control of the debtor and give it to the creditor. When the creditor disposes of the collateral, all rights in the collateral are transferred to the buyer.

The creditor has options other than sale of the collateral. The creditor may lease, license, exchange or otherwise dispose of the collateral in a commercially reasonable manner. The creditor may even retain the collateral if the creditor agrees to discharge the secured debt. Maximum flexibility for the creditor leads to maximum reduction of the secured debt.

Granting creditors such rights would strengthen Bangladesh law. Stronger law would improve the climate for credit. Care should be taken to maximize the chance that the debtor will agree to transfer the collateral to the creditor. Expedited procedures are required. Where judicial process is absolutely required, creditors should be entitled to interlocutory orders (orders in advance of the final determination of the case) granting the creditor possession of the collateral.   Such a rule would help the creditor to preserve the value of the collateral and weaken the resolve of the debtor to resist the action. When debtors know that creditor rights will be enforced, they are likely to become more cooperative with the creditor upon default. More cooperative debtors are likely to find more cooperative creditors, and together they may find ways to work around the default.

Debtors must have rights in the process, too. Debtors must have the right to take the collateral back if the default is cured, provided that any expenses incurred by the creditor in taking the collateral and pursuing enforcement measures. Debtors should have recourse against a creditor who disposes of collateral in an unreasonable manner.