

Secured Transactions Act

Summary for Lenders and Other Filers

October, 2009

1. Overview

The Secured Transactions Act was enacted May 16, 2007. The Act amends Title 24 of the MIRC by adding a new Chapter 5 to its contents. The Act facilitates lending secured by movable property serving as collateral by allowing the creation of “security interests” in such collateral. These security interests are then recorded with a central “filing office” so that others may determine whether a proposed debtor has previously pledged particular collateral to secure another loan. Section 557 of the Act provides that it is to become effective when the “filing office” called for in the Act is established, which occurred on November 30, 2009.

This paper is intended to provide a short overview of the Act and list the activities that lenders should undertake in preparation for the date on which the Act is to become effective. As that date approaches, specific hands-on training on how to use the electronic registry will be provided so that the transition into the new filing regime runs smoothly.

2. Summary of the Act

The Act is divided into four major parts. The first part provides for the creation of a security interest in personal property to be used as collateral pursuant to an agreement between the parties. Personal property is defined broadly, and can include such things as intangible property and property to be acquired in the future, as well as existing goods. Section 502 contains definitions of the various types of personal property covered under the Act. The intent of the Act is to be applied as broadly as possible, covering a variety of types of property. Similarly, the term “security interest” includes any form of interest in personal property that is used to secure an obligation regardless of what it is called (for example, it could be a pledge or a finance lease). Under Section 510, no formalities such as notarization or witnessed signatures are required for the agreement to bind the parties, though there must be some form of written agreement, which could be as little as an exchange of e-mail messages. The parties are free to set the terms of their underlying agreement as they see fit, including the payment terms, designation of the collateral and definition of default.

The second part of the Act sets out the method of determining priorities among competing interests in the same property that may be used as collateral. Section 511 sets out the four ways in which priority in specific collateral may be “perfected,” or established:

- 1) filing a notice in the filing office covering the property;
- 2) possession of the collateral by the secured party;
- 3) automatic grant of priority (in a few limited instances);
- 4) exercise of control by the secured party over the collateral.

In practice, the default method of establishing priority is through filing, and most secured transactions documented by a formal security agreement will require filing in the filing office to ensure priority. However, Section 512 the Act spells out the conditions for securing priority in all the various types of property that can be used as collateral. For example, Section 512(1)(c) states that a security interest in cash is only valid if the secured party takes possession of the cash. This section 512 gives every secured party the information it needs to assure its priority in collateral. See also sections 516 to 527 for more rules governing the priority of competing interests in collateral.

Special rules apply when a lender or merchant finances the purchase of consumer goods. The lender or merchant can take a security interest in the goods by entering a security agreement with the purchaser. Under Section 512(1)(a), the lender or merchant does not need to file a notice of its security interest unless it is

concerned that the purchaser may sell the goods in violation of the agreement. Under Section 505, a secured party cannot take a security interest in consumer goods other than those being purchased. For example if a person borrows money for the purchase of a wide screen TV, the lender could only take a security interest in the TV, but not in the other consumer goods of the borrower. Note that under the definition of “consumer goods” in Section 502(g), motor vehicles are not considered to be consumer goods under the Act even when used exclusively for personal or family use.

The third part of the Act provides for a filing office where notices of security interest may be filed to publicize the secured party’s claim of the interest. By publicizing the security interest, the secured party establishes its priority as of the date and time of filing. Since a notice may be filed before the secured party completes its agreement with the debtor or advances any funds to the debtor, the secured party may be certain of its priority in the collateral before it is at risk. The Act provides that the information in the filing office is limited to what is necessary to give notice to a searcher that particular property may be subject to a security interest; i.e. it only identifies the debtor, the secured party and the collateral. There is absolutely no requirement to supply the intricate details of a loan transaction, including payment terms. Since the description of the collateral may be general under Section 506, a filed notice may apply to future collateral, as in the case of inventory or accounts that secure an obligation. The one exception to this rule is found in Sections 512(1)(g) and 519(3), which require the serial number of equipment or motor vehicles to be entered into the filing office database to ensure priority over subsequent buyers and/or lessees. All notices filed in the filing office are public records and may be searched via the internet.

The final part of the Act establishes the process for enforcement against the collateral in the event of default on the obligation by the debtor. Since the value of personal property generally declines rapidly over time, the process is streamlined to optimize the value realized from the collateral. Sections 542 and especially 543(1) of the Act provides for taking possession of collateral without judicial action in certain instances. In general, if the secured party has possession or control of the collateral, they may dispose of the collateral without judicial action. Otherwise, the secured party may recover possession without judicial action only if the debtor consents or if the collateral can be taken without breaching the peace. Failing that, Section 543 also provides a simplified and expedited judicial action for pre-judgment possession of the collateral. Section 543(3)(d) of the Act also provides for rapid disposition of the collateral, but protects the debtor against loss by requiring retention of the proceeds until final disposition of the case. The secured party may dispose of the collateral in any reasonable manner. Disposition may be made publicly or privately, and under Section 544 the secured party may buy the collateral at a sale. Under Section 546 the secured party must give notice of proposed disposition to the debtor, other secured parties and other persons who have an interest in the collateral, except in limited circumstances. Section 550 provides debtors with protections by granting them with the right to redeem the collateral at any time prior to its disposition by paying the costs of enforcement and fulfilling the remaining obligation.

Once there is no remaining dispute about rights in the collateral, the secured party may distribute the proceeds of disposition in order of priority established by the law. Section 548 of the Act then sets out the distribution scheme according to the relative priorities of parties in the collateral.

3. How a Secured Transaction Really Works

In a typical situation under the Act, a going business or an entrepreneur (debtor) comes to a lender (secured party) to apply for a loan or an operating line of credit for the business. The debtor may offer the secured party a security interest in the business’ equipment, its inventory and accounts receivable or other assets. The lender searches the records of the secured transactions filing office via the internet to see whether the assets being offered as collateral are subject to a prior security interest or lien. The search is generally made on the name of the debtor, though if the proposed collateral is a motor vehicle or an item of heavy equipment, the search may be made on the serial number. If there is no prior notice of a security interest in the proposed collateral, the secured party may immediately file a notice of its prospective interest in this debtor’s collateral via the internet.

The secured party can then enter the agreement with the debtor with confidence of its priority in the collateral against other lenders.

If the potential lender finds in its search that a notice of security interest in the proposed collateral has already been filed by another person, it has several options. The potential lender may contact the prior secured party to determine if the existing obligation is small enough that there is sufficient excess value in the collateral to secure the proposed loan, and then file its own notice of security interest (in this case, the second-to-file would have secondary priority in the collateral). Conversely, the potential lender may try to secure an agreement with the prior secured party to subordinate the prior interest to the current secured party's security interest, and then file a notice. Or the secured party may simply decide not to lend based upon the asset because the risk of the prior security interest is too great.

Implementation of the Act will not relieve secured parties of the need to exercise standard due diligence measures such as checking the credit-worthiness of the debtor, examining business plans for viability and ensuring the debtor has sufficient non-financial assets to make repayment possible. The Act will simply provide a means to secure an obligation with assets and to ensure the secured party's priority in them.

4. The Transition Period

The filing office will be organized under the Ministry of Finance and Treasury and administered by the Land Registration Authority. It will be an electronic operation, with all filing and searching of the records done via the internet. The technology system will apply fixed rules to accept notices and perform searches, so it will not matter where it is located. There will be a fee for filing notices that will be established under the regulations, but there will be no fee for searching unless the searcher requests a certified report.

Section 555 of the Act governs the period of transition between existing law and the new regime under the Secured Transactions Act. This section permits a secured party in a secured transaction that occurred before this law took effect (a prior transaction) to file a notice in the filing office, provided that the secured party gives the debtor a copy of the notice.

If a secured party in a prior secured transaction files a notice within the first 60 days after the law becomes effective, e.g., when the filing office comes online, the notice will establish the security interest's priority as of the effective date of the law. If the notice is filed after 60 days after the Act becomes effective, its priority will date from the date of filing. If a notice of a prior transaction is not filed or otherwise perfected under this law, it will be considered to be unperfected as against a security interest that has been perfected under this law.

If a notice of a lien has been filed under prior law, it remains effective to establish the lien's priority for 6 months after the effective date of this Act. If a notice of such a lien is filed under this law during the 6 month period, priority of the lien will relate back to the date of filing under the prior law.

It is strongly recommended that all entities that hold a security interest in collateral that should be perfected via filing a notice should make such a filing within the first 60 days of the effective date of the law. The only data that is required to make an effective filing are the names and addresses of the debtor(s) and secured party and a description of the collateral. Please ensure that the names entered in the debtor field comply with Section 531(1)(a) as a wrongly entered debtor name could negate the effect of the filing. Similarly, please ensure that the collateral description complies with Sections 506 and 531(1)(c), which applies to collateral fixed to immovable property.